

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TESTIMONY TO**

**INTERNAL REVENUE SERVICE OVERSIGHT BOARD
PUBLIC MEETING**

**FURTHERING COMPLIANCE BY LEVERAGING EXTERNAL STAKEHOLDER
CONTACTS AND ADMINISTRATIVE SIMPLIFICATION**

February 1, 2005

The American Institute of Certified Public Accountants thanks the IRS Oversight Board for the opportunity to appear before you today. I am Tom Purcell, Chair of the AICPA's Tax Executive Committee; and Associate Professor of Accounting and Professor of Law at Creighton University, Omaha, Nebraska.

The AICPA is the national, professional organization of certified public accountants comprised of more than 340,000 members. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from this broad perspective that we offer our comments today.

Today's meeting addresses two critical topics affecting tax administration: (1) how the IRS can leverage its external stakeholders to achieve a more highly compliant taxpayer population; and (2) how the IRS can help taxpayers and its own enforcement efforts through administrative simplification.

LEVERAGING EXTERNAL STAKEHOLDERS

The IRS can use tax practitioners to increase taxpayer compliance in two ways. First, the Service should take advantage of each profession's efforts to encourage pro bono tax assistance, bolster professional ethics, and develop continuing professional education. The AICPA's efforts in these areas are detailed below. Second, the IRS must continue to focus on retaining, replacing, and developing the professional expertise of its own personnel.

Pro Bono Activities

AICPA members have a long-standing track record of becoming active in their local communities through pro bono activities. From a tax perspective, this involves volunteering to serve at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites, community and academic-based low-income tax clinics, and other non-profit organizations. The AICPA's Tax Division has established a pro bono task force to foster CPA volunteers for federal, state, and local tax programs and clinics.

Our members routinely provide free seminars to local associations on tax, accounting, and finance topics. They regularly write articles and serve on non-profit organization boards. CPAs volunteer for reasons of personal satisfaction; and such opportunities provide avenues for developing or sharpening their professional and communication skills, and developing their practices.

We view pro bono activities by tax practitioners as one of the best opportunities for the Service to leverage its resources and, at the same time, foster an increase in tax compliance. We offer two examples of pro bono activities. First, in addition to programs like VITA and TCE, the AICPA is currently in discussions with the IRS about setting up a pilot program to utilize CPA volunteers at disaster relief sites in certain states. In the past, the IRS has found it necessary to request agency employees to temporarily set aside examination and collection cases in order to staff these disaster relief sites. By using CPA volunteers to augment IRS employee volunteers, this should free-up and permit other Service employees to continue working their examination and collection cases without being required to report temporarily to disaster relief sites. Second, the IRS has asked CPAs within our state societies to teach local tax practitioner courses and small business tax workshops that IRS staff may have otherwise taught in the past.

Professional Ethics

The AICPA is encouraged by Commissioner Everson's commitment to high professional standards for tax professionals, as exemplified by the final regulations revising Circular 230 (as released on December 8, 2004), and his efforts to upgrade the Office of Professional Responsibility. We view this commitment as one of the best leveraging opportunities for the Service with external stakeholders.

We have a longstanding track record of establishing high professional standards for our CPA members, including the AICPA Code of Professional Conduct and enforceable *Statements on Standards for Tax Services* (SSTSs). These standards provide meaningful guidance to CPA members in performing their professional responsibilities.

The AICPA is actively communicating with our membership and state CPA societies regarding the new Circular 230 provisions governing "best practices" for tax advisors and tax shelter ("covered") opinion standards. We agree with the preamble of the final regulations, which states: "Tax advisors play a critical role in the Federal tax system, which is founded on the principles of compliance and voluntary self-assessment. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice."

With respect to abusive tax transactions, the AICPA has a clear position – we unequivocally support their eradication. We have consistently supported the protection of the public interest and prohibitions against the misuse of our tax system. Our enforceable SSTSs are a clear example of this. We continue to be actively engaged in proposing and evaluating various legislative and regulatory measures designed to identify and prevent taxpayers from undertaking, and tax advisers from rendering advice on, transactions having no purpose other than the reduction of federal income taxes in an abusive manner.

In addition to any governmental sanctions imposed (e.g., as a result of the February 2003 reportable transaction regulations or the *American Jobs Creation Act of 2004*), our own disciplinary process will be (and has been) invoked where our rules of professional conduct are violated. The AICPA's Tax and Professional Ethics Divisions are in close consultation regarding the scope of the SSTs and how to best implement the standards' enforceability. Most recently, the AICPA adopted an Interpretation to SSTs No. 1 that outlines members' ethical obligations and responsibilities in connection with tax planning and clarifies how these standards apply across the tax practice spectrum, including situations involving tax shelters (regardless of how that term is defined).

We also support initiatives focused on ethics training for Service employees. We believe that IRS examination and collections employees must be able to "step into the shoes" of tax professionals and vice versa. Government workers and professional tax practitioners must be able to understand each other in order to ensure greater strides in tax compliance.

We need to point out that our ethical rules do place limits on our members with respect to their professional relationships with clients and what our members can disclose to taxing authorities. For example, under SSTs No. 7, if a CPA is representing a taxpayer in an administrative proceeding with respect to a return, and the professional then becomes aware of an error on the return, the CPA should recommend to the taxpayer the corrective measures to be taken to address the error. However, under our ethical rules, the CPA is not allowed to inform the taxing authority without the taxpayer's permission, except where required by law. The SSTs also state that it is the taxpayer's responsibility to decide whether to correct the error; and if the client does not correct the error, the CPA should consider resigning as the taxpayer's representative.

Commitment to Continuing Professional Education (CPE)

Our commitment to "raising the bar" for CPAs in the area of continuing professional education (CPE) is consistent with our strong support for high professional standards. We firmly believe that this commitment helps ensure positive technical competency, values, and ethics among CPAs.

In general, the state boards of accountancy mandate CPE under the purview of protecting the public, particularly given the complexity of the field of accountancy in general, and the scope of the tax law in particular. Due to the dynamics of the tax profession, continuing education helps CPAs to maintain and learn the skills necessary to perform in the business world.

The AICPA and the state CPA societies work closely to develop appropriate continuing professional education programs for CPAs that address the technical competencies and standards of professional conduct demanded by the marketplace. Training programs on professional ethics is one critical area in which the AICPA is working closely with state CPA societies, highlighted by the strong trend by state societies to include ethics training as a component of their fall taxation seminars. In this context, the Institute has developed training materials on our Statements on Standards for Tax Services for use at these seminars.

In fact, we are one of the leading developers and sponsors of tax training for CPAs across the country. Our primary goal is to provide top quality training to help ensure the highest level of technical proficiency. The training focuses on both tax planning and compliance matters, and is authored and technically reviewed by a host of highly qualified CPAs and attorneys.

To ensure the highest quality, our training meets the rigid requirements of both the joint AICPA/National Association of State Boards of Accountancy (NASBA) Statement on Standards for Continuing Professional Education Programs and the NASBA Quality Assurance Service program. And, to ensure the maximum outreach to CPAs, the training is offered in a variety of media, including paper-based self study, online training, video training, webcasts, conferences, onsite live training, and live training offered via state CPA societies throughout the country. Moreover, to ensure the cost of high-quality training does not become an issue for CPAs, we offer all of our online training programs at a low annual subscription price (approximately \$150) and provide the course materials to the state societies at no cost in exchange for their agreement to offer members a discount on each live program offered.

Similarly, the IRS has developed a series of yearly National Tax Forums designed to address the knowledge and ethics base of mainstream tax professionals. We support the IRS's National Tax Forum program, and, as we did last year, we look forward to participating in the Service's tax forums being planned for 2005. Clearly, a strong commitment to continuing professional education is one of the best ways of influencing and "raising the bar" for tax compliance among the public overall.

Addressing the IRS's Aging Workforce

The recruitment, development and retention of a quality workforce is essential for the IRS, and we commend the Service for its recruitment in recent years of senior executives from outside the agency. In our experience, effective leadership results when these new executives are partnered with internally developed executives who have critical institutional knowledge. We are also encouraged by the quality of the outside technical experts who were brought into the four operating divisions. We encourage continued recruiting from outside the Service.

The IRS is experiencing a higher than normal attrition rate among its mid-level and rank-and-file employees, primarily through retirements. These retirements are clearly having an impact on the Service's ability to implement the reorganization¹, including the ability to increase productivity among its employees overall. Replacing these retirees and the resulting loss of "institutional memory" is a major challenge for the IRS.

We support full funding for the Staffing Tax Administration for Balance and Equity program (STABLE), the initiative to restore IRS staffing to mid-1990s levels and strengthen the Service's tax compliance and customer service functions. We continue to applaud the STABLE initiative

¹ Due in large part to passage of the IRS Restructuring and Reform Act of 1998, the IRS has changed its structure to include four operating divisions, organized around four major customer segments; specifically the Wage & Investment, the Small Business/Self-Employed, Large & Mid-Size Business, and Tax Exempt & Government Entities Divisions. This change in the IRS structure is commonly referred to as the "reorganization."

as a means to achieve the balance between taxpayer service and the enforcement necessary for effective tax administration.

The AICPA stands ready to support the IRS in achieving its goals for staffing over the coming years. There are a number of CPAs and recent accounting graduates who are interested in government and public service.

In order to help facilitate the hiring of new agency employees, we recommend that the IRS study its current salary/grade level structure. The study should take into account the salaries for comparable employees in other federal agencies and in comparable private sector positions. Also, the IRS should continue its recruitment efforts on college campuses, and possibly introduce an advertising campaign regarding agency job openings.

We welcome the opportunity to help the IRS identify qualified CPAs for employment within the Service.

IRS Employee Training

The AICPA also believes that there are significant leveraging opportunities for the Service and stakeholders in the area of IRS employee training. Some of the most frustrating experiences realized by taxpayers and tax practitioners in dealing with the IRS occur because of a lack of training on the part of IRS employees. It is much easier to work out a solution that is fair to both the tax system and the taxpayer if the IRS personnel resolving the issue are knowledgeable and well-trained.

The IRS needs to target meaningful resources toward training Service employees, including training needed to overcome any inertia of mid-level and rank-and-file personnel that works against the reorganization or new agency programs. The AICPA strongly supports such efforts.

We believe we can be of immense help to the Service with employee training. First, we suggest that the Service seek prior input from key stakeholders on the details and development of the program, including suggestions from the AICPA and other stakeholders regarding training materials for the new initiative. Second, we recommend that the Service utilize CPAs and other stakeholders in teaching parts of the training curriculum for IRS personnel.

We firmly believe private sector involvement in the training process helps IRS employees to conduct new programs effectively for the tax administration process, while minimizing intrusion and taxpayer burdens.

The Service has taken positive steps to ensure stakeholder input on new IRS programs and initiatives. During 2004, our CPA members provided feedback on numerous draft IRS forms, examination reengineering proposals, training materials for the National Research Program (NRP) flow-through entity reporting compliance initiative, Schedule M-3, and other programs.

STREAMLINING TAX ADMINISTRATION THROUGH ADMINISTRATIVE SIMPLIFICATION

The AICPA commends the Oversight Board for focusing part of today's public meeting on administrative simplification, which could yield significant tax administration enhancements, resulting in administrative efficiencies for the IRS and an overall increase in voluntary compliance.

We have been a strong supporter of tax simplification for many years, and we view administrative simplification as a way of fostering fewer errors on tax returns. Simplification would mitigate taxpayers' need to rely on vague, contorted interpretations of the law that have resulted in the marketing of abusive transactions. Also, for many years, we have collaborated closely with the American Bar Association and the Tax Executives Institute to identify specific proposals for simplification.

Administrative Simplification Demands a Vibrant IRS Budget

The AICPA applauds the Oversight Board's strong support for full funding for the IRS budget, and we urge the Board to continue such support as Congress and the Administration begin their deliberations on the fiscal year 2006 budget. Absent proper funding, administrative simplification is unlikely to yield any significant results.

Giving the Service the necessary resources to properly enforce the tax laws is vital to maintaining our voluntary compliance tax system. Obviously, we expect the Service to identify responsible ways to allocate any additional resources it receives over prior year funding, and Congress will, through its oversight responsibilities, ensure that those resources are properly utilized.

Commissioner Everson recognizes that any increase in enforcement funding must be balanced with positive responses to the taxpaying public as customers. We encourage this type of balanced approach and stand ready to work with the Service to ensure that the needs of America's taxpayers are fulfilled.

Many AICPA members are tax practitioners. As such, we have seen first-hand the problems caused by an IRS that is not responsive to the taxpayers as customers. We have also witnessed the improvements initiated by Commissioner Everson, particularly with respect to enforcement. Any lack of attention to IRS funding needs will only undercut simplification efforts, and the nation's taxpayers will suffer as a direct result.

The Pre-Filing Phase and Taxpayer Education

In previous comments to the Oversight Board, the AICPA has stated that we strongly support the IRS's efforts to place a greater emphasis on the pre-filing phase within all four operating divisions. Examples include establishing the Stakeholder, Partnership, Education, and Communication Office (SPEC) in the Wage and Investment Division (W&I) and the Taxpayer, Education, and Communication Office (TEC) at the Small Business/Self-Employed Division

(SB/SE), and their broad commitment to improving communications through websites, conferences, and newsletters. Another critical component is taxpayer education about recordkeeping responsibilities and major substantive areas of noncompliance.

We have received reports that the IRS is considering, in some cases, the downsizing of organizations like TEC and SPEC and the reassignment of personal to the enforcement side of the agency. We recommend that the IRS consult with the stakeholder community about the impact these proposed changes might have on future customer service and enforcement. The stakeholder community has been a vital sounding board for the reorganization; and should be consulted about proposed changes.

Administrative Simplification Should Enhance Enforcement

We are well aware of the substantial decline in the number of income tax examinations conducted by the Service in recent years. For example, the percentage of individual returns examined by the IRS fell from a rate of 1.67 percent in 1996 to a low of 0.49 percent in 2000, followed by a modest upturn in the audit rate to 0.65 percent in 2003.

Much of this decline can be attributed to fewer IRS compliance personnel and the increased workload resulting from the *IRS Restructuring and Reform Act of 1998*. We support the IRS's efforts to reverse this trend by (1) hiring new Revenue Agents and (2) implementing a number of administrative simplification measures within the four operating divisions and Appeals.

LMSB Enforcement Initiatives

The Large and Mid-Size Business Division (LMSB) has implemented a number of initiatives that enhance enforcement while gaining the benefits of administrative simplification for taxpayers, practitioners, and Service employees.

LMSB has implemented a number of initiatives designed to foster meaningful improvements in case currency, cycle time, and direct examination time. We are encouraged by LMSB's Compliance Assurance Process (CAP) program, a pilot examination program that may include about 20 large companies as volunteers. Under CAP, a corporate taxpayer undergoes a "real-time" audit whereby the company is examined during the course of the current year as opposed to waiting until after the traditional return has been filed. Another positive response is LMSB's efforts to focus examinations on the material issues within an audit and shortening the length of time devoted to an audit. These efforts should help the Service reallocate resources from large case audits by fostering greater audit coverage of middle-market companies, which have traditionally received less attention.

We remain interested in providing additional input on examination reengineering efforts as the program continues to develop and evolve. Practitioners appreciate constructive ways to better target the overall scope of an examination, because it will reduce taxpayers' burden in terms of the time and cost of an examination.

Focus on Flow-Through Entities

SB/SE and LMSB have established a Flow-Through Compliance Committee to identify issues for return examinations, potentially leading to an increase in flow-through examinations and a higher rate of compliance for S corporations and partnerships. The goal is to increase the examination coverage of middle-market flow-through entities.

A sub-component of this focus on flow-through entities is the Service's Schedule K-1 matching program, a significant initiative within SB/SE. While we support the K-1 matching program, we stress that program success will be achieved only if the Service continues to consult on a regular basis with the practitioner community about any potential or unresolved implementation issues.

As the IRS moves forward with the K-1 matching program, we continue to recommend that the Service (1) reduce the agency's short-term goals for the program, and instead, phase-in implementation of the program over an extended period of time; (2) actively seek input from key practitioner and stakeholder groups; (3) improve the training of employees involved with the K-1 program; (4) develop new outreach programs and education materials to better inform taxpayers and practitioners about IRS expectations for the program; and (5) design improvements in forms, like Schedule K-1 and Schedule E. We are pleased the IRS has taken steps to implement many of these recommendations, including redesigns of Schedules K-1 and E.

The AICPA commends the IRS for the release, on January 10, 2005, of the revised Schedule K-1 for the 2004 tax year. While the revised form was based in part on input from stakeholders, like the AICPA, we have received some reports that the form may still prove difficult for certain specialized industries, with distinct needs and characteristics. A more targeted Schedule K-1 may be necessary for such industries.

Business Systems Modernization

We are aware of the Oversight Board's conclusions on Business Systems Modernization (BSM) in its December 2003 report and the Service's announcements regarding further delays in implementing BSM. These problems emanated from the continuing delays involved with the Service's implementation of the customer account data engine, the system designed to replace the master file of taxpayer records.

Despite these problems, we strongly urge the Oversight Board and Congress to continue their support for appropriate funding for the modernization effort. This must remain a central feature of the Service's strategic plan.

The BSM goals are critical to the future successes of the Service. The program is designed to change the entire way the IRS conducts business with taxpayers and stakeholders, by: (1) implementing systems to improve IRS effectiveness in receiving, routing, and responding to millions of taxpayer telephone calls; (2) establishing a modern, reliable data base; (3) implementing a nationwide email and voice-mail messaging system for Service employees; and (4) supplying Revenue Agents with software capable of accurately assessing a taxpayer's liability when faced with a complex tax matter or calculation.