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CIVILIAN CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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THURSDAY, JUNE 16, 2005

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:34 a.m., in room 563, Dirksen Senate Office Building, Hon. Norm Coleman, Chairman of the Subcommittee, presiding.

Present: Senators Coleman, Collins, Levin, and Akaka.

Staff Present: Raymond V. Shepherd, III, Staff Director and Chief Counsel; C. Jay Jennings, Senior Investigator; Mary D. Robertson, Chief Clerk; Mark Greenblatt, Counsel; Steven Groves, Counsel; Mark Nelson, Counsel; Brian White, Professional Staff Member; Katherine Russell, Detailee (FBI); Richard Fahy, Detailee (ICE); Caitlin Foley, Intern; Corey Bakken, Intern; Elise J. Bean, Staff Director/Chief Counsel to the Minority; Eric J. Diamant, Detailee, GAO; John Lavinsky, Intern; Audrey Soffer, Intern; Alec Rogers (Senator Collins); Richard Kessler and Robert Westerbrook (Senator Akaka).

OPENING STATEMENT OF SENATOR COLEMAN

Senator COLEMAN. This hearing of the Permanent Subcommittee on Investigations is called to order. Good morning. Good morning to Chairman Collins. It is great to be with you and Ranking Member Levin. Welcome to today's hearing.

This hearing is about tax cheats, not your everyday tax delinquents but rather Federal contractors who do not pay their fair share of taxes even though they receive billions of dollars from American taxpayers each year. The Subcommittee's efforts, in concert with the hard work of the Government Accountability Office (GAO), have revealed that 33,000 Federal contractors at civilian agencies owe back taxes amounting to a whooping $3.3 billion. Some of these delinquent contractors provide crucial services to some of our most critical agencies, such as the Department of Justice and the Department of Homeland Security.

To get a sense of the problem, let us review a handful of egregious cases. A contractor for the Justice Department was paid more than $700,000 this year, even though it owes more than $2 million in back taxes. Over the last few years, as the company refused to

pay its proper share of taxes, it withdrew literally millions of dollars from its bank accounts.

A contractor that provides security guard services to the Department of Homeland Security owes more than $400,000 in unpaid taxes. In addition to the company's tax debt, the owners repeatedly failed to file individual income taxes and diverted the employees' payroll taxes to a foreign bank account to build a house overseas. Despite that, the Federal Government paid this company more than $200,000 last year.

A health care company that provides services to the Departments of Veterans' Affairs and Health and Human Services was paid more than $300,000 from the Federal Government this year alone. That company owes more than $18 million in back taxes. While the company was cheating the American taxpayers, the owner of the company brought multi-million dollar properties and a fleet of luxury cars.

These are just a handful of the 33,000 government contractors that failed to play by the rules. Our hearing today will show just how widespread the problem is. We will also examine the considerable obstacles that prevent the government from collecting back taxes from Federal contractors.

But first, it would be helpful to review how we got here. Last year, this Subcommittee with the GAO uncovered disturbing evidence that the Defense Department had 27,000 contractors who had $3 billion in unpaid taxes. To make matters worse, GAO determined that the government's program to collect unpaid taxes from Federal contractors, which is called the Federal Payment Levy Program, simply wasn't working. The Federal Payment Levy Program should have collected more than $100 million from these contractors. Unfortunately, instead of the $100 million it should have collected, it obtained a paltry $680,000.

In February of last year, I requested the IRS, Financial Management Service, Department of Defense, and other affected agencies to establish the Federal Contractor Tax Compliance Tax Force, which would identify and resolve problems that frustrated the Federal Payment Levy Program. I am pleased to report that as a direct result of the tax force's efforts, tax levy collections from defense contractors have increased dramatically.

For instance, in all of 2003, back taxes recovered from defense contractors amounted to a mere $680,000. In the first 7 months of this year, however, that number has risen to more than $11.5 million. At that rate, the government will recover $17.2 million in unpaid taxes by the end of 2005. That is an increase of more than 2,500 percent in just 2 years.

One of the principal problems we identified was that many Federal contractors provided false Taxpayer Identification Numbers when they register with the government. To remedy this problem, Senator Levin and I, and other interested Senators, introduced the Central Contractor Registry Act to ensure that Federal contractors' Taxpayer Identification Numbers would be validated by the IRS.

In light of the problems found with defense contractors, we asked GAO to determine if similar problems also existed in other Federal departments and agencies. In response to our request, GAO has conducted an extensive analysis and prepared an alarming report,

which we are releasing today. As I mentioned earlier, GAO's report reveals that 33,000 civilian contractors who receive billions of dollars from the U.S. Government in contract payments each year currently owe $3.3 billion in unpaid taxes. Even worse, most of these contractors withheld payroll taxes in trust for their employees and then failed to pay those taxes to the Internal Revenue Service. As a result, they cheated not only the American people, but their own employees, as well.

Some of these contractors fraudulently used the withheld taxes for business or personal use. GAO investigators found contractors who bought luxury cars, multi-million-dollar properties, and vacation homes even though they owed hundreds of thousands of dollars in unpaid taxes.

One significant problem is Section 6103 of the Internal Revenue Code, which is designed to promote tax compliance by protecting honest taxpayers from having their names and other personal information disclosed. That privacy provision has been turned on its head and covers tax cheats who do not file their returns or do not pay their taxes. These tax cheats act with impunity because Section 6103 prevents the IRS from disclosing their identities. As a result, Federal contract officers cannot determine if a contractor owes taxes before signing a contract.

Even the President of the United States is not immune from contracting with a tax cheat. In one case examined by the GAO, the Executive Office of the President contracted with a medical, dental, and hospital equipment company that owes nearly $2 million in unpaid taxes. In 2004, the company was paid over $900,000. While the Financial Management Service collected $6,000 in unpaid tax from some of these payments, it was not screening all such payments and, therefore, missed the opportunity to collect an additional $133,000 from this company.

This is but one of the 50 worst examples that GAO identified in their investigation. Many of these documents demonstrate a continuing pattern of fraud and abuse in which some contractors use every available means to delay or avoid paying their taxes. In fact, 27 of the 50 cases GAO investigated demonstrated a pattern of avoidance.

For example, over a 20-year period, one contractor has repeatedly not paid taxes and accumulated tax debt of more than $900,000. He declared bankruptcy and reopened his business under a new name. In 2004, the Federal Government paid this delinquent contractor more than $1 million.

In another case, a building maintenance company that owes nearly $1 million in unpaid tax, entered into an installment agreement with the IRS and then defaulted on that agreement. The company then made the IRS an offer in compromise to settle the tax debt. IRS rejected the offer and this company has avoided any tax levy for more than 5 years.

In another case, the IRS entered into an installment agreement with a court reporting service with the Department of Justice who owes over $400,000 in unpaid tax. Last year, the company paid a mere $2,000 pursuant to the agreement. At that rate, I think the tax debt will be paid off in about 200 years.

Other examples that GAO identified involve potential fraud that included an armed guard service company that has contracts with the Department of Justice and the Environmental Protection Agency and owes nearly $400,000 in unpaid taxes. In 2004, the company was paid about $500,000. The owner of this company is under indictment for embezzlement and money laundering.

A doctor who works for the Veterans' Administration owes nearly $700,000 in unpaid taxes and was paid over $180,000 in 2004. The doctor's payments should have been levied to collect $27,000. However, none of the payments were levied.

A building maintenance services company that has numerous contracts with Federal agencies, including the Department of Treasury, owes over $700,000 in unpaid taxes. The company was paid over $4 million in 2004. Nearly $100,000 was offset for its unpaid taxes. However, they should have been levied for $630,000.

Under these circumstances, we must bar certain companies and individuals from receiving Federal contracts. When individuals or companies demonstrate flagrant disregard for the tax system through a pattern of continued and repeated tax abuse, it is appropriate to publish their names and bar their receipt of Federal contracts. GAO's report that is being released today found serious problems in the contractor payment system that permit these abuses to continue.

For instance, GAO found that the Financial Management Service (FMS), which makes payments to contractors for the Federal Government, does not check all contractor payments to determine if taxes are owed. In addition, contractor payments that should be checked have inaccurate or incomplete information and cannot be matched to the Internal Revenue Service's list of delinquent taxpayers. FMS failed to adequately update agency location codes and ensure that agencies submitted payment documentation that was complete and valid. As a result, the FMS did not match these payments and irrevocably lost the opportunity to collect an additional $50 million in back taxes.

FMS is the lead agency for the Federal Payment Levy Program. FMS should not hide behind the mantra that FMS is simply the paying agent for the Federal Government and must rubber stamp Federal agencies' payments. This position completely abdicates FMS's true leadership and managerial responsibilities for the program. I am concerned that FMS has placed the payment of contractors ahead of recognized accounting principles that require complete and accurate documentation.

Let me be clear. The system in place requires FMS to identify tax cheats and levy their payments. The contracting agency and GSA have no ability to identify the tax cheats or to bar them from doing business with the government. When FMS fails to do its job, the system fails, and the system and FMS are failing today.

As the government's paying agency, FMS has clear responsibility for ensuring adherence to basic requirements that must be met before making disbursements. I fully expect Commissioner Gregg and FMS to aggressively resolve the shortcomings identified by GAO.

FMS must assure that contractors are screened up front and pay their taxes. FMS must be sure that agency documentation is complete before disbursements are made and must regularly update

agency location codes. FMS must take the lead on requiring civilian agencies and departments to register their contractors in the Central Contract Registry, as required by the Federal Acquisition Regulations and directed by the Office of Management and Budget. Without this proper exercise of responsibility, billions of taxpayer dollars will continue to be paid to delinquent contractors without being levied. This is simply not acceptable.

On the first panel this morning, we will hear from GAO representatives on the results of our request to determine if there are tax delinquent Federal contractors working for civilian departments and agencies. Last year, their hard work resulted in the identification of 27,000 Department of Defense (DOD) contractors who owe $3 billion in unpaid taxes, including 47 contractors that had flagrantly abused the tax system.

On the second panel, we will hear from the IRS and FMS concerning actions they have taken or plan to take to ensure that civilian contractors pay the taxes they owe. I would like to make it clear that I am pleased with the results that the Federal Contractor Tax Compliance Task Force has achieved to date and that the Commissioners of IRS and FMS have agreed to continue the work of the task force.

A lengthy statement, but a lot of information here, and I appreciate the indulgence of my colleagues as I went through that.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Mr. Chairman, thank you, first of all, for your leadership on this issue. It has been critically important in the progress that we have made. You and your staff and our staffs have worked very closely together on this and we are making some progress, but as you pointed out, we have got a long way to go, but without your leadership, we wouldn't have gotten to where we are.

The current annual tax gap in this country is about $300 billion, and that $300 billion gap is the difference between the taxes that businesses, organizations, and individuals owe the Federal Government and what they have actually paid. When so many Americans fail to pay the taxes that they owe, it begins to undermine the fairness of our tax system, forcing honest taxpayers to make up the shortfall needed to pay for basic Federal protections, like Social Security, Medicare, and weapons needed by our men and women on the front lines of our military.

Today's hearing focuses on one particular group that contributes to that $300 billion tax gap, government contractors who get paid with taxpayer dollars while at the same time failing to pay their taxes.

In a report released today, the GAO describes 33,000 civilian contractors who have dodged their tax obligations and have accumulated tax debts to Uncle Sam totaling at least $3.3 billion. In a related report released last year, GAO found 27,000 DOD contractors with accumulated tax debts totalling $3 billion. Those are huge numbers—tens of thousands of companies receiving contracts and payments on those contracts from the Federal Government, while owing billions of dollars in unpaid taxes. It is simply mind-boggling that this is allowed to continue.

Tax dodging by any Federal contractor is unfair, not only to the honest taxpayers left to make up the difference, but it is also unfair to honest companies that have to compete against the tax dodgers that aren't paying their fair share.

The main responsibility here has got to be with FMS, as our Chairman has said. There should be a red flag on any contract where a company owes back taxes, and there should be monies withheld from any payments on that contract until those back taxes are paid.

There are some tax dodgers who simply should not receive contracts to begin with, since tax debts should be paid before more contracts are awarded or, at a minimum, until arrangements are made to pay the back taxes.

GAO tells us that about $1.2 billion, or 37 percent of the unpaid taxes owed by the civilian contractors involve payroll taxes. Now, what that means is that contractors fail to send to the IRS sums withheld from employees' wages for Federal, Social Security, and Medicare taxes. The failure to send those payroll taxes to the IRS is more than a debt that is owed to the Federal Government. It is a crime, since payroll funds withheld from employees' wages are held in trust, and it is illegal for companies not to send those funds to the government.

Another $1.5 billion, or 40 percent of the total, involve unpaid corporate income taxes.

All of the $3.3 billion are unpaid taxes which a court has determined or the taxpayer has admitted are owed to the government. The taxes at issue here are not disputed amounts, in other words.

The GAO also took a closer look at 50 of the contractors with unpaid taxes and found egregious examples of companies dodging taxes, sometimes for years, and in some cases spending money meant for payroll taxes on luxuries for themselves, such as expensive homes or cars. Despite those abuses, those contractors kept getting contracts and payments on those contracts using taxpayers' dollars.

The Chairman has identified a number of specific cases, and I am not going to repeat those, but they are part of my entire statement which will be made part of the record, Mr. Chairman, with your order.

Senator COLEMAN. Without objection.

[The prepared statement of Senator Levin follows:]

PREPARED STATEMENT OF SENATOR LEVIN

The current annual tax gap in this country is about $300 billion. That $300 billion gap is the difference between the taxes that businesses, organizations, and individuals owe the federal government and what they've actually paid. When so many Americans fail to pay the taxes that they owe, it begins to undermine the fairness of our tax system, forcing honest taxpayers to makeup the shortfall needed to pay for basic federal protections—like social security, Medicare, and the weapons needed by our men and women on the frontlines of our military.

Today's hearing focuses on one particular group that contributes to that $300 billion tax gap—government contractors who get paid with taxpayer dollars while, at the same time, failing to pay their taxes. In a report released today, GAO describes 33,000 civilian contractors who have dodged their tax obligations and accumulated tax debts to Uncle Sam totaling at least $3.3 billion. In a related report released last year, GAO found 27,000 DOD contractors with accumulated tax debts totaling $3 billion. Those are huge numbers—tens of thousands of companies receiving contracts and payments on those contracts from the federal government, while owing

billions of dollars in unpaid taxes. It's simply mind boggling that this is allowed to continue.

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The main responsibility here has got to be with FMS, as our Chairman has said. There should be a red flag on any contract where a company owes back taxes and there should be monies withheld from any payments on these contracts until those back taxes are paid. Some tax dodgers should not receive contracts to begin with—their tax debts should be paid before more contracts are awarded, or, at a minimum, until arrangements are made for them to pay the back taxes.

GAO tells us that about $1.2 billion, or 37% of the unpaid taxes owed by civilian contractors, involve payroll taxes. What that means is that contractors failed to send to the IRS sums withheld from employees' wages for federal, Social Security, and Medicare taxes. The failure to send those payroll taxes to the IRS is more than a debt owed to the federal government—it is a crime, since payroll funds withheld from employees' wages are held in trust, and it is illegal for companies not to send those funds to the government. Another $1.5 billion, or 40% of the total, involve unpaid corporate income taxes. All of the $3.3 billion are unpaid taxes which a court has determined or the taxpayer has admitted are owed to the government. The taxes at issue here are not disputed amounts, in other words.

GAO also took a closer look at 50 of the contractors with unpaid taxes and found egregious examples of companies dodging taxes, sometimes for years, and, in some cases, spending money meant for payroll taxes on luxuries for themselves such as expensive homes or cars. Despite those abuses, those contractors kept getting contracts and payments on those contracts using taxpayer dollars. For example, one contractor owing $1 million in unpaid taxes was paid $1.5 million in FY2004 by the Department of Homeland Security and other federal agencies. Another contractor owing $900,000 had a 20-year history of opening a business, failing to remit payroll taxes to the IRS, closing the business, and then repeating the cycle. On and on, while continuing to get more government contracts.

Tax chiseling by federal contractors is not a new story. In 1997, Congress enacted the Taxpayer Relief Act which, in part, authorized federal agencies to withhold 15 percent of any federal payment going to a person with an outstanding tax debt. The goal was to stop taxpayer dollars from being paid to a tax deadbeat, unless a portion was withheld off the top to reduce that person's tax debt. Last year, we increased the percentage that can be withheld from a contract payment to up to 100%.

The Taxpayer Relief Act sought to apply a common sense principle to government operations: to offset the taxpayer dollars sent to people who haven't paid their tax bills by directing a percentage of the total be withheld to reduce their tax debt. That common sense principle isn't always easy to apply in a government that has hundreds of thousands of contractors on the books, but it must be applied and the computer capability to apply that principle exists.

The Financial Management Service or FMS in the Treasury Department took until July 2000 to establish an automated tax levy program under a larger Treasury Offset Program that handles offsets from government payments for a variety of reasons. It took another two years—until the end of 2002—for DOD to follow suit.

GAO estimates that, last year, the tax levy program for civilian contractors ought to have collected a minimum of $50 million, but FMS actually collected only about $16 million, or just over 30% of the projected total. The GAO report spells out a number of reasons why this collection rate is so low.

First, out of the $250 billion in contractor payments last year, the GAO determined that $100 billion was made in ways that made it virtually impossible for a payment to result in a computer match and tax levy. About $66 billion of those payments were made with payment forms filled out by various federal agencies that left out key information. The FMS shouldn't accept those payment forms, but they have so far. Key information is left out by agencies; nonetheless, checks are sent. That information which is left out includes the contractor's name or taxpayer identification number, which you have to have for a computer match. Another $10 billion was paid on government-issued credit cards held by federal agencies, which means that the payments were directed to the bank administering the credit cards and the bank then paid the contractors, instead of direct payments to the relevant contractors. Since the agency payments did not name the contractors, they couldn't be matched against the IRS tax data. Still another $25 billion of payments were made through wire transfers that also were directed to banks instead of contractors, and so did not trigger any computer matches with IRS data. Each of these problems can and should be addressed to increase the chances for computer matches identifying contractors with unpaid taxes. It should not be difficult to simply red flag the con-

tractor to say that no payment should be made to that contractor, through a bank or otherwise, without the deduction for back taxes being made.

Second, of the $150 billion in contractor payments that were subjected to the tax levy computer matches, the GAO found that too many failed to result in an actual levy because the IRS had failed to mail a 30-day notice to the relevant contractors warning them of an upcoming levy. After last year's hearing, to address the tax levy notice problem, the IRS initiated a new approach with DOD contractors. Instead of waiting for the first contract payment to mail a tax levy notice, the IRS instead evaluated the tax status of contractors as soon as they were awarded a contract and immediately sent tax levy notices to those contractors with unpaid taxes. This new approach apparently resulted in the mailing of 6,000 accelerated notices. That's a bit of progress, although we have to wait to see the extent to which this new approach solves the notice problem and it needs to be applied to civilian contractors as well.

Other approaches to the notice problem should also be considered. One possibility that should be explored is combining tax levy notices with the tax delinquency notices that are already mailed to contractors with unpaid taxes. Another possibility would be to amend the Prompt Payment Act to allow FMS and DOD to delay contract payments to tax delinquent contractors until the 30-day tax levy notice period expires and a levy can properly be placed on their payments. Another approach is to include a contract provision in the original contract that simply says if you owe back taxes, you waive your right to a levy notice. Alternatively, we can modify the law to say that notices of levies are not required on those contracts where back taxes are owed.

Federal contractors should not be allowed to get away with cheating on their taxes. Dodging taxes is never acceptable, but it is particularly galling when engaged in by folks who make their living from taxpayer dollars.

It is clear that we can make major progress in the tax levy program and ensure that deadbeat contractors start paying their tax debts. That progress has already begun. After the Subcommittee's hearing last year on DOD contractors, the IRS, DOD and FMS formed a joint task force to improve the DOD tax levy program. In the span of about a year, using improvements initiated by this task force, DOD has increased its collections from $1 million in 2003, to a likely total in 2005 of $17 million. While $17 million is still far short of the $100 million that GAO thinks DOD ought to be collecting each year, and even farther from the $3 billion owed by DOD contractors, it is a start.

The improvements made in the DOD tax levy program include the following:

- FMS and DOD have automated the tax levy computer matching system for 18 out of DOD's 20 payment systems, up from just 1 system in 2004. The final 2 DOD payment systems are scheduled for automation during 2005.
- FMS is now conducting tax levy computer matches twice per week instead of once per week, resulting in more computer matches.
- The IRS has cleaned up the tax levy database by removing $27 billion of uncollectable tax debt.
- The IRS has eliminated a policy that delayed tax levies on federal contractors for one year or until an IRS revenue agent was assigned to the relevant case.
- The IRS is now checking the tax status of DOD contractors as soon as a contract is awarded, instead of waiting for the first contract payment, so that tax levy notices can be mailed earlier.
- In October, DOD will begin requiring everyone who files an application with the Central Contractor Register to become a potential bidder on federal contracts to consent to having their taxpayer identification numbers validated by the IRS. The end result will be a more accurate and complete database of contractor TINs.

Each of these steps is moving us toward a more effective tax levy program, but a lot more needs to be done, including ensuring timely tax levy notices, barring payments to contractors using agency forms that lack key information needed for tax levy computer matches, and barring contractors with unpaid taxes from getting paid via government-issued credit cards or wire transfers. Even better would be putting a hold on contract awards to contractors owing an undisputed amount of unpaid taxes.

Last year, Senator Coleman and I introduced legislation to improve the tax levy program by strengthening taxpayer identification numbers. We reintroduced this bill in this Congress as S. 679. In the meantime, the IRS, DOD and FMS have voluntarily taken some of the steps called for in that bill, which we appreciate. Senator Coleman and I are now planning to introduce a more comprehensive bill to address the broader spectrum of problems that impede the tax levy program.

Most federal contractors provide valuable goods or services, and do so while paying their taxes. Other contractors, however, take payment in taxpayer dollars, while dodging the taxes owed to Uncle Sam. This tax dodging hurts honest taxpayers, honest businesses, and our country as a whole. Effective use of the federal tax levy program is necessary to help keep the tax dodger's hand out of the taxpayer's wallet.

I commend Senator Coleman for his leadership on this important issue. I look forward to the testimony today.

Senator LEVIN. Tax chiseling by Federal contractors is not a new story. As our Chairman pointed out, in 1997, Congress enacted the Taxpayer Relief Act which in part authorized Federal agencies to withhold 15 percent of any Federal payment going to a person with an outstanding tax debt. The goal was to stop taxpayers dollars from being paid to a tax deadbeat unless a portion was withheld off the top to reduce that person's tax debt. Last year, we increased the percentage that could be withheld from a contract payment to up to 100 percent.

The Taxpayer Relief Act sought to apply a common sense principle to government operation, to offset the taxpayers' dollars sent to people who haven't paid their tax bill by directing a percentage of the total be withheld to reduce their tax debt. That common sense principle isn't always easy to apply when the government has hundreds of thousands of contractors on the books, but it must be applied, and the computer capability to apply that principle is here. This may have been difficult without computers, but this should not be so difficult now that we have computers.

There are a number of reasons why the collection rate is low, and I am just going to spend a minute or two on some of these reasons. We have made progress, as the Chairman has pointed out, but we still have a low collection rate from these contractors.

First, out of the $250 billion in contractor payments last year, the GAO determined that $100 billion was made in ways that made it virtually impossible for a payment to result in a computer match and a tax levy. About $66 billion of those payments were made with payment forms filled out by various Federal agencies that left out key information. Well, the FMS shouldn't accept those payment forms, but they so far have. Key information left out by agencies. Nonetheless, checks are sent. That information which is left out includes the contractor's name or a Taxpayer Identification Number, which you have to have for a computer match.

Another $10 billion was paid on government-issued credit cards held by Federal agencies, which means that the payments were directed to the bank administering the credit cards and the bank then paid the contractors, instead of the agencies' making direct payments to relevant contractors. It should not be difficult to simply red flag a contract and to say that no payment should be made on that contract to a bank or otherwise, or wire transferred, or in any other way, without the deduction for back taxes being made.

Now, of the $150 billion in contractor payments that were subjected to tax levy computer matches, the GAO found that too many failed to result in an actual levy, because the IRS had failed to mail a 30-day notice to the relevant contractors warning them of an upcoming levy. That should be easily correctable with a contract provision in the original contract that simply says, if you owe back taxes, you waive your right to contest a levy, or we will modify the

law if necessary to say that notices of levies are not required in those contracts where back taxes are owing.

So progress has been made, but we have got a long way to go, and Federal contractors should not be allowed to get away with cheating on their taxes. Dodging taxes is never acceptable, but it is particularly galling when engaged in by folks who make their living from taxpayer dollars.

Mr. Chairman, again, I thank you for your leadership. You have been doing critically important work, and I commend you for it.

Senator COLEMAN. Thank you, Senator Levin, and my thanks to you and your staff for the strong partnership. It has been a very bipartisan effort and hopefully we are getting some results.

Chairman Collins.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. Thank you, Mr. Chairman. Let me join Senator Levin in commending you for your leadership on this issue, but let me also commend Senator Levin. I know the two of you have worked very closely on this important investigation.

I am pleased to join you today for the second hearing on government contractors who cheat on their taxes. Federal contractors have an obligation to operate according to the highest ethical standards. That is not just my opinion, that is the law. The law requires bidders for Federal contractors to be found to be responsible. I don't understand how a contractor who is delinquent on Federal taxes could meet the standard of being a responsible bidder.

The Subcommittee's investigation reveals a shocking lack of such ethical standards. At our first hearing last year, we learned that civilian contractors doing business with the Department of Defense owed an estimated $3 billion in back taxes at the end of fiscal year 2002. At that time, the GAO advised us that this problem of tax delinquency and noncompliance may not be confined to the Department of Defense, and indeed, further investigation demonstrates clearly that it is not.

The estimated tax delinquency of contractors doing business with other government agencies, including key departments such as the Department of Homeland Security and NASA, may well be in excess of $3.3 billion. Among the 50 civilian agency contractors investigated by the GAO for the report we will discuss today, all were found to have engaged in abusive or potentially criminal activity.

I think it is important for us to emphasize that these tax delinquencies were not the result of legitimate hardship. They were the result of these contractors willfully deciding that the laws of our country do not apply to them. Rather than pay their fair share of taxes on income derived from the taxes of others, they chose instead to inflate their own salaries, to purchase multi-million-dollar properties, and in some cases to divert payroll taxes withheld from employees. In one egregious case, they diverted that money to an offshore bank to finance a luxury home overseas. And like Senator Levin, I find the cases where payroll taxes were not remitted to be particularly outrageous. That isn't even the contractors' money. That is money that belongs to the employees and it is just totally unacceptable that this is occurring.

The case studies described in the GAO report do not merely tell a story of how a business from time to time can pull a fast one. In far too many cases, contractors pull fast ones repeatedly, chronically, and apparently without meaningful penalty.

One example particularly stood out to me. That is the owner of a business that provides temporary workers which currently owes $900,000 in delinquent taxes. Through its investigation, GAO discovered that this contractor has a nearly 20-year history of closing businesses with tax debts, opening up new ones, and then incurring new tax debts. In other cases, the GAO found that some contractors with unpaid Federal taxes had been convicted of crimes, such as embezzlement and money laundering, and yet they still received government contracts.

Mr. Chairman, a system that permits participation by such contractors is a system in failure. I think it is important that we focus not just on the levy system, which is after the fact to catch those who fall through the cracks. We have to correct this up front so that there is a review that prevents contractors from receiving Federal contracts in the first place if they are cheating on their taxes.

I very much look forward to hearing our witnesses today. I would especially like to note that Greg Kutz is here today in his first appearance as head of the GAO's new Forensic Audit and Special Investigations Unit. Earlier this year, Senator Lieberman and I encouraged the Comptroller General to establish this new unit so that we could focus more on agency and financial management of high-risk areas. I believe that this new unit is going to greatly improve our oversight capacity and I am very pleased that Mr. Kutz has been chosen to lead it.

So thank you again, Mr. Chairman, for your attention and commitment to this matter of such importance. We simply cannot allow contractors that get paid with taxpayer dollars to refuse to pay their fair of Federal taxes. Thank you.

Senator COLEMAN. Thank you, Senator Collins. Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I thank you, Chairman Coleman, for holding this hearing and for your continued commitment to closing the gap between what Federal contractors owe in taxes and what is collected by the Federal Government.

As our budget deficit increases and the national debt grows, it is essential that the Federal Government does everything possible to collect what is due. And when we hear guesses of the amount that is due, it is amazing. No business could survive very long with billions of dollars in accounts receivable and little success in collecting them.

Exactly how much is owed? According to the Government Accountability Office, $3.3 billion in unpaid taxes is owed by 33,000 civilian contractors. What is staggering is that this amount is in addition to another 27,000 DOD contractors who owe an additional $3 billion. That is a total of $6.3 billion in Federal tax debt owed by Federal contractors.

I am particularly disturbed that two-thirds of the outstanding tax debt is for failure to remit payroll taxes. This is not about busi-

nesses that run into financial hardship and don't have money to pay taxes. No. This is about employers who collect money from employees in trust, pocket the money, and then continue to profit from Federal contracts. This has been mentioned by the Chairman of our full Committee.

In investigative case studies, GAO found patterns of abuse with some contractors. While honest Americans are paying their taxes, these tax cheats open a business, profit from Federal contracts, steal the payroll taxes, close the business, then start all over again. In the meantime, they have purchased luxury cars, commercial real estate, and in one case, even a professional sports team.

The Financial Management Service of the Treasury Department bills itself as the Federal Government's money manager. FMS is responsible for disbursing payments for most Federal agencies. FMS is also responsible for collecting money owed to Federal agencies by offsetting various types of payments that pass through FMS, including payments to civilian contractors.

Since 1996, FMS has administered the Treasury Offset Program (TOP), to collect delinquent non-tax debts owed to Federal agencies. FMS collects delinquent tax debt on behalf of the Internal Revenue Service through the Federal Payment Levy Program. Under the levy program, IRS sends tax debts to TOP for collection. Today, we will learn if FMS is living up to its responsibilities as the government's money manager.

Under TOP, the names and Taxpayer Identification Numbers (TINs), of debtors in an FMS database are matched against the names and TINs of recipients of Federal payments. If there is a match, the Federal payment is reduced or offset to satisfy that debt.

The questions we ask today are, why aren't there more matches in TOP, and why was only $16 million collected last year from contractor payments?

According to GAO, there are various reasons that prevent matching: No name, no TIN, an invalid TIN, and lack of an agency location code, to name a few. GAO estimates that FMS could collect $50 million, or three times more than what is collected now, If FMS simply exercised greater oversight to ensure that these data fields are complete and accurate. It should be as simple as no TIN, no money.

In March 2004, I asked GAO to expand its original review of unpaid Federal taxes by contractors to determine how much FMS is collecting from Federal contractor payments for unpaid State taxes. I thank Chairman Coleman and Ranking Member Levin for extending this courtesy to me. The Debt Collection Improvement Act of 1996 allows FMS to collect State tax debts from Federal payments to contractors. Before FMS can do so, a State must enter into a reciprocal agreement with FMS that would require the State to collect unpaid Federal tax debt from State payments.

The Federal Government and the States have worked together to collect unpaid tax debts from State and Federal tax refunds. In 2004, for example, FMS collected $229,000 on behalf of my home State of Hawaii. But there has not been similar leadership efforts by FMS to collect State tax debts from Federal contractor payments.

According to GAO, FMS said that no States expressed interest. However, the States that were contacted by GAO said they were unaware of this provision and are interested in pursuing such agreements.

I am pleased that Mr. Gregg, the head of FMS, is here with us today. I encourage you, Mr. Gregg, to do whatever is necessary to make this happen. While this hearing is about how a Federal program is being used to collect tax debt, the larger goal is to ensure that those who receive the benefit of Federal contracts act as good corporate citizens.

Let me state this. Federal contractors must be held accountable for their actions. This is why, for example, I introduced the Federal Contractor Extra-Territorial Jurisdiction for Human Trafficking Offenses Act of 2005 just this week. My bill, S. 1226, closes a loophole in Federal criminal law and allows the prosecution in U.S. court of Federal contractors who engage in human trafficking overseas. And so we are looking at Federal contractors.

I look forward, Mr. Chairman, to the testimony of our witnesses on the tax issue, and Mr. Chairman, I thank you so much for what you are doing in this regard. Thank you.

Senator COLEMAN. Senator Akaka, thank you. I want to thank you for your keen interest in this area and all the focus that you have put on it. It has been extraordinarily helpful and it is greatly appreciated.

And I want to thank Chairman Collins for her work in establishing the Office of Forensic Audits and Special Investigations. I would say, and we are going to get a chance to hear from Mr. Kutz in a little bit, but to him and to Mr. Ryan and Mr. Sebastian, we do appreciate the work that you have done. We have fought to continue the relationship that this Committee has and Subcommittee has with you to identify fraud, waste, and abuse. So I want to thank the Chairman. We are already reaping dividends from the focus that has been provided.

I would like to welcome our first panel to this important hearing. Gregory Kutz, Managing Director, Forensic Audits and Special Investigations, Government Accountability Office; Steve Sebastian, Director of Financial Management and Assurance Team at GAO; and finally, John Ryan, Assistant Director of the Office of Forensic Audits and Special Investigations at GAO.

GAO is here to testify on our request for investigation of civilian agency contractors who are abusing the Federal tax system by not paying their taxes. The purpose of this hearing is to identify further corrective actions that can be taken to improve the effectiveness of the Federal Payment Levy Program.

It is good to see you gentlemen here again. I appreciate your hard work that has resulted in the identification of tens of thousands of Federal contractors who owe billions of dollars in unpaid taxes. I also appreciate your efforts and look forward to hearing about Federal contractors at civilian agencies who are not paying their taxes, including the problems you have identified with regard to collecting unpaid taxes from them.

Before we begin, pursuant to Rule 6, all witnesses before the Subcommittee are required to be sworn. At this time, I would ask you all to please stand and raise your right hand.

Do you swear the testimony you are about to give before the Subcommittee is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. KUTZ. I do.

Mr. SEBASTIAN. I do.

Mr. RYAN. I do.

Senator COLEMAN. As you are well aware, gentlemen, having been here before, we will be using a timing system today. When the green light turns to amber, give yourself about another minute to finish up. Your full statements will be entered into the record in their entirety.

We will begin with Mr. Kutz, then Mr. Sebastian will be presenting the GAO statement this morning, as I understand. Gentlemen, please proceed.

TESTIMONY OF GREGORY D. KUTZ,[1] MANAGING DIRECTOR, FORENSIC AUDITS AND SPECIAL INVESTIGATIONS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; ACCOMPANIED BY STEVEN J. SEBASTIAN,[1] DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; AND JOHN J. RYAN,[1] ASSISTANT DIRECTOR, FORENSIC AUDITS AND SPECIAL INVESTIGATIONS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. KUTZ. Mr. Chairman, Members of the Subcommittee, and Chairman Collins, thank you for the opportunity to discuss contractors with tax problems.

Last year, we testified that DOD contractors were abusing the Federal tax system with little or no consequence. At that hearing, you expressed concerns that this was a governmentwide problem. Unfortunately, our bottom line today is that thousands of civilian agency contractors are also abusing the tax system.

Our testimony has two parts. First, I will discuss contractors that abuse the tax system, and second, my colleague, Mr. Sebastian, will discuss why these contractors face few consequences.

First, we found that 33,000 civilian agency contractors had over $3 billion of unpaid Federal taxes.[2] We investigated the activity of 50 of these contractors, including the owners, officers, and any related businesses. For all 50 case studies, we found abusive and potentially criminal activity related to the Federal tax system.

Forty-eight of these case study contractors, as you have all mentioned, had unpaid payroll taxes, which represent amounts withheld from employee wages for individual income taxes, Social Security, and Medicare. However, rather than fulfill their role as trustees of this money and forward it to the IRS, these contractors diverted the money for the use of their business or for personal gain. Regardless of the cause, willful failure to remit payroll taxes is a felony.

While these companies were stealing millions of dollars from the government, as shown on the posterboard, our investigations found

[1] The prepared statement of Mr. Kutz, Mr. Sebastian, and Mr. Ryan appears in the appendix on page 47.

[2] See Exhibit No. 2, GAO Report entitled *FINANCIAL MANAGEMENT—Thousands of Civilian Agency Contractors Abuse the Federal Tax System With Little Consequence, which appears in the Appendix on page 97.*

the owners spending money on their own professional sports team, gambling, million-dollar homes, a shopping mall, luxury automobiles, and a recreational vehicle worth hundreds of thousands of dollars. Diversion schemes included the transfer of money to a foreign bank account, inflated salaries for the owners and officers, and millions of dollars of cash withdrawals.

Some of the owners were simply poor business managers. However, others clearly accumulated substantial personal wealth at the same time their companies failed to pay their taxes.

The companies that we investigated were small to mid-sized and were closely held. Industries included health care, building maintenance, manufacturing, security, and a casino. Ironically, these potential felons are doing business with the Departments of Homeland Security and Justice.

Senators, let me end by saying that there is something fundamentally wrong with this picture. If we can't trust these contractors to pay their taxes, then how can we trust them to guard our Federal buildings, to manufacture parts for the Space Shuttle, or to provide health care for our veterans? Instead of these owners and officers doing time, the government is paying them millions of dollars for their time.

Mr. Sebastian will now discuss why little has been done to deal with abusive contractors.

Senator COLEMAN. Thank you, Mr. Kutz. Mr. Sebastian.

Mr. SEBASTIAN. Thank you, Mr. Kutz.

Mr. Chairman, Members of the Subcommittee, and Chairman Collins, Federal law presently does not prohibit contractors with unpaid taxes from receiving government contracts. However, tools exist to assist in collecting unpaid taxes from contractors, most notably the Federal Payment Levy Program.

Unfortunately, despite some progress, substantial amounts of potential tax collections under the program go uncollected each year. We estimate that in fiscal year 2004, the Federal Government could have collected as much as $350 million in outstanding taxes from contractors had all tax debt owed by civilian agency contractors been eligible for levy action, and all contractor payments disbursed by Treasury's Financial Management Service been subject to a 15 percent levy.

In contrast, as you noted, FMS collected just $16 million in outstanding taxes from these contractors. This gap between potential and actual collections, which we refer to as the levy collection gap, results from both exclusions of substantial tax debt from the program and a lack of proactive oversight and management. I want to briefly discuss both components.

First, of $269 billion in outstanding Federal taxes, only $35 billion, or 13 percent, is eligible for immediate levy action. The posterboard provides a graphic illustration of this. As it shows, $71 billion of tax debt, or about 26 percent, is excluded because of statutory restrictions, such as bankruptcy. Another $100 billion, or about 37 percent, is excluded by IRS policy restrictions, including what IRS refers to as hardship cases.

Of the $98 billion that is forwarded to the levy program, only 30 percent is actually eligible for immediate levy action. The other 70

percent is not eligible until IRS's collection due process is completed, which can take months and sometimes years.

Second, with respect to FMS's oversight and management of the levy program, FMS failed to subject to levy tens of billions of dollars in payments it disbursed to contractors in fiscal year 2004 due to control breakdowns. For example, FMS erroneously excluded $40 billion in payments related to 150 agency pay stations from its debt collection database for matching with outstanding taxes. Nine billion of this was paid to contractors with outstanding tax debt.

And FMS paid $17 billion to contractors where Taxpayer Identification Numbers, or TINs, were not contained on agency payment files or were obviously invalid, and it paid another $4 billion where contractor names were not included on those pay files. Without a valid TIN and name to match against the tax debt, these payments could not be levied.

While inaccurate and incomplete information provided by agencies contributed to some of these omissions, FMS, as the Nation's debt collector, has a responsibility to actively identify and resolve issues that adversely impact the effectiveness of the levy program. FMS policy decisions have also led to at least tens of billions of dollars in additional disbursements to contractors being excluded from potential levy.

Specifically, FMS uses several methods to disburse funds, but only payments made through one method are included in the levy program. FMS excluded the other payment methods because their inclusion would require system and process changes. However, FMS performed no study to determine whether the benefits from additional tax collections would outweigh the costs associated with such processing and system changes. This is like flying blind. The lack of proactive oversight and management of the program has resulted in the Federal Government forfeiting its ability to collect at least $50 million more in annual tax collections through the levy program.

FMS faces other challenges. Increasingly, the government is using purchase cards to pay contractors, $10 billion in fiscal year 2004. Because payments are made to the banks that issue the cards and not the contractors, the government doesn't presently have a means to levy such payments.

Additionally, FMS and IRS have yet to fully implement the American Jobs Creation Act provision that authorizes the government to levy up to 100 percent of contractor payments to collect outstanding tax debt.

In conclusion, allowing contractors to do business with the government while not paying their taxes creates an unfair competitive advantage for them at the expense of the vast majority of Federal contractors that fulfill their tax obligations. The levy program has thus far failed to achieve its potential, primarily because substantial tax debt is excluded and because FMS, the Nation's debt collector, has not exercised effective and proactive oversight and management of the program. As a result, the government has missed opportunities to collect substantial amounts of tax debt.

We believe prompt implementation of the recommendations contained in our report released today will result in tens of millions of dollars in annual tax collections.

Mr. Chairman, this concludes our statement. We would be pleased to answer any questions you or other Members of the Subcommittee may have.

Senator COLEMAN. Thank you, gentlemen, and again, we do appreciate the work that you have done.

Mr. Sebastian, you indicated that Federal law doesn't stop contractors from receiving contract payments even if they are not paying their Federal taxes. Should there be, in your opinion, or any of you, should there be a debarment option for egregious and repeated conduct for individuals? I think both of my colleagues talked about cases over, in one case, a 20-year period. Should there be a debarment, do you believe? I am going to ask the next panel the same question.

Mr. SEBASTIAN. Mr. Kutz and I actually testified on this issue a number of years ago. A bill was introduced that would have, in fact, barred such tax delinquents from entering into contracts, as well as receiving loans, grants, etc. The bill was actually voted out of the House Government Reform Committee and then languished, quite frankly.

Certainly it is a policy option that the Congress could consider. I would caution you, as we have cautioned in the past, that there are a host of issues associated with implementing such a barring provision, including ensuring that the information related to tax delinquents is accurate and that the IRS would be able to respond to an inquiry within a matter of hours as opposed to the days or weeks that it would presently take. There are other issues with respect to the contracting community, trying to expedite the negotiation of contracts as quickly as possible. All of those would have to be considered.

Mr. Kutz may be able to add more to that.

Senator COLEMAN. Mr. Kutz.

Mr. KUTZ. Well, I think it is the difference between a preventive and a detective control. The levy program is after the money has been stolen, basically, when it comes to payroll taxes, so you are trying to collect it after it is out the door, versus you are talking about more preventive controls. Once someone has stolen from us once, let us not do business with them, so it is a valid policy option.

Senator COLEMAN. And I would be generous. Not once, five times, whatever it is. Chairman Collins raised that in her statement. It is one thing to act after the fact, but when you have patterns of abuse, not to have the ability to say, hey, this person is not a responsible contractor——

Mr. KUTZ. Right, and the patterns are years and decades in some cases.

Senator COLEMAN. Let me ask, Commissioner Gregg from FMS, in his written statement, he says our effective management of the levy program is demonstrated by the fact that through the first 8 months of this fiscal year, FMS has collected more taxes, $126 million on behalf of the IRS, than in any previous year. I don't want to get agencies fighting with each other, but I would like an honest assessment. Do you feel that, as we sit here today, that FMS has had an effective levy management program?

Mr. SEBASTIAN. Let me take a shot at that, and then Mr. Kutz can add to it. I think the information contained in our report and

included in our oral statement would indicate that we believe that FMS has exercised less than effective oversight and management of the program, as evidenced by such omissions as $40 billion in payments related to 150 agency pay stations.

Senator COLEMAN. The chart on the board,[1] one of the comments, I believe it was Mr. Sebastian, in your testimony, you talked about payments that are made that do not go through the Treasury Offset Program. In other words, as I understand it, what you have is FMS makes contractor payments. If they go through the Treasury Offset Program, they can be screened for levies, whether people have tax obligations. The money then can be levied, 15 percent to the IRS, and the system is working.

But apparently there are a series of payments—Fedwire, purchase card, I believe you mentioned—that do not go through the Treasury Offset Program, that they go directly to the contractor, or in the purchase card, to the bank which then goes to the contractor. Can you explain to me why there isn't a Treasury Offset Program for these kinds of payments and what it would take to have a levy in place?

Mr. SEBASTIAN. With respect to the first three on the chart, the Fedwire, the automated clearinghouse, CTX, and Type A payments, the issue really comes down to a couple of things, primarily, the structure of the payment files that are sent forward. They currently are not compatible with the setup within the TOP database to affect a matching. So that would require some programming changes.

Senator COLEMAN. So I want to correct myself. There is not a legal impediment. There is not a statutory impediment. This is a program change that could correct the situation, is that fair?

Mr. SEBASTIAN. That is correct. The added complexity with respect to the Fedwire payments, of which there were over $190 billion disbursed in 2004, is that these are same-day payments. They are actually deposited into the payee's account within the same day. They are high dollar value, low-volume payments. Of that $190 billion, neither we nor FMS were ever able to get a handle on how much of that represented payments to contractors.

Senator COLEMAN. Again, what would it take to get a better sense of whether there are some levy obligations here? Are these programming changes? Are these software changes?

Mr. SEBASTIAN. Programming and processing changes within FMS.

Senator COLEMAN. And I suspect there is a cost-benefit analysis that one has to do here to say, what is the cost of the change and what is the benefit? Have you been able to do a cost-benefit analysis, even in a cursory fashion, to determine whether, in fact, if we make some programmatic changes to ensure that these payments go through the levy program it will be worth the price or the cost of the software changes?

Mr. SEBASTIAN. We were able to come up with estimates of the amount of contractor payments that were being sent through the CTX and the Type A. It was about $26 billion in contractor payments. And when we matched those payments against the out-

[1] See Exhibit No. 1 which appears in the Appendix on page 96.

standing tax debt within IRS, we were able to come up with some significant dollar values that will be added to the levy. That was actually a component of the $50 million that we computed FMS could collect above and beyond the $16 million it had collected.

Senator COLEMAN. So again, in your judgment, there would be the cost-benefit analysis of what it would take to change the system versus the monies that would be collected, it would be the interest of the government to do the programmatic changes so that we could collect the levies and make sure a tax obligation is being taken care of, is that correct?

Mr. SEBASTIAN. There is clearly some benefit with respect to the additional revenue streams. What we don't have is information on what it would actually cost to facilitate such programming and processing changes.

Mr. KUTZ. One more thing I would add on the purchase card is that the payments to the banks actually would go through TOP, like Bank of America and CitiBank. But the payments to the contractors don't. The banks actually make the payments to the contractors.

Senator COLEMAN. Mr. Kutz, let me ask you, we talked about having 50 cases here which I know you have labeled abusive and criminal, willful failure to remit payroll taxes, a felony. We had 47 cases, and I am going to ask the Commissioner about this when I have a chance to question him. Do we have a sense of whether there has been any criminal action or any criminal cases filed either in the 47 that you did with the Defense Department or even in these 50, any sense of whether that is being done?

Mr. KUTZ. Yes. I will let Special Agent Ryan follow up, but we don't see a lot of evidence that there has been any prosecutions or indictments at this point. There is some activity, but most of the activity seems to be recent. But it is interesting to look at some of the information we got back about some of the contractors that said that they were defunct or bankrupt. I think that kind of misses the point here in that the actual owners are the ones we are going after.

So to the extent that there is a shell company—if we had stopped our investigation when we saw that there was a defunct company, we would have missed a lot of what we were reporting to you today. So there is something behind the defunct companies, because someone steals the money, shuts down the company, and moves on.

Senator COLEMAN. And they are able to restart another company and do business with the government, aren't they?

Mr. KUTZ. Absolutely.

Senator COLEMAN. I mean, that is one of the frustrations that we have here. Agent Ryan.

Mr. RYAN. I would just like to add, Senator, that in the cases that we looked at, of the 47 in the first report, shortly after your hearing, the IRS did come over. They did review our work papers and indicated that there were 10, 12, or 14 cases that needed further investigation.

After that, we really didn't hear from them until about 2 months ago, when this hearing was announced, that we started to get some inquiry from the field from the agents that had the cases assigned

to them. I don't believe that there was any action taken because the agents were never contacted by U.S. Attorneys' Offices, our work papers were never requested under discovery, and there were no subpoenas issued for potential witnesses.

So with that, we are here today, like Mr. Kutz just said. I don't believe that at this stage of the game there has been a lot of action on those cases.

Senator COLEMAN. I understand the sense that we should be looking at administrative remedies before criminal remedies. I was a prosecutor for many years, and if we can settle something, you don't have to file criminal charges.

My concern is that in cases of clearly the most willful, the most abusive cases, if you don't use that authority, I think it sends the wrong signal. Again, if we could clearly identify cases of repetitive conduct, of clear fraud, of money going into personal pockets at the expense of both the employee and the government. So that is the frustration I have with what I am seeing and the lack of action that we are seeing in regard to these cases.

Mr. KUTZ. We concur. Certainly, we would believe that some prosecutions, possibly high-profile ones, in some of these cases would send a message out to people that this is not proper behavior.

Senator COLEMAN. Thank you. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

I want to go through the process a little bit with you. The IRS sends to FMS the list of people or companies that owe taxes, and that is done on a regular basis, I believe?

Mr. SEBASTIAN. Weekly.

Senator LEVIN. Weekly. So FMS knows the names of companies that owe the government taxes.

Mr. SEBASTIAN. It has a control name sent over by the IRS along with the Taxpayer Identification Numbers, four characters, alpha characters.

Senator LEVIN. It just has the four? OK. That list, then, when an agency enters into a contract, presumably could be compared by the FMS with the contract if they had that four-digit identifier, is that correct? FMS could make that match before any payments are sent out to a contractor.

Mr. SEBASTIAN. If they had a listing of prospective contractors or contractors with that information.

Senator LEVIN. Either one. If they got a list from an agency, we are about to enter into contracts with these 50 people. Are any of those on your list, FMS? Could FMS tell the agency—are they allowed under current law—there is a notice of tax delinquency that has been sent, or they owe back taxes? Is that permitted under current law?

Mr. SEBASTIAN. Presently, I do not believe so.

Senator LEVIN. Is there any reason why we shouldn't amend the law so that the FMS can be informed by the IRS of the list that was sent to them of contracts about to be entered into that X number are on the IRS delinquency list? Is there any reason that you can think of why we shouldn't allow FMS to be given that information by IRS?

Mr. SEBASTIAN. It is certainly a valid policy option for you all to consider.

Senator LEVIN. We will ask IRS as to whether they would have a problem with that.

So now you have a situation where payments are about to be sent out by the FMS to presumably either a company or a bank which is going to send money to that company. At that point, they make a match. For reasons I don't understand, the current law doesn't allow them to make the match before the contract is entered into, but we will go there with the next panel.

Now you have payments going out. A significant number of those payments go to people who owe money on their taxes because the FMS doesn't have the TIN number, is that correct?

Mr. SEBASTIAN. That is correct.

Senator LEVIN. And that is a decision which FMS has made, right? I mean, they get a form from an agency. If it doesn't have the number on it, they could tell the agency, you give us that number. They could do that under current law, right?

Mr. SEBASTIAN. Yes, they could. In fact, agencies are required under law to provide TINs.

Senator LEVIN. But they don't do it at times, right?

Mr. SEBASTIAN. That is correct.

Senator LEVIN. And the FMS up until now has not said, you give us a completed form or we are not going to pursue it.

Mr. SEBASTIAN. That is correct. They have not rejected payment requests for that reason.

Senator LEVIN. That seems to me to be a fairly simple step. Otherwise, there is not going to be a match made in a lot of cases, because there is no number to match. The TIN number isn't on the form for the payment.

Mr. SEBASTIAN. Now, there are some exceptions with respect to the TIN requirement. For example, payments to a foreign company being made by a Federal agency would be exempt. But what would be required is a certification of those exempted entities from the TIN requirement.

Senator LEVIN. There could be a note made of that.

Mr. SEBASTIAN. That is correct.

Senator LEVIN. Now you have also got a situation—and sometimes these forms come in with no name of the contractor on it, either, is that correct?

Mr. SEBASTIAN. That is correct.

Senator LEVIN. And FMS has the power under current law to reject the form from the agency. You give us a complete form, TIN number, name, or else we are not going to accept it.

Mr. SEBASTIAN. I am not aware of anything in law that would preclude them from doing that.

Senator LEVIN. All right. Now, we also allow under current law the payments to be made to a bank, in effect, instead of directly to the contractor, is that correct?

Mr. SEBASTIAN. That is correct.

Senator LEVIN. Is there any reason that you know of that we couldn't say that payments—assuming we can get the list from the IRS to the FMS of folks that are in arrears on taxes—that you cannot have that indirect payment made? You must, if you are on a

delinquent list, have that payment go directly to you. The computer will not accept a check going to a bank, or a wire transfer, or use of another credit card, in effect, if that delinquent company is on the delinquency list. Is there any reason why we can't provide for that?

Mr. KUTZ. I would say the purchase—if you are talking about the purchase card——

Senator LEVIN. Both.

Mr. KUTZ [continuing]. That is a little harder problem because the banks are involved and it is merchant banks and so it is a little more complex situation, which I think they have just begun to look at. So they may have looked at it before, but that is a harder one to do than the FMS process you have just described.

Senator LEVIN. Well, explain to me why, if FMS has a list of companies that are deliquent—the law changes, and the IRS can give them the list of companies that are delinquent in their taxes—we couldn't simply say to the computer, you cannot send a payment owing by the government to that contractor that is on that list unless it is made directly to the contractor, which then means we can hold off the 15 percent or more for back taxes.

Mr. KUTZ. I believe you would have to share that information with the banks that are making the payments to the contractors in that case.

Senator LEVIN. You would have to share the——

Mr. KUTZ. The information on tax problems with the actual bank who is making the payment to the contractor, because the contractor gets paid in a matter of days——

Senator LEVIN. No, but I am not even allowing the payment to go to the bank. I am stopping the payment from going to the bank if there is a contractor that owes money.

Mr. KUTZ. It is just like your credit card, though. There is maybe a thousand vendors on one credit card bill. So if you stop the payment, you would be stopping the payments to everyone, not just the one. What happens—it is just like your credit card.

Senator LEVIN. Isn't it FMS that is making the payment to the bank?

Mr. KUTZ. Yes.

Mr. SEBASTIAN. Correct.

Senator LEVIN. On a contract.

Mr. KUTZ. Well, on a purchase card which is—again, it is just like your credit card statement. You might get a bill with 200 charges on it that are going to go to contractors, so the bank is making the payment to the contractors.

Senator LEVIN. I am missing something here, though, and I want to try to understand it. If a contractor is saying, send the payment owing me to a bank, that has to happen, right? Instead of sending it to me, send it to a bank. Apply it to a purchase card.

Mr. KUTZ. Yes. The bank gets paid and the bank pays the contractor, correct.

Senator LEVIN. But that is at the request of the contractor, is it not?

Mr. SEBASTIAN. I think what you may be referring to is actually preventing a vendor with delinquent taxes from being able to get payment through a purchase card——

Senator LEVIN. Exactly.

Mr. SEBASTIAN [continuing]. Stopping it before they actually get the purchase card.

Senator LEVIN. Right. You just say that the vendor is on that list, which should exist, that FMS has of delinquent vendors, that payment can not go in directly. It cannot go to a bank. It must go directly to the vendor and then it is subject to the 15 percent.

Mr. KUTZ. It would seem possibly that the other agencies might need to be involved so that they would deny those contractors from using the purchase card, from being paid through a purchase card.

Senator LEVIN. My time is up. There is a contractor out there, right?

Mr. KUTZ. Yes.

Senator LEVIN. The money is owed that contractor.

Mr. KUTZ. Yes.

Senator LEVIN. And the contractor must say, don't send it to me. Apply it to a purchase card. Isn't that what happens? Isn't that the decision of the contractor?

Mr. RYAN. Senator, I think we are talking about apples and oranges here. I understand what you are saying. That would be more in line with using the card as a payment method in regard to a contract that is set up, as Senator Collins and Senator Coleman mentioned earlier, about identifying a contractor in the early stages before the contract is awarded. When the credit card is being used as a payment method, there can be a hold put on those payments.

Senator LEVIN. That is what I am saying.

Mr. RYAN. And there is also another method——

Senator LEVIN. Albeit it at a slightly later stage. Their question was, why even issue the contract, which is a perfectly important question as far as I am concerned. But I am saying, after a contract has been issued, if that person is on the list that FMS has of delinquent contractors, why then can we not tell the computer—you may not apply the payment owing the contractor to the purchase card. You must send it directly to the contractor. We are not going to accept that request to send it to the bank.

Mr. RYAN. I think that is an issue that is probably going to be addressed later on in regards to what you are talking about. But there is also another system called Power Track that is being used in the government in which there is a certain financial institution that is hired to handle the payment process. When receipt and acceptance comes in to pay on these bills, they would absolutely have the ability under your scenario to know who that contractor is before they would make the payment to that contractor. So the intermediary would be whoever the government would contract to handle that payment.

Senator LEVIN. I don't know why FMS can't simply notify its computer that we have a list from IRS. These are the delinquent companies. You do not send a check to anybody except that company. It doesn't get wire transferred. It doesn't go through a credit card. It has to go to that company, and then that is subject to the withholding for back taxes. I don't know why the FMS can't get that list from IRS and then cannot tell its computer, only direct payments subject to withholding for back taxes.

That is my question. I am not, perhaps too obviously, a high-tech guy, but I will see if my staff can explain this to me.

Senator COLEMAN. Chairman Collins.

Chairman COLLINS. I guess I shouldn't send you a Blackberry message? [Laughter.]

Mr. Kutz, I want to go back to the issue that I raised in my opening statement. We have talked about some important reforms that would help with this unacceptable situation. One is improving the levy system. The second one is to strengthen the Federal Acquisition Regulations to allow firms engaged in tax evasion to be debarred. That has been, I am told, a recommendation of the joint task force.

But I am still fixated on what we could do on the front end to prevent businesses or individuals with serious tax delinquencies from receiving Federal contracts in the first place. It is fine to have systems to take care of those who slip through the cracks and get contracts despite evading taxes, but we really ought to have a system that allows us to screen out potential contractors who have serious tax delinquencies. Do you have any recommendations in that regard?

Mr. KUTZ. That was what Mr. Sebastian mentioned earlier with the legislation from 2000 on the House side that would have barred contractors from doing business, and the process would have been the contracting officers would have checked with the IRS to determine whether a company had severe tax delinquencies, and if they did, that would have barred them from getting that contract. And that was—the procurement community at that point in time fought that legislation with the streamlined acquisition problems. They didn't want to have contracting officers spending their time looking to see what kind of people we were doing business with, quite honestly.

Chairman COLLINS. I remember that bill being mentioned in testimony last year when I brought up this same frustration that I have. But are there technical reasons why that couldn't be done? Would it slow the procurement process in a way that would be unacceptable, or do you see that as a practical way for the contracting official to do a check with IRS? Is this a practical solution?

Mr. KUTZ. With respect to IRS, and the Commissioner can probably talk about that further. There are a couple of issues: The timeliness of the response of IRS back to the contracting officers, and, of course, the issue of accuracy. We don't want to prevent taxpaying contractors from doing business with the government. So we were concerned when we testified on that legislation in 2000 of timeliness and accuracy of data, and so with tax system modernization, I think that would be a question for the Commissioner. But aside from those things, it is an absolutely valid policy option. I think it is much easier to explain to the American taxpayer something like that than just relying on this levy program after they have already stolen the money.

Chairman COLLINS. I certainly agree. You have done work now looking at delinquent contractors in the area of defense contracts and now civilian agency contracts. Have you come across any evidence that contractors who are evading tax obligations are receiving Federal grants?

Mr. KUTZ. Yes. Several of our case studies were receiving Federal grants, which is another outrageous situation, that sometimes the grants were larger than the amount of taxes that they owed and there was nothing done about that. Special Agent Ryan can add further to the two cases, I believe.

Chairman COLLINS. Mr. Ryan.

Mr. RYAN. Senator, in the cases that we investigated, we found out that after we conducted the interviews that the corporations did, in fact, receive grants. Some of the grants were from the Department of Energy, and as Mr. Kutz said, the grants were larger than the taxes that were owed. And I am not quite sure, but I don't think that the grants were ever levied.

Mr. KUTZ. And I believe the other one was with the Department of Homeland Security.

Chairman COLLINS. That was going to be my next question, because you mentioned in your testimony that you had looked at the Department of Homeland Security. The Chairman mentioned the case of security guards being provided by a contractor with a serious tax problem. Are you finding even examples of contractors who have committed crimes of integrity, such as embezzlement, who are doing business with sensitive agencies like the Department of Homeland Security? I know you found that with some defense contractors from your last study.

Mr. KUTZ. Yes, and I think three of our 50 had been convicted of those types of crimes and had those types of issues in their background. Also, drug issues were involved with some of these folks. So certainly, it is a bit disturbing to see that the people who we are talking about today are guarding our Federal buildings, and if we can't trust them again to pay their taxes, it is very difficult to explain how we can trust them to guard our buildings. How do we know if we are dealing with who we think we are dealing with?

So that gets back to the front-end controls you are talking about, trying to determine who we are doing business with before we let a contract.

Chairman COLLINS. Mr. Chairman, I would suggest that this is a whole new area that we should look into because it is outrageous that a contractor is receiving contracts if there is a serious tax delinquency. But if they are receiving grants, in some ways, I think that is even worse and we need to do some further work in this area.

I want to switch to another issue that troubles me greatly and that is the competitiveness of a contractor who isn't paying his taxes, who may even be withholding his employees' payroll taxes. Doesn't that business have a competitive advantage in competing for a contract? He may well be able to offer a better price because he is cheating on his taxes.

Mr. KUTZ. That is absolutely true, yes. When you think about wage-based industries, which is most of what we looked at here, it is a 15.3 percent advantage on the wage base. In addition to that, we identified many of the contractors, as some of you have mentioned, that owed corporate taxes. And so if you are not paying your corporate taxes, you are not paying your payroll taxes, and then we had a number of the officers and owners who had hundreds of thousands of dollars of individual income taxes that they

owed. So this all presents a very unfair situation for the vast majority, as Mr. Sebastian said, of government contractors who do pay their taxes.

Chairman COLLINS. This is not only unfair to the taxpayers, it is unfair to the legitimate businesses who are trying to compete for Federal contracts.

Just one final quick question. In testimony submitted for the record, Mr. Everson has indicated that the administration is proposing to incentivize FMS to levy payments by allowing them to keep part of the levied funds. It strikes me as an odd situation to have to provide an incentive to FMS to do what it is designed to do, but maybe I am missing something. Mr. Sebastian, what is your view on that?

Mr. SEBASTIAN. I guess my only reaction to that is with respect to the levying of payments or offsetting of payments for non-tax debt, it is my understanding that FMS does, in fact, get a small user fee related to any collections coming out of that process. So it is not unique in terms of the services FMS has provided to other agencies for non-tax debt.

Chairman COLLINS. Mr. Kutz, do you have a comment on expanding that?

Mr. KUTZ. Well, they are the Nation's tax debt collector and other debt collector, so it is part of their responsibilities. I would say anything that can help make this better, I would support certainly, and if it takes that—I am not sure it should need that, but if, in fact, something like that helps better incentivize the system so that you can collect tens and hundreds of millions of dollars more, we are looking for results either way.

Chairman COLLINS. I must say that it seems odd to me to give an incentive to FMS when their job is to levy such payments. But perhaps the system is so broken that we need to consider that.

Thank you, Mr. Chairman.

Senator COLEMAN. Thank you, Senator Collins. Senator Akaka.

Senator AKAKA. Thank you, Mr. Chairman.

Mr. Kutz, in your written testimony, you testified that FMS has not taken proactive action to notify States that they can enter into reciprocal agreements with the Federal Government to collect each other's debts through offsetting contractor payments. How does that fit into your overall findings related to FMS's overall management and oversight of the Federal Payment Levy Program and would pursuing reciprocal agreements with the States be beneficial to both them and the Federal Government?

Mr. KUTZ. Yes, I believe it is consistent with our finding of ineffective management oversight and control, and you see the posterboard Senator Coleman had up there and you could just add that as another example of FMS not being proactive in their approach here, and certainly evidence to other programs that have been—agreements with States have resulted in hundreds of millions of dollars of collections. So it would seem that there is a mutually beneficial situation here for the Federal Government and States to pursue this alternative.

Senator AKAKA. Thank you. Mr. Kutz, you have testified that civilian contractors owe billions of dollars in unpaid taxes. Some of this amount is not available for matching in the TOP database for

various reasons, including legal restrictions or policy decisions. Other debt is not matched against Federal contractor payments in the TOP database because of various issues relating to the quality of the payment records. Some of these limitations are outside of FMS's direct span of control.

My question to you is what specific improvements could FMS make to the levy program without additional legal authority to increase collections?

Mr. KUTZ. I would just say, overall, most of this is a management issue from the FMS side that would not require much more legislation. It really is a management issue. I would let Mr. Sebastian expand on that.

Mr. SEBASTIAN. I think Mr. Kutz is absolutely correct. The $50 million in additional tax collections that we identified, and recognize that would not be complete because of our own limitations with respect to data, is all within the power of the FMS to change without any legal modifications.

With respect to the extensive tax debt that does not go over to the TOP program, as we pointed out in our written statement, a good percentage of that, about $71 billion, currently is legally restricted from going forward to the TOP program. Bankruptcy is one scenario. Another scenario would be where the IRS has not completed the process of notifying the taxpayer with respect to the amount due and giving that taxpayer the opportunity to appeal the tax debt.

Senator AKAKA. Mr. Sebastian, during the review, your team discovered that most of the payment files from the State Department did not have valid contractor names.

Mr. SEBASTIAN. That is correct.

Senator AKAKA. In fact, over $3.8 billion in contractor payment files that you found which did not have valid contractor names, of that $3.2 billion was from the State Department alone.

Mr. SEBASTIAN. Yes.

Senator AKAKA. How difficult was it for your team to find this error and how hard was it for the problem to be fixed?

Mr. SEBASTIAN. Unfortunately, a cursory review of that file disclosed the fact that there were no names included. So it did not take sophisticated techniques to identify that problem.

We notified FMS as well as the State Department of the issue. The State Department was able to ascertain that they had incorrectly been providing the wrong field on their payment file that was going forward to FMS, and they had actually been doing this since the 1980's. They were able to effect a change almost immediately. So those payments should now be coming forward with contractor names and will be subject to levy.

Senator AKAKA. Mr. Sebastian, as noted in the GAO testimony, there are various reasons that prevent a match in TOP between a tax debt and a payment. One such reason is an invalid agency location code. Your team found that $40 billion of last year's contractor payments were not even sent to TOP for potential matching against debt because FMS does not have a current agency location code list in TOP.

Is it true that FMS has a list of invalid agency location codes in its disbursement system, and if so, what would it take for FMS to

update the TOP database? Do you know if FMS has, in fact, updated the list after GAO told them about this problem?

Mr. SEBASTIAN. I think part of the issue goes back to the fact that when the Treasury Offset Program and then the Federal Payment Levy Program were developed, in designing the TOP database, at that point in time, FMS put together a complete inventory of all agency location codes. Those codes were then loaded within the TOP database to effect a match.

The problem was that there was no consistent oversight where when new agencies, such as the Department of Homeland Security, came into being that generated additional agency locations or paying stations, the agency location codes associated with those were entered into TOP. It would be a fairly simple process to update that and then continuously monitor it as new agency paying stations cropped up.

My understanding is that FMS is in the process of developing some appropriate oversight for that to make sure that the inventory is maintained. I don't know whether they have updated TOP for all of the 150 paying location codes we identified.

Senator AKAKA. Thank you very much, Mr. Chairman.

Senator COLEMAN. Thanks, Senator Akaka.

Senator Levin, I know you have to leave, but I want to defer to you if you have any follow-up questions you want to ask.

Senator LEVIN. I just had one additional question. I have a lot, but one I am going to ask the panel. Is there any reason why we should not require people who are getting Federal contracts to represent on their contract which they sign that there are no outstanding tax delinquency notices against them, or if there are, to list them, to make a representation to the government which would then, if false, be the basis of action against them under the criminal code? Is there any reason why we shouldn't put that right in the contract?

Mr. KUTZ. I am not aware of any.

Senator LEVIN. Is it in the contract, as far as you know, right now?

Mr. KUTZ. Not that we are aware of.

Senator LEVIN. I think that would be a fairly simple step to take. That becomes a criminal misrepresentation. I am not saying that they don't owe taxes. I mean, people can owe taxes and they can be in dispute or they can owe taxes which are not in dispute. It is not a crime to owe taxes. It is a crime to owe trust fund taxes, payroll taxes.

Mr. KUTZ. Right.

Senator LEVIN. That is a crime. But it is not a crime to owe taxes to the Federal Government. But it is a crime to misrepresent to get a contract whether you owe taxes. It seems to me that would be a fairly effective mechanism to get some of this money that is owing to us. Thank you.

Senator COLEMAN. Thank you, Senator Levin.

If there are no follow-up questions, I will excuse this panel. Thank you, gentlemen, for your outstanding work.

We will now call the second panel. I would like to welcome our final panel of witnesses for this morning's important hearing. We have with us the Hon. Mark Everson, Commissioner of the Internal

Revenue Service, and Richard Gregg, the Commissioner of the Treasury Department's Financial Management Service.

Mr. Everson, it is good to see you again. We always appreciate you coming before this Committee and appreciate the cooperation we have been getting from the Internal Revenue Service on the investigative matters we have pursued. As you remember, in February 2004, you testified before the Subcommittee regarding IRS's plans to make $28 billion in additional tax debt available to the Federal Payment Levy Program. I look forward to hearing the results of this action as well as the status and results from implementing the Federal Contractor Tax Compliance Task Force recommendations, which I commented on in my opening statement and have been very appreciative of the work that has been done there. I would also be interested in knowing of any further action that IRS can take to improve the effectiveness of the Federal Payment Levy Program.

Mr. Gregg, I also want to welcome you back and look forward to hearing how you will work with us to identify the problems identified by the GAO in their latest report on tax delinquent civilian contractors and Federal-State reciprocal tax collection efforts.

I also want to thank you both for your participation in the Federal Contractor Tax Compliance Task Force. The continuing success of that effort would not have been possible without your personal involvement and commitment. While I recognize that a task force is a team effort, there are members who provide vision and direction to the effort. In that respect, I would also like to recognize Pam Watson, Fred Schindler, and Julie Schwartz of the IRS, Dean Balamaci and Paul McVicker of the FMS, Lisa Romney, Matt McGinnis, and Martha Stearns of the Department of Defense for their exceptional dedication to achieving the goals of that task force.

Again, I sincerely thank both of you for being with us at this morning's hearing. As you are aware, all witnesses, pursuant to Rule 6, are required to be sworn before the Subcommittee. At this point, I ask you to raise your right hand and ask, do you swear that the testimony you will give before the Subcommittee is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. EVERSON. I do.

Mr. GREGG. I do.

Senator COLEMAN. You again are familiar with the timing system here. When the green light turns to amber, you have about a minute to sum up and your entire written statement will appear in the record in its entirety. I would ask that you limit your testimony to no more than 10 minutes and we will do 10-minute rounds for the panel.

Commissioner Everson, you will go first, followed by Commissioner Gregg. After you have given your testimony, we will turn to questions. Commissioner Everson.

TESTIMONY OF HON. MARK W. EVERSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY

Mr. EVERSON. Mr. Chairman, Senator Akaka, thank you for inviting me here today. First, let me say that I appreciate your strong support for strengthening the integrity of the Nation's tax system through enhanced enforcement activities. This Subcommittee has done important investigative and oversight work in a number of areas, particularly abusive tax shelters. And I thank you for the support you have offered for the Administration's budget request for IRS enforcement activities.

As to today's subject, I welcome your continued interest in tax compliance by Federal contractors. Vigorous enforcement of the tax law will help reduce the tax gap. Earlier this year, we announced that the gross tax gap, the difference between what taxpayers should pay and what they actually pay on a timely basis, exceeds $300 billion per year. Even after IRS enforcement recoveries and late payments, the tax gap is over a quarter-trillion dollars per year. That is inexcusable.

Average Americans pay their taxes honestly and accurately. They have every right to be confident that when they do so, neighbors and competitors are doing the same. To bolster public confidence in the tax system, the IRS has ramped up its audits of individuals, particularly high-income taxpayers and corporations. As you know, we are focusing more on abusive shelters and conducting more criminal investigations. We have collected over $3.7 billion in the settlement initiative for Son of Boss, a particularly egregious shelter of which this Subcommittee is well aware.

To frame the discussion of tax collections from Federal contractors, let me share with you two charts.[2] The first shows our overall enforcement revenues. Enforcement revenues are the direct revenues the IRS gets from collection, audit, and document matching programs. We are doing better, as you can see, up to $43 billion last year.

The biggest piece of enforcement revenues comes from collections. Levies are an important component of our collection program. This second chart traces the number of levies we have made over the same period.[3] You can see how they disastrously decreased after enactment of the IRS Restructuring and Reform Act of 1998. They are now up considerably, but still well below historic levels.

As part of our broader collection efforts, we are particularly cognizant of the need to ensure tax compliance by Federal contractors. Simply stated, if someone wants to do business with the government, the people can and should demand that vendors are current with their Federal tax obligations.

Since your hearing 16 months ago, we have taken a number of steps to assure monies owed are paid. Results are promising. Frankly, I think that the Subcommittee can take much of the cred-

[1] The prepared statement of Mr. Everson with attachments appears in the appendix on page 76.

[2] The charts referred to are attached to IRS Commissioner Everson's prepared statement which appears in the Appendix on page 87.

[3] The chart referred to appears in the Appendix on page 88.

it for this progress, and I want you to know that we expect continued improvements in the future.

When I appeared before this Subcommittee in February last year, I spoke about the establishment of a joint task force that you have mentioned. In March 2004, the IRS, FMS, and DOD established the Federal Contractor Tax Compliance Task Force. The new task force also includes representatives from GSA, OMB, and Justice. The task force has implemented several actions to ensure that Federal contractors pay their taxes and that we take appropriate enforcement actions, including levies, to collect unpaid taxes.

We have both increased the pool of debt subject to levy and improved our collection procedures. Compared to January 2004, an additional $28 billion of tax is now subject to levy. We have improved and accelerated the collection process by increasing the frequency of matching activities. We have taken steps to streamline our notice process to ensure that all notice requirements, including due process notices, are met earlier in the collection process.

The IRS and the Defense Department are working to implement a system to verify the name and Taxpayer Identification Number of each new potential contractor prior to contract award. Accurate records will ensure that delinquent contractors are identified and a portion of any vendor payment is levied and applied to the tax debt.

As a result of these improvements, total collections through the Federal Payment Levy Program surpassed $126 million through May of this fiscal year. This is the whole program, which includes not just contractors. But you can see, this is the last 2 years. I guess that program sort of fell off the tracks. [Laughter.]

This last piece here, this is just through 8 months only. So already we have surpassed—this is the contractor piece. This is the whole program, including Federal contractors and everybody. The difference between this and what we are talking about here is a lot of levies that come off of Social Security checks basically. So that is up already compared to a year ago. That is the overall program that is speeding collections.

Now let us go to the contractors themselves. This is just what we are talking about today, the Federal contractors, DOD and civilian contractors are both in these numbers. Same thing, this shows that collections are dramatically up, and already in 8 months we surpassed what we did in the whole fiscal year.

You have suggested that the task force expand its mission to include civilian contractors as well as those used by DOD. We will do this. I have also charged the task force with reviewing all remaining operational exclusions from the levy program in hopes of further increasing the number of debts available for levy. The task force will take up the challenges identified in the GAO report.

While we continue to vigorously attack non-compliance by contractors, I want to emphasize as I did last year that protecting taxpayer rights is a cornerstone of our collection process, even when it means collection action is delayed. Consideration for taxpayer rights must be balanced with our desire that Federal contractors pay their taxes. Thank you.

Senator COLEMAN. Thank you, Commissioner Everson.

Commissioner Gregg.

TESTIMONY OF RICHARD L. GREGG,[1] COMMISSIONER, FINANCIAL MANAGEMENT SERVICE, U.S. DEPARTMENT OF TREASURY

Mr. GREGG. Chairman Coleman, Members of the Subcommittee, I welcome the opportunity to discuss the role of the Financial Management Service in the collection of delinquent Federal tax debt owed by Federal contractors conducting business with civilian agencies.

Mr. Chairman, I believe that FMS has a track record that clearly demonstrates excellent leadership and program management with respect to the governmentwide collection of debts, both non-tax and tax. Since the inception of the Debt Collection Improvement Act of 1996, FMS has collected $24 billion in delinquent debts that would otherwise have not been recovered. More importantly, for the past several years virtually every trend line shows increases in collections with more than $400 million collected in the tax levy program alone.

Our effective management of the levy program is demonstrated by the fact that through the first 8 months of the fiscal year FMS has collected more tax debts, $126 million, on behalf of IRS than in any previous fiscal year. Of key interest to this Subcommittee, the collection of tax debts by levying vendor payments has increased to $26 million in the first 8 months in fiscal year 2005 compared to $20.8 million in all of fiscal year 2004.

We will continue to make improvements in fulfilling our responsibilities, recognizing that managing any program involves making choices and setting priorities. FMS has made such choices in managing our limited, but nonetheless important, tax levy program. We have allocated resources to the highest management priorities to maximize collection and ensure that proper management controls are in place. The growth of the debt collection program in general and the tax levy program in particular is a result of setting plans and priorities and then maintaining the focus and discipline to execute them.

In my statement this morning I will use my time to discuss the actions FMS is taking in response to four key recommendations by the Government Accountability Office regarding the tax levy program and its use in the collection of tax debt owed by civilian contractors.

The first one is the taxpayer identification number and names. GAO has recommended that FMS reject payment requests that do not contain the information necessary to carry out the levy program. Such action on the part of FMS has great potential to interfere with the timely disbursement of Federal funds to contractors who do not owe delinquent taxes. Even more importantly, it would blur important legal authorities and responsibilities.

As the Federal Government's chief disbursing office, FMS ensures that certified payments submitted to FMS are disbursed in a timely and an accurate manner. The certifying officials at Federal program agencies are responsible for ensuring the accuracy and validity of the payment information, such as name, TIN, and payment type, and for ensuring that the payment is legally author-

[1] The prepared statement of Mr. Gregg appears in the appendix on page 91.

ized. Federal law provides that the certifying official is responsible for the information contained on a certified voucher. Putting FMS in a position of picking and choosing which payments to disburse would, I believe, blur the critical distinction between the agency's certification authority and FMS disbursement authority.

I believe a better approach is to step up our efforts to monitor and ensure agency compliance. A major step forward relates to the recommendation by the Federal Contractor Tax Compliance Task Force.[1] In October, a program was implemented whereby as part of the contractor registration process a registering contractor's TIN number will be validated. If the TIN cannot be validated, with very few exceptions, the contractor will not be eligible to conduct business with DOD or any Federal agency.

As part of the stepped-up efforts, FMS has also been sending out reports on a monthly basis to all CFOs providing updates on their agency TIN, name, and payment type compliance. We will work closely with those agencies whose payment requests continue to contain incomplete information. This will also help compliance.

In addition, FMS is working with the Federal Credit Council, a group of top executives of creditor agencies and the council's debt collection subcommittee regarding TIN, name and payment type compliance. We will evaluate this multifaceted approach after one year and determine at the time whether withholding payments should be reconsidered.

GAO has recommended that FMS develop and implement procedures to include Type A, automated clearinghouse corporate tax exchange—that is ACH–CTX—and Fedwire payments in the levy process. FMS fully agrees with the goal of including all eligible contractor payments and I would like to update you on the actions taken to levy Type A payments and our plans to address ACH–CTX and Fedwire payments.

Type A payments are often unanticipated and typically made by agencies that do not have the payment volume to support sending large-scale bulk payment files. Disaster relief payments are an example of Type A payments. FMS is currently implementing system changes that will allow us to begin levying these payments later this year and we expect to be fully operational next year.

The Fedwire payment system is used for low volume, high dollar transactions that are deposited into a recipient's bank account on the same business day. This same-day payment requirement for Fedwire is in contrast to our normal electronic and check payments where FMS has more time to match the payment file against our debtor database. Because of Fedwire's same-day payment requirement, operational and program changes to include these payments in the levy process will be extremely difficult and would increase the risk of erroneous payments.

While the dollar value of the payments that run through Fedwire is large, Federal agencies have advised us that only a small percentage of these payments are disbursed to Federal contractors. In the last several weeks, FMS has begun to work with agencies to identify more precisely the payments in the Fedwire portfolio. In

[1] See Exhibit No. 3, *Federal Contractor Tax Compliance Task Force Report, which appears in the Appendix on page 186.*

the near future, FMS will make payment changes which will require agencies to identify in all instances the type of payments being made through Fedwire.

In addition, we are developing new guidelines for all Federal agencies to submit contractor payment requests to payment systems that can be levied. We will notify agencies about these new guidelines in the next monthly letter to agency CFOs.

Our approach should help to minimize the number of contractor payments going through Fedwire, but it does not resolve the larger issue of whether FMS's overall debt collection program can offset or levy the remaining Fedwire payments. Within the next year we will conduct an analysis of the payments going through Fedwire, the potential delinquent debt that could be collected if we are able to offset or levy those payments, and the determination of whether the additional amount of debts that could be collected warrant the program changes that would be needed to the Fedwire application.

The ACH–CTX payments are used for multiple payments to the same payee or one payment with multiple invoices, and allow for transmitting with the payment complete remittance information. While this system is an appropriate and cost-effective way for agencies to make vendor payments, given the relatively small volume of payments going through ACH–CTX, the complexity of the payment file, and FMS's need to set priorities, we have not yet decided how to levy these payments. We will conduct an analysis of the ACH–CTX payments to determine the feasibility and the potential benefits of modifying the system.

The purchase card program. I would like to address the matter of the collection of unpaid taxes of contractors that are paid using purchase cards. Simply stated, the purchase cards model does not fit the Federal payment levy process. When FMS is in receipt of a levy from IRS our legal obligation is to surrender any property in our possession that is subject to levy. When a purchase is made using a purchase card, however, FMS never has in its possession property belonging to the vendor. Credit card payments to vendors are not processed through FMS or any other authorized disbursing official.

Mr. Chairman, FMS agrees with GAO recommendations that a thorough review of the purchase card program geared toward exploring options for incorporating the collection of both tax and nontax debt is warranted. However, since the purchase card program is not an FMS program and we do not disburse purchase card payments to vendors or have information regarding what vendors receive credit card payments, FMS is not the proper government agency to lead this review. Government credit card programs are under the authority of the General Services Administration and we believe that working with GSA and IRS we can further explore the options.

The American Jobs Creation Act of 2004 enacted last October authorized IRS to levy up to 100 percent of certain vendor payments. FMS modified its systems in November 2004, one month after the law was enacted, to implement this authority where 100 percent levy is available. For example, IRS recently levied 100 percent of some DFAS vendor payments and collected $432,000 compared to $100,000 that would have been collected prior to the law's enact-

ment. However, full use of this new authority has been delayed because the provision only permits 100 percent continuous levy for payments for "goods and services" and does not appear to apply to payments made for other kinds of property. FMS stands ready to work with IRS as it attempts to resolve this issue.

Mr. Chairman, I would just like to echo the good work that has been done by the Federal Contractor Tax Compliance Task Force. I think we have made a lot of progress and I would support going forward with that. That concludes my remarks. I would be happy to answer any questions.

Senator COLEMAN. Thank you, Commissioner Gregg. I do appreciate the work that is being done by the task force. I also want to say that I appreciate FMS agreeing with the goal of doing those things we can to make sure we limit the bypasses for the Treasury Offset Program. I understand some of the challenges faced with Fedwire and some of the volume issues with ACH–CTX. I just think it is important that we review these programs and in fact limit as best we can those dollars that are passing around the levy program. So let us continue the review on one of those areas.

I have a question though about your concern with picking and choosing which type of payments to dispense. At least as I listened to your testimony—I think your approach is, let us work with the agencies to make sure that they do a better job. First, I take it you would agree with the presumption that any agency it makes sense to get the correct taxpayer identification number for anybody contracting with an agency.

Mr. GREGG. Yes.

Senator COLEMAN. So if we require that, and I think we have done it now—I think there is a voluntary system now, give us that. That would go a long way to getting that. As I understand it, in the past year four-fifths of the State Department's payment documents had no names, three-quarters of the Department of Education, and half of the Department of Transportation's payment documents had erroneous or no taxpayer identification numbers. Would those statements be correct from your perspective?

Mr. GREGG. I am not sure where those numbers came from, Mr. Chairman. What I would say is that I reviewed a March 2005 report, and while we still have a ways to go, many agencies are doing an outstanding job in getting tax ID numbers for contract payments. Many of them are at 95 to 99 percent. There are a handful of agencies, at least in the report that I saw, where the numbers are very small. Whether or not some of those may have legitimate reasons, security or other reasons, I am not sure. But I think in the last 2 years, the increase in tax ID numbers and the compliance has grown tremendously.

Senator COLEMAN. I believe that those numbers came from the GAO report. My concern is this, that we still have evidence, for whatever reason—I am not pointing fingers at agencies, but that we are not getting the kind of compliance that we should have with the Debt Collection Improvement Act. FMS is the central player, in a position not to pick and choose who are winners or losers in this process, not to interfere with the disbursal of funds, but to say up front that unless we get names, unless we get taxpayer identification numbers, we are not processing these payments.

How is that somehow interfering with the timely disbursal of funds or picking and choosing which payments are disbursed if we simply tell the agencies and the contractors that we are going to require this? This is the process that we are going to follow.

Mr. GREGG. If we do that we certainly run the risk of not paying contractors who in fact do not owe taxes. That is an issue that I think is one that I would much prefer to go back to solving at the front end and not putting us in a position of saying—since this field is not complete, for some reason we are going to reject it. We make nearly one billion payments a year, Mr. Chairman, and 78 percent of those are electronic. I would note the speed with which those flow through and go out, and the fact that we actually match the great majority of those against our debtor database before they go out the door.

The other thing is the legal responsibility of that certifying officer who says this is a legal payment that has to be made by the government. I would really find it very difficult for FMS to be in the questionable role of saying, this field did not have quite enough information and we are going to reject it.

Senator COLEMAN. I am not going to debate this with you, Commissioner Gregg, but it appears to me that you are in a very central place here. I want to make sure that payments are made timely. I want to make sure that we are not harassing or abusing folks who are fulfilling all their obligations. But it appears to me when you do a contract with the Federal Government there are certain things you can be required to do. Senator Levin raised one by saying, maybe an affirmative statement about whether you owe any taxes. It is not a right to do business with the government. It is a contractual obligation of which we then have certain requirements, and one of the requirements should be to simply provide certain information that should allow us to get those folks who are abusing the system. Not hurting or slowing up anybody else.

My problem is that we are relying now upon agencies, and I am reading GAO reports that say we are still getting three-quarters of one, Department of Education, half of another department, not providing taxpayer identification numbers. At a certain point in time we have to get back to them also.

But you are in a unique position here and my sense is that we are not being clear enough, and we are not being aggressive enough, and we are not being complete enough in getting this basic information that would allow the system to work. This system should not slow up payments. It simply puts in place saying, if there is a problem—based on a taxpayer ID number and a name. Two bits of information. Not hard to do. So again we are going to push this because we are not—the problem is the system today is not working. It is not working the way it should.

Mr. GREGG. If I might, Mr. Chairman. I think it is working in the great majority of cases. I am not sure whether those are particular agency location codes so they may not be for the whole department. They may be subcomponents. But when I said in my statement that we are going to take a look at this within a year, one of the concerns is narrowing this down to making sure that we are dealing with contractor payments. Sometimes, as you heard from the GAO report, the field that identifies the type of payment

may or may not be accurate. We are normally not in a position to know that.

So if we can take a look at this to see what is going to happen with the voluntary provision that we are working on through the task force to get the information, and go back and see what agencies that we are sending out letters to every month say, here are problem areas. See where we are and then to see whether or not we can really hone in on contractor payments. If we were to go this route, give the agencies and contractors sufficient notice that this is what we are going to do, I would like the time, if I may, to study the issue and see what progress we can make.

Senator COLEMAN. One final question to follow-up and, Commissioner, I may have to come back to you in a second round. But I believe that in 1997, as I recall in September 1997, the Department of Treasury published proposed regulations requiring a taxpayer identification number to be provided. The proposal required Federal agencies provide taxpayer identification numbers. That was 1997. That was then rejected. The final rule did not have that requirement. We went to a TIN implementation report. Now the GAO comes back and says we have $17 billion in payments to contractors that did not pass through the Treasury Offset Program because they had blank or invalid taxpayer identification numbers.

So in 1997 we had something on the table that could have corrected this; and stepped back. Obviously we have the problem today. Do you intend them to go back and look at this 1997 regulation and see if in fact we can be in a position where we actually require taxpayer identification numbers?

Mr. GREGG. In fact I am the one who pulled that back when I first arrived at FMS. I thought it was too broad a brush. I would much rather focus—we are collecting $3 billion a year from our overall debt collection programs, so we are matching a lot of taxpayer names and numbers. If we were to do something, I would much prefer going in for a more finely-honed approach in dealing with contractors, I agree it is terrible that in fact they are doing business with the government and getting paid and owe debt. So I would not go with a broad brush approach. If we did something, I would focus it more on contractors.

Senator COLEMAN. Commissioner, I will just ask one question, but I do want to come back to have some follow-up questions after Senator Akaka.

This question about contractor debarment that has been raised, and it goes to Senator Collins' issue of, could we define a type of conduct, maybe a pattern of conduct—I understand the consequences of debarment and that there may be business folks who have some poor business practices and they need to be better educated and I am willing to work with them. But I worry in the egregious cases. Clearly what we saw with the Defense Department there were case of egregious abuse; what we have seen with the GAO and these civilian contractors of in some cases long term patterns of abuse.

Do you think that it would make sense to have a contract debarment provision available to Federal agencies?

Mr. EVERSON. I think that as the Chairman indicated, you want to get at this at the front end, so that is important. The other thing

you want to do, frankly, is you want the IRS to do a better job of the collections process on an ongoing basis. I talked about the tax gap; it is terribly important that we get after the piece of it that is the non-payment. That is about 10 percent of the total tax gap. Then you have this back end piece that we are talking about here today. I think we can make progress, frankly, on all of those areas.

You are raising what I think is, frankly, a broader procurement question for OMB and Clay Johnson who runs the management side as to what procurement policy ought to be governmentwide. From my point of view, obviously anything you do to tighten up in this area sends a strong message. My overall concern is though that when you start to carve out contractors with different procedures, it can be problematic because people and businesses shift in and out of that role, if you will, and you want to make sure that you are doing, once again, the proper balancing of the taxpayer rights.

Senator COLEMAN. Just one quick question. Are there any debarment mechanisms for drug offenses, for national security?

Mr. EVERSON. There are debarment procedures—my recollection—I cannot totally take the Fifth on this since I did have that management job at OMB. There are very real debarment proceedings. If you look at what happened with some of the big corporate convictions, Enron, for instance, was debarred after it had its problems, and it is my recollection in other big outfits that does happen. So that is there and there is the possibility right now to go forward on that.

But I think maybe I was responding more broadly. I think that the Senator was raising questions about looking at tax debts. But again, this is complicated, because as Senator Levin says, we had this conversation last year. You can have a very legitimate dispute with the government over a balance that is owed.

I want to also say, not all the employment taxes that are owed are criminal. They have been characterized as criminal in this hearing today. I am a little disturbed by that. What happens is we are looking at, oftentimes, these smaller businesses and a lot of these businesses get in trouble. If you wandered around with our revenue officers who are trying to collect these monies, what happens is somebody really thinks they are going to make it and they say, I am just going to borrow this money to get through this next quarter, and then another quarter goes by, and then if we are not on them soon enough it keeps going and it pyramids. Now that is different from some of the matters that you have raised and the GAO has identified where there are willful patterns of abuse. But I do not want to paint all these 27,000 contractors or the ones last year as criminals. I think that is wrong.

Senator COLEMAN. I think it would be correct to say that there are criminal penalties for this type of conduct. You still have to prove the case. You have to show intent. But there are certainly criminal penalties and I think that is what Senator Levin was referring to.

Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Mr. Gregg, in a March 2004 letter to the Chairman of this Subcommittee you indicated that your agency was closely monitoring

actions it could take to aid in the collection of State tax debt, specifically with regard to the formation of reciprocal agreements under DCIA. However, GAO's June 2005 draft report indicates that none of the States they contacted, and they contacted 17 of them in all, none of them had been contacted by FMS. Also none of the States were aware of the program, all of them expressed interest in participating.

Can you reconcile this for us, the statement you made in March 2004 and also the GAO findings?

Mr. GREGG. You mentioned that we are helping the State of Hawaii collect State tax debt, and when we got that authority we went out to every State and aggressively pushed that, and we still have four or five States that are not doing it. We were not actually looking for reciprocal agreements there. We were saying, we will, for a very modest fee, help you collect your State tax debts.

So I would slightly differ—I do not disagree with what GAO said the answers were, but when you go out to States and start saying, here is what you have to do to be able to work with—even to collect State tax debt, and then if we actually did reciprocal agreeing where we were looking to them to help us collect some of our Federal debt, I am pretty sure that the answer is not going to be, "no problem, we will do it right away." They are going to want to take a hard look at what is the bottom line.

On the State tax debt that we have collected, we have collected $200 million a year, clearly an obvious winner with minimal amount of effort from the States. But you get into States like California where finally, after pushing for about 4 years, we finally got them to start the offset process for State tax debts. They are still not taking advantage of the whole thing. They are a very decentralized State.

For example, the State of Michigan has disclosure issues, the State of Connecticut is building a new system. Those are the sort of things that you run into when you really start talking about, the fact that we have a database that is huge and if you are going to help us collect some of our Federal debts, here are the kinds of things you would have to do.

Let me take one other point. We collect each year about $1.5 billion in child support payments. We do that through the offset program. Most of that, virtually all of that comes from offsetting tax refunds. They do have authority and we use it to collect from other payments that we have. We collected $2.6 million in fiscal 2004. So you see, when you get out of the tax refund area, which is where the bulk of that money came from, and you get to these other payment systems such as Federal salary and vendor payments, the amounts are quite modest. And that has been in place for a while. It is $2.6 million versus $1.5 billion that we collected.

So I guess my point is that we would certainly be willing to work with States if we thought that the cost benefit for both of us made sense. It is just one of those things that while we have recently broached it with some of the State organizations, we will have to wait and see whether or not there is a real interest, because there is going to be some expense and there is not as much gold in those hills as it might appear.

Senator AKAKA. Mr. Gregg, what would you say about working with States on these reciprocal agreements? Are you going to press it? Because the report we have had is that States are not aware of this. If you are going to press it, do you have a program on a timely basis?

Mr. GREGG. We will begin to raise the issue with them, but they are going to have to look at what it is going to cost them to do this, and we are going to have to help them look and see what the possible return might be, because for some of these the return may be quite modest. As you know, all the States are strapped for money too, so if they are going to invest $50,000, $100,000 or $200,000 to change to do reprogramming or build a database to take any of our debts, it may well not be worth it for them. But we will continue to discuss it with them and see if there are areas that have potential.

There is legislation, by the way, that was proposed last year that would do more, far more in this area than anything else that at least I think is in the GAO report, and that was legislation that we supported a couple of years ago which would allow for the collection of State tax debts even if someone had moved to a new State. Right now we are limited—the debt has to be owed in the State in which they currently live. If we have the authority to match for people who move to another State, we could collect considerably more money. That legislation was proposed I think in IRS legislation that did not get passed last year. So that would actually help a lot.

Senator AKAKA. These will have to be enforced and records need to be shared on that.

Mr. Gregg, I am disappointed with FMS's leadership in the area of debt collection. While FMS should be proactive in this area, it seems that any improvements have been made in reaction to the good oversight work of Chairman Coleman, this Subcommittee, and GAO. Can you describe what FMS has done since 2004 in the area of improving Federal debt collection that has not been in reaction to congressional oversight?

Mr. GREGG. If you take everything off the table that the task force has been working on, maybe the list is not that long. I will say that it takes the IRS and FMS and others to make those a reality, so I think that, for example, working with IRS to increase the amount of tax debt that is made available for matching. That is something that we have been advocating for some time. The fact that it was also part of the task force I do not think diminishes our role in thinking that was a good idea a long time ago.

We were also advocating some time ago improving the due process. I would like to see that built into the contracts when contractors first sign the contract, that they waive the due process notice that they might have through levy. That is something that we have been for, or something like that, for some time.

We have brought in a lot of new debts into our system. We have to make sure that is controlled properly. If you visualize the billions and billions of dollars of debts that we have there, trying to manage that process, make sure the proper security, proper controls, and the right authentication happens to match, where we do not go out and improperly take funds from people, it is not some-

thing you do once and forget about. It is an ongoing process. At the same time we have many things going on. In another part of our program we are building new systems.

So I think to me the characterization that we are not managing this properly is wrong because it focuses on the things that we have not been doing as well as we should perhaps, but there is a ton of things that we have been doing. If you look at the fact that we are collecting $3 billion a year, and with relatively small staff, those are important achievements. And the number of complaints that we get about the contractors that we hire, the private collection agencies, is minimal. Why? Because we actively manage that and monitor what they are doing. So I disagree with that assessment.

Is there more that can be done? Yes. But there is just a ton of things that we have going on in a relatively small organization.

Senator AKAKA. Mr. Gregg, GAO reports that about $66 billion in payments to civilian agency contractors were unable to result in computer matches to identify contractors with unpaid taxes because the agency payment forms left out key information such as the contractor's name or taxpayer identification number. It seems reasonable to me that the agency should have this information available for each contractor that is receiving Federal dollars.

Why can't you withhold these payments until all of this information is updated and complete? And if information is not there, why does FMS have to make the payment?

Mr. GREGG. It does go back to the earlier question. I think the other thing that I would want to say is that agencies have been making really good progress. I am not saying that it is perfect, because it is not. What we have been doing is going out and pushing agencies to make sure that all the payment information is right that should be there, and I expect that will have additional results, especially after they see the transcript from the Subcommittee.

But what I would like to do is to work on that, with the IRS and others to make sure that the information is obtained when the contract is signed through that voluntary basis, and then let us take a look at it, and see where we are. If, in fact, we continue to have a problem with contractor payments not having enough information then I would reconsider whether or not to withhold those payments. But I know if we do that we will stop payments for people who do not know taxes and there will be an uproar on that. But that is something that if you would allow us time to take a look at it we will do.

Senator AKAKA. Thank you, Mr. Chairman. My time has expired.

I have further questions and also some questions on behalf of Senator Levin.

Senator COLEMAN. Thank you, Senator Akaka. I am going to have a follow-up round and I will also keep the record open for 2 weeks to ensure that if there are any questions that other Members of the Subcommittee have, that they will be responded to. So I am just going to follow up for a few minutes with Commissioner Everson and if you want to continue, you can. If not, we will, as I said, hold the record open and make sure that there are responses to both your questions, Senator Levin's, and any other Members of the Subcommittee.

Commissioner, let me follow up on this concern about how do we get on top of things up front rather than just responding. Clearly, the Federal Government does not need to do business with tax cheats. There is no requirement to do business with tax cheats, and in fact as my colleagues have indicated, tax cheats have a competitive edge. They have an unethical competitive edge over those individuals who are paying their taxes as a cost of doing business. The tax cheat can factor the non-payment as a none cost lower than the amount that they need in order to make a profit and submit a lower bid, and there is something egregious about that.

I am getting into the Section 6103 issue. It is interesting, we are listening to these outrageous stories of tax cheats who invest in sports team. We do not even know the name of the sports team. GAO can get this information and issue a report but we get no information as to who these people are.

Can the IRS notify Federal contracting officials about Federal contractors who are abusing the tax system so they can avoid signing contracts with them? What kind of ability do you have to do that up front? If not, how do you overcome these limitations?

Mr. EVERSON. Let me respond first to your overall observation about the effect of non-compliance. Non-compliance is corrosive, and what we are focusing on here is old debts that are due. That does not even begin to get at the tax gap. The bulk of the tax gap relates to individuals and it relates to the under-reporting of income. If somebody is running their business and they are under-reporting their income then they can price their goods and services at a lower level, so they have an absolute competitive advantage. That exists in this discussion that we are having today, but it exists more broadly.

Again, it would be easy to ramp up our enforcement efforts with a lot more information sharing. The code is quite clear on the privacy of tax returns. The real exception to this is in the charitable sector where not-for-profit returns are public. I have testified that Section 6103 should be looked at in terms of more information sharing with other State regulators in areas like the charities. The Subcommittee has expressed interest in some of these abuses.

Right now we are precluded from sharing this information. The kind of steps we have done jointly with FMS, I think, have improved things. I think that what Commissioner Gregg is talking about in terms of going into the future, starting in October where there will be this consent to provide the information, the TIN, by the contractor if you want to be on that DOD registry. That is going to help. That is going to make a difference.

But it does not get at this core issue of the absolute wall that exists. I testified, I remember being here in late 2003, I cannot even share information with the PCAOB about investigations that we are doing on accounting firms, or with the SEC about investigations that we have on companies where we think that there is a heightened risk of compliance issues.

So this is a broad object. It clearly is one that gets at that very real conflict between two public policy purposes here. One, making sure people who do business with the government have a clean bill of health. But two, this protection of taxpayer privacy.

Senator COLEMAN. There is though an avenue by which this information is available that you presently have, as I understand it. If you bring criminal charges or you place a lien on a taxpayer, is that not public information with the court of jurisdiction?

Mr. EVERSON. Yes, sir, that is right. Once it gets out in the public domain—go back to Son of Boss as an example, the settlement issue that you are familiar with. We had two-thirds of the players came in. Now some of them did not come in. Some of them are under criminal investigation. Some of them are in other litigation already. Once they go public, once they get into tax court or into district court they become known litigants, if you will. So if you go down an actual judicial proceeding, that changes things. That gets out there, that is right. And if there is an active criminal investigation, of course that gets shared with the people who need to know.

Senator COLEMAN. But let me see if we can tie this to Federal contractors. You have a Federal agency that is going to contract with a security firm that has had a lien placed against them. They have gone through the system. It would go through the offset program. You have the lien and you would be able to then take X number of dollars. So the agency, as I understand it, would not know that the contractor with whom they are dealing has a tax lien or has a criminal conviction; is that correct?

Mr. EVERSON. That is a procurement question. I do not know what the procurement procedures are for the individual agency, be it—you talk about Homeland Security or Veterans Affairs. I am not sure what their procedures are and what they check beforehand. But I think we all agree that tax compliance is not something that is a centerpiece of their procurement process.

Senator COLEMAN. It goes back to the question Senator Levin said, asking folks to volunteer—two ways to approach it. One, you ask them, voluntarily, do you owe taxes, just so that we know that. That way you would make sure payments would go through the offset program in spite of whether they are Fedwire or anything else. So you would have a system, somebody owes taxes——

But here is my question. If it is public information, if it information that goes through a court, why couldn't the IRS provide that information to Federal contract officials? Why couldn't there be——

Mr. EVERSON. Something like a lien? You are saying we would have a special program if a lien exits—to make sure that other agencies know that?

Senator COLEMAN. Public information. At the point you publish the lien, taxpayer's name, address, taxpayer identification number, amount and type of tax owed is public information, but only in the court of jurisdiction. So it is there. It is public, but if you are a Federal contract official you are not going to go to every court in the country to find that.

Mr. EVERSON. I think we can obviously look at that. The task force could look at what it would take to do that. That is a thin strip of this though, I would indicate.

Senator COLEMAN. I would appreciate taking a look at information that is already public, to simply make it more available and see if that would help the Federal agencies in being more effective in dealing with those that have obligations.

Let me get back to this question I talked about earlier about prosecutions. We had the 47 cases regarding the Department of Defense. You have done, I think, an extraordinary job working with the task force in correcting some of the problems we have seen.

But the question that I asked the first panel, it did not appear that in any of those 47 cases that any criminal action had been taken. I recall one of those cases was an individual who I believe bought some property on an island offshore, contractor owed in $10 million in unpaid taxes. I think the business was turned over to relatives who were also tax delinquents. It would appear to me that we had in those instances some outrageous cases.

The first thrust should be administrative. We should use administrative remedies. Criminal prosecutions are a measure of last resort. But if you have an outrageous case like the guy that owed $10 million and had relatives that owed money, I am not aware of whether any criminal actions have been taken. Can you tell me whether any have been in regard to those 47 cases?

Mr. EVERSON. Last year when we talked I committed that what we would do is take these 47 cases out of the queue. Normally, our business units take a look at these matters and they may or may not make a referral. We short-cut that process and asked the criminal investigators just to take a look at the files and see whether they would want to sweep any in. My understanding is that we have active criminal investigation underway in three of these matters.

Now again, there is a difference, as you appreciate, between what is a colorful, dramatic write-up without names and then when you get to establishing what is going to be prosecutable in a courtroom, and then also how that matches out against—criminal investigations, we are forced into doing things like supporting, for the first time, a technical tax shelter investigations, or the charitable abuses.

So what I asked our people to do is to make sure our CI people took a look at each of these, and apparently they reached a judgment that three of these merit, in their view, this full follow-up. They are going to do the same thing, I think they have done on the 50 that have already been identified by GAO and I understand there are three or four that they think are promising as well. Now that does not mean that there will be an indictment in any of these cases. There can be a variety of reasons, as you, better than most, appreciate. But we have gone through that and looked at it on that basis.

Senator COLEMAN. I would just urge you to—I would hope that one of the deciding factors would not be whether it is an ongoing business. I am just concerned here—I appreciate the judgments that have to be made. I was in that position myself for many years. But I just want to make sure in making those judgments that we are not factoring in things that should not be factored. In this case one of them would be whether it is an ongoing business. You have individuals—particularly in cases where we see people doing things, getting rid of the business, and then doing it again. Just sometimes there is a tendency to say, they are not in knotted operation anymore so we are not—we have other more important stuff.

I want you to take a look at that and at least recognize the concern of this chair, and I think other Members of the Subcommittee.

Mr. EVERSON. I agree with you. As I said to you when I think we chatted a few weeks ago in your office, I think that having the hearing again will give me a good opportunity to go back, ask those questions again, and put a finer point on it. I am very proud of the rebuilt enforcement efforts that the IRS has been undertaking. I know you are enthusiastic about it. So there are individual choices that our folks make, but I can certainly go back and ask about this particular program again and I will.

Senator COLEMAN. We have seen the results with the Son of Boss, billions of dollars that are now coming back into the system because of increased enforcement efforts. I think this is one where from a cost-benefit analysis we are seeing clearly the benefit that far exceeds the cost. I wish we were able to provide more resources for enforcement. A number of us will certainly continue to fight for that in areas where it needs to be done. We are not talking about getting the poor individual who just cannot make ends meet and finds they have a problem with the IRS. There is some massive fraud and abuse going on that costs the government billions of dollars and I think we can direct resources where across-the-board folks will say this is fair, this is equitable, this is just and needs to be done.

Mr. EVERSON. I wish both you and Senator Levin were appropriators, but I am not sure you would not change your stripes once you got over to the other committee.

Senator COLEMAN. If that happens, we will chat.

Gentlemen, I want to thank you for your testimony. The record will be kept open for 14 days.

With that, this hearing is adjourned.

[Whereupon, at 11:57 a.m., the Subcommittee was adjourned.]

APPENDIX

United States Government Accountability Office

GAO

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FINANCIAL MANAGEMENT

Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence

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Highlights

Highlights of GAO-05-683T, a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

Tax abuses by contractors working for the Department of Defense, which GAO previously reported on, have led to concerns about similar abuses by those hired by civilian agencies. GAO was asked to determine if similar problems exist at civilian agencies and, if so, to (1) quantify the amount of unpaid federal taxes owed by civilian agency contractors paid through the Financial Management Service (FMS), (2) determine whether there are indications of abusive or potential criminal activity by contractors with unpaid tax debts; and (3) identify any statutory or policy impediments and control weaknesses that impede tax collections under the Federal Payment Levy Program (FPLP).

What GAO Recommends

In its report (GAO-05-637), on which this testimony is based, GAO makes recommendations to FMS to improve the FPLP and increase by tens of millions of dollars annually the amounts levied from payments to contractors with unpaid federal taxes. GAO also recommended that IRS review the 50 case study contractors identified in the report, and if warranted, pursue collection or criminal investigation. IRS agreed and FMS partially agreed. FMS did not agree that it should withhold payments to contractors without names, or work with IRS to address challenges related to levying purchase card payments. GAO disagreed with FMS's assessment and reiterated support for its recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-05-683T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Greg Kutz at (202) 512-9095 or Steven Sebastian at (202) 512-3406.

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What GAO Found

FMS and IRS records showed that about 33,000 civilian agency contractors owed over $3 billion in unpaid federal taxes as of September 30, 2004. GAO investigated 50 civilian agency contractors with abusive and potentially criminal activity. For example, businesses did not forward payroll taxes withheld from their employees to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Furthermore, several individuals owed multiple businesses with unpaid federal taxes—one owned about 20 businesses that did not fully pay taxes on over 300 returns. Some diverted payroll taxes for personal gain or to fund their businesses, such as building a house, purchasing other real property, and increasing the salary of the company's officer/owner. These contractors worked for a number of federal agencies including the Departments of Justice and Homeland Security, and the National Aeronautics and Space Administration.

Examples of Abusive and Potentially Criminal Activity

Business	Unpaid tax amount	Fiscal year 2004 FMS payments	Contractor activity
Health care	$18 million	$300,000	Purchased multimillion-dollar properties while not paying millions in payroll taxes
Consulting	$1 million	$200,000	Doubled salary of one officer/owner to over $750,000 while not remitting payroll taxes
Temporary help	$900,000	$1 million	A pattern of over 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts
Security	$400,000	$200,000	Diverted payroll taxes to a foreign bank account to build a house overseas

Source: GAO's analysis of civilian agency, IRS, FMS, public, and other records.

If all tax debts owed by, and all payments made to, the 33,000 contractors were included in the FPLP, FMS could have collected hundreds of millions of dollars in fiscal year 2004. However, because only a fraction of all unpaid taxes and a portion of FMS payments were included in the levy program, FMS collected only $16 million. For example, about $171 billion of unpaid federal taxes was not sent to the levy program to be offset against payments because of statutory requirements or IRS policy exclusions such as claims of financial hardship or bankruptcy.

Tens of billions of dollars in federal payments were not matched against tax debts for potential levy because FMS did not proactively manage and oversee the levy program. Until GAO brought it to FMS's attention, FMS was unaware that $40 billion of contractor payments had not been submitted for potential levy. FMS also did not identify payment files that lacked contractor taxpayer identification numbers, names, or both, resulting in another $21 billion that could not be levied. FMS also excluded billions of dollars from levy because of what it considered limitations in its automated systems without taking steps to overcome those limitations. Furthermore, civilian agency purchase card payments to contractors totaling nearly $10 billion could not be levied.

Mr. Chairman, Members of the Subcommittee, Senator Collins, Senator Lieberman, and Senator Akaka:

Thank you for the opportunity to discuss payments to civilian agency contractors that abuse the federal tax system. Our related report, released today and developed at the request of this Subcommittee, and Senators Collins, Lieberman, and Akaka, describes problems we identified in the management of the Federal Payment Levy Program (FPLP), in particular the program's collection of levies from civilian agency contractors with unpaid taxes.[1] These problems illustrate the overall challenges the federal government experiences in managing the federal tax system in a way that contributes to taxpayers' perception of the tax system's fairness, i.e., their perception that their friends, neighbors, and business competitors are complying with the tax laws and actually paying their taxes. These challenges are exacerbated by our identification, in our testimony at a hearing on February 12, 2004, of fraud, waste, and abuse among certain Department of Defense (DOD) contractors that owed billions of dollars in unpaid taxes. Because of these problems, you asked us to perform an audit and related investigation of civilian agency contractors to determine whether, and to what extent, civilian agency contractors also have unpaid federal taxes.

With some exceptions, civilian agency contractors receive disbursements from the Department of Treasury's Financial Management Service (FMS).[2] FMS is also the federal government's central debt collection agency. Since July 2000, FMS has operated the FPLP in conjunction with the Internal Revenue Service (IRS) to collect unpaid federal taxes, including tax debt owed by businesses and individuals who contract with civilian agencies. Under the FPLP, specified payments to federal contractors are compared with tax debt data—updated on a weekly basis by IRS—using the Treasury Offset Program (TOP), a centralized debt collection program operated by FMS. When payment data are sent to TOP, it electronically compares the

[1] GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, GAO-05-637 (Washington, D.C.: June 16, 2005).

[2] A few civilian agencies, such as the U.S. Postal Service, have their own disbursing authority and do their own disbursements. Although DOD has its own disbursement authority, some DOD payments are made through FMS.

names and taxpayer identification numbers (TINs)[3] on the payment files with the control names (first four characters of the names) and TINs of the debtors listed in TOP. If there is a match on a debt for which IRS has completed all legal notification requirements for levy, the federal payment is reduced (levied) to help satisfy the unpaid federal taxes. In fiscal year 2004, FMS collected $16 million from levying payments to civilian agency contractors.

Today, we will summarize our work on why substantial payments that FMS made on behalf of civilian agencies to contractors with tax debt were not levied. Our testimony will provide a perspective on (1) the magnitude of unpaid federal taxes owed by civilian agency contractors, (2) the statutory and policy impediments and control weaknesses that impeded tax collections under the FPLP, and (3) abusive or criminal activity by civilian agency contractors related to the federal tax system. In addition, we will summarize our work covered in a separate draft report, which we have transmitted to FMS and IRS for their comments, on the progress FMS has made on obtaining reciprocal agreements with states so that payments to contractors made by the states could be levied for unpaid federal taxes.

Summary

Our analysis of FMS and IRS records showed that about 33,000 civilian agency contractors who owed over $3.3 billion in unpaid federal taxes received payments from numerous federal agencies during fiscal year 2004. During the same period, the federal government missed many opportunities to collect some of the unpaid federal taxes owed by these civilian agency contractors. We estimate that if there were no legal or administrative provisions that excluded a significant amount of tax debt from the levy program, and if all contractor payments for which FMS maintains detailed information were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, IRS and FMS could

[3] A TIN is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number assigned by IRS serves as the TIN. For individuals, the Social Security Number, assigned by the Social Security Administration, serves as the TIN.

collect hundreds of millions of dollars annually.[4] However, during fiscal year 2004, FMS collected only $16 million from the FPLP, leaving a tax levy collection gap totaling hundreds of millions of dollars.

A significant portion of the levy collection gap arises because only a fraction of unpaid tax debts is included in the levy program and matched against payments. Specifically, because of legal requirements and IRS policy provisions, only 37 percent of the unpaid tax debts are included in the FPLP. In addition, only about 30 percent of the debt included in the FPLP is actually ready for immediate levy. While the exclusion of unpaid federal taxes from the levy program is justified in some circumstances, it nevertheless results in significant losses in the collection of revenue from levies. In a later report, we will examine the accuracy and reasonableness of the IRS exclusions.

The remaining levy collection gap exists because of a lack of proactive oversight and management of the levy program by FMS. For example, FMS was not aware that it did not submit tens of billions of dollars in payments to the levy program for matching against tax debts. These included payments without payment type code and payments from certain agency paying units. Even when FMS was aware that many payments from agency payment files did not contain TINs, without which a match could not be made between the payment file and the tax debts, FMS did not address this deficiency. Consequently, these payments had no possibility of being levied. Furthermore, FMS decided to exclude tens of billions of dollars in payments from the levy program without determining whether the cost of making changes to its automated systems and other efforts necessary to include them in the levy program would exceed the potential benefits, specifically increased tax collections and improved compliance. We estimate that if FMS addresses its control and related weaknesses, it could collect an estimated $50 million more from the FPLP annually. Furthermore, FMS has not addressed other challenges in the levy program that further limit its effectiveness at collecting unpaid taxes. These challenges include levying contractors paid with government purchase

[4] Our estimate was derived by analyzing data from FMS's Payments, Claims, and Enhanced Reconciliation (PACER) system, which maintains detailed data on payments made via checks and Automated Clearing House. PACER payment data for fiscal year 2004 contained about 12.9 million contractor payments valued at $247 billion. As will be discussed later, PACER does not maintain detailed information related to $191 billion in payments made via Fedwire—payments requiring same-day settlement.

cards and fully implementing, with IRS, the increased 100 percent levy provision authorized in 2004.[5] Furthermore, as will be communicated in a separate report, a draft of which was transmitted to FMS and IRS for comment on June 7, 2005, FMS and the states are not collecting debt, including unpaid taxes, on behalf of one another through the offset of contractor payments.[6] These mutually beneficial tax collection activities are not occurring because FMS has not actively pursued avenues to encourage states to enter into reciprocal agreements with the federal government to collect each other's taxes. Officials at the 17 states we contacted informed us that they were not aware that such a debt collection opportunity exists, but all expressed interest in pursuing this opportunity.

We also found numerous instances of abusive or potentially criminal activity related to the federal tax system during our audit and investigation of 50 civilian agency contractor case studies.[7] The 50 case studies involved mostly small companies—many of them closely held by the owners and officers—with unpaid payroll taxes. These payroll taxes included Social Security, Medicare, and individual income taxes withheld from employees' paychecks. We found that these contractors did not fulfill their role as "trustees" and forward these amounts to IRS. Rather, by diverting the money for personal gain or to fund their business, these contractors potentially committed a criminal felony. For example, one of the contractors used the payroll taxes not remitted to IRS to build a house overseas. A few contractors were involved in more than one business, all of which had unpaid tax debts. One case study contractor is one of a group of

[5] The American Jobs Creation Act of 2004 contains a provision authorizing the federal government to levy up to 100 percent—up from a maximum of 15 percent—of specified payments for goods and services provided by contractors with unpaid federal taxes. Pub. L. No. 108-357, § 887(a), 118 Stat. 1418, October 22, 2004, to be codified at 26 U.S.C. § 6331 (h)(3).

[6] GAO, *Debt Collection: State and Federal Governments Are Not Taking Action to Collect Unpaid Tax Debt through Reciprocal Agreements*, GAO-05-697R (Washington, D.C.: to be issued).

[7] A case study consists in some cases of multiple related entities, some or all of which owe tax debts. When our audit and investigative work indicated that the 50 contractors we originally selected were related to other entities—defined as entities sharing the same owner or officer or common addresses—we performed work to determine whether the related entities and the owners owed tax debts as of September 30, 2004, and received other federal payments during fiscal year 2004.

20 businesses that owed $13 million in unpaid taxes covering over 300 tax periods.[8] Another case study contractor had a 20-year history of opening a business, failing to remit to IRS the taxes withheld from employees, and then closing the business, only to repeat the cycle again and incur additional tax debts almost immediately.

As discussed in our report released today, we are making 18 recommendations to FMS to improve collections under the FPLP and 1 recommendation to IRS to review the 50 case study companies and determine whether additional collection action or criminal investigation is warranted. IRS agreed and FMS partially agreed with our recommendations. FMS did not agree with our recommendations that it should withhold payments to contractors without a name or work with IRS to explore options to levy or otherwise collect from purchase card payments. FMS also disagreed with our characterization of its management of the levy program but did not dispute the factual basis on which we based our findings and recommendations. We disagree with FMS's assessment and reiterate support for our recommendations. In our related report on state participation in the levy program, a draft of which has been sent to FMS and IRS for comment, we are also making three additional recommendations to FMS to increase state participation in the collection of unpaid federal and state taxes.

Civilian Contractors Owe Billions of Dollars in Unpaid Federal Taxes

As was the case at the Department of Defense, thousands of civilian agency contractors throughout the federal government abused the federal tax system with little consequence. Our analysis of FMS and IRS records indicated that during fiscal year 2004, FMS made payments on behalf of civilian agencies to about 33,000 federal contractors with over $3.3 billion in unpaid federal taxes as of September 30, 2004. This amount is likely understated because, first, we intentionally limited the population of contractors with unpaid tax debts to debts and payments that were

[8] A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is one-quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, although payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year.

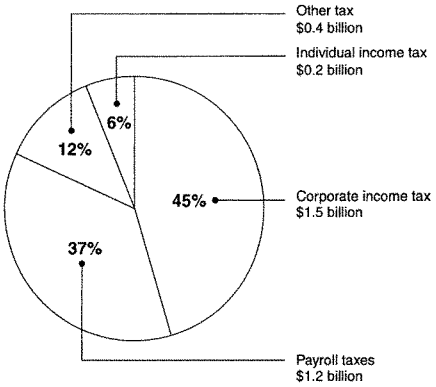
significant and agreed upon,[9] and second, because the disbursement files we received from FMS were not complete, i.e., they did not always contain the information we needed to determine whether the contractors owed federal taxes. For example, contractors receiving $17 billion in payments from FMS could not be identified because of blank or obviously erroneous TINs in the payment files submitted to FMS by the civilian agencies. Without an accurate TIN, we could not determine whether the contractor had unpaid federal taxes and, if so, the amount of unpaid taxes owed by the contractor. Similarly, as we have seen from our annual audits of IRS's financial statements, the taxpayer account database we received from IRS reflects only the amount of unpaid taxes either reported by the taxpayer on a tax return or assessed by IRS through its various enforcement programs.[10] The IRS database does not reflect the amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed the tax amounts due.

The over $3.3 billion in unpaid taxes owed by these civilian agency contractors ranged from a small amount owed by an individual for a single tax period to a group of related businesses owing about $13 million for over 300 tax periods. The type of unpaid taxes varied and consisted of payroll, corporate income, individual income, and other types of taxes. As shown in figure 1, over a third of the total tax amount owed by civilian contractors was for unpaid payroll taxes, and over 40 percent was for corporate income taxes.

[9] Our initial matches of civilian contractor payments made during fiscal year 2004 with IRS tax debt as of September 30, 2004, identified about 63,000 contractors that had tax debt totaling $5.4 billion. We excluded from our preliminary estimates tax debts that had not been agreed to by the tax debtor or affirmed by the court, tax debts from calendar year 2004, tax debts of $100 or less, and fiscal year 2004 FMS payments of $100 or less to arrive at our estimate of about 33,000 contractors with $3.3 billion in tax debts.

[10] GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

Figure 1: Type of Federal Tax Debt Owed by Civilian Contractors



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Unpaid payroll taxes include amounts that an employer withholds from an employee's wages for federal income taxes, Social Security, and Medicare—but does not remit to IRS—and the related matching contributions of the employer for Social Security and Medicare. Employers who do not remit payroll taxes to the federal government are subject to civil and criminal penalties. Because employers are responsible for holding payroll taxes withheld from employees "in trust" for the federal government and making a federal tax deposit in that amount,[11] the employer is liable for the amounts not forwarded to the federal government, as well as the employer's matching Social Security and Medicare contributions. Willful failure to remit payroll taxes is a criminal felony offense punishable by imprisonment of not more than 5 years,[12]

[11] The law further provides that withheld income and employment taxes are to be held in a separate bank account considered to be a special fund in trust for the federal government. 26 U.S.C. § 7512(b).

[12] 26 U.S.C. § 7202.

while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense punishable by imprisonment of up to a year.[13] The law imposes no penalties upon an employee for the employer's failure to remit payroll taxes, since the employer is responsible for submitting the amounts withheld. However, individuals may be held personally liable for the withheld amounts not remitted to IRS and assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).[14]

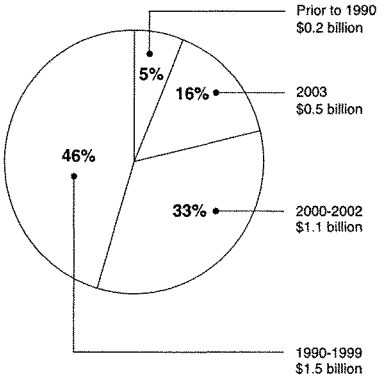
A substantial amount of the unpaid federal taxes shown in IRS records as owed by civilian contractors has been outstanding for several years. As reflected in figure 2, over half of the unpaid taxes owed by civilian contractors was for tax periods prior to calendar year 2000.[15]

[13] 26 U.S.C. § 7215 and 26 U.S.C. §7512 (b).

[14] 26 U.S.C. § 6672.

[15] The tax period may not always correspond to the age of the tax debt, as when a tax form is filed years after the due date or when IRS assesses additional taxes to earlier tax periods.

Figure 2: Civilian Contractors' Unpaid Federal Taxes by Tax Periods through 2003



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Prompt collection of unpaid taxes is vital because, as our previous work has shown, as unpaid taxes age, the likelihood of collecting all or a portion of the amount owed decreases.[16] This is due, in part, to the continued accrual of interest and penalties on the outstanding federal taxes, which, over time, can dwarf the original tax obligation. Furthermore, there is generally a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect tax debt.[17] Consequently, if the contractors owed federal taxes beyond the 10-year statutory collection period, the older tax debt typically would not be available for collection

[16] GAO, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AIMD/GGD-99-211 (Washington, D.C.: Aug. 2, 1999).

[17] The 10-year time period may be suspended, including for periods during which the taxpayer is involved in a collection due process appeal, a litigation, a pending offer in compromise or an installment agreement. Accordingly, figure 2 includes unpaid federal taxes that are for tax periods prior to 1995.

because the debt would have been removed from IRS's records. We were unable to determine the amount of unpaid tax debts of federal contractors that had been removed because of the statutory collection period's expiration.

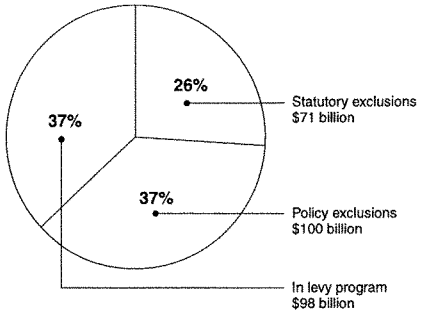
Millions in Unpaid Federal Taxes Are Not Collected

A large levy collection gap exists between the potential levy amount we estimated and the amount FMS actually collected under the FPLP. According to our estimate, if there were no legal or administrative provisions that removed a substantial amount of tax debt from the levy program, and if all contractor payments for which FMS maintained detailed information were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, FMS could have collected as much as $350 million in fiscal year 2004. However, during fiscal year 2004, FMS collected about $16 million from civilian contractors—or about 4 percent of the maximum levy collection we estimated. Because almost two-thirds of unpaid federal taxes are excluded from the FPLP because of statutory requirements and IRS policies, FMS and IRS will never be able to completely close the levy collection gap. Additionally, FMS's lack of oversight and proactive management of the levy program further impeded the government's ability to close the levy collection gap, leading to at least $50 million in lost levy collections from civilian agency contractors during fiscal year 2004. Until FMS corrects the deficiencies in its oversight and management of the levy program, the federal government will continue to miss opportunities to collect unpaid taxes through the FPLP.

Billions of Dollars in Unpaid Taxes Excluded from Levy Program

According to IRS records, as of April 2005, IRS had coded about $71 billion of unpaid federal taxes as being legally excluded from the levy program and $100 billion as being excluded because of policy decisions. As shown in figure 3, this leaves only 37 percent ($98 billion out of $269 billion) in unpaid taxes that IRS sent to FMS to be included in the FPLP for potential collection. Furthermore, IRS had completed all legal notification requirements for immediate levy on only 30 percent the amount of unpaid tax debts in the FPLP as of September 30, 2004. Consequently, 70 percent of those tax debts sent over for levy were still not eligible to have payments levied.

Figure 3: Levy Status of Unpaid Federal Taxes



Source: GAO analysis of unaudited IRS data as of April 2005.

According to IRS records, bankruptcy and taxpayer agreements, including installment or offer in compromise agreements,[18] each account for about a quarter of the $71 billion in statutory exclusions. Another 38 percent—$27 billion—is due to IRS not having completed all initial taxpayer notifications required by law before a tax debt could be referred to the FPLP. These are cases that IRS refers to as being in notice status.

For tax debt in notice status—the first phase of IRS's collection process—IRS sends a series of up to four separate notices to the tax debtor demanding payment of the tax debt. Upon receipt of each notice, the debtors have a minimum of 30 days to respond and have a number of different options, including appealing the tax debt if they disagree with the tax assessment, entering into a payment arrangement, applying for a hardship determination,[19] or paying the tax debt in full. Each time the debtor responds to a notice, IRS must make a determination on how to

[18] Installment agreements allow for payments on the debt in smaller, more manageable amounts. An offer in compromise approved by IRS allows a tax debtor to settle unpaid tax debt for less than the full amount due.

[19] In these instances, the tax debtors demonstrate to IRS that making any payments at all would result in a significant financial hardship.

dispose of the response, for example, whether to accept or reject an installment agreement if one is offered, before proceeding further with another notice or collection action. The process of notification, response, disposition, and further notification could occur up to four times. Until the series of notifications is complete, the tax debt is excluded from the levy program.

In addition to legal restrictions, $100 billion in tax debts is excluded because of IRS policy decisions. According to IRS data as of April 2005, slightly over half ($51 billion) of all policy exclusions were due to IRS's determination that the tax debtor was in financial hardship.[20] Other policy exclusions include debts belonging to debtors who are working with IRS to voluntarily comply and debtors under active criminal investigation, among others. The amount excluded for policy reasons remained substantial even after IRS added more than $28 billion to the levy program by reducing the number of policy exclusions in response to recommendations we made in our previous report on DOD contractors.[21]

In addition to the above, our past financial audits have indicated that IRS's records contain coding errors that affect the accuracy of taxpayers' account information, resulting in lost opportunities to collect outstanding taxes. The effective management of these codes is critical because if the codes used to exclude tax debts from the levy program (such as codes identifying a contractor as being in bankruptcy or having an installment agreement) erroneously remain in the system for long periods, tax debts may be needlessly excluded from the levy program.

Billions More in Tax Debts Referred to FMS Were Not Leviable

FMS's records indicate that as of September 30, 2004, about 70 percent of the tax debt in the FPLP was still not immediately leviable because IRS had not completed all the legal notification requirements necessary for levying to begin. Before levying a payment or any other asset, IRS is required to send the debtor an additional notice of intent to levy—known as a collection due process notice—that notifies the debtor of the impending levy. IRS gives the debtor up to 10 weeks to either resolve the debt or file

[20] According to IRS, financial hardship can be either a statutory exclusion (under 26 U.S.C. 6343(e)) or policy exclusion, depending on when and who makes the determination. For reporting on the FPLP, IRS categorizes hardship cases as policy exclusions.

[21] GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (Washington, D.C.: Feb. 12, 2004).

an appeal. The debtor has the same response options as in the initial notice phase. In addition, the taxpayer can file a collection due process appeal. Once IRS completes action on the response or if the tax debtor does not respond, IRS codes the tax debt in the FPLP for immediate levy. Payments cannot be levied until this process is complete.

Prior to 1998, IRS was authorized to levy a payment immediately upon matching a tax debt with a federal payment as long as the collection due process notice had been sent. However, the IRS Restructuring and Reform Act of 1998 requires that debtors be afforded an opportunity for a collection due process hearing before a levy action can take place. To comply with this provision, IRS currently waits a minimum of 10 weeks for the tax debtor to respond to the collection due process notice before it proceeds with levy, thereby causing the federal government to miss levying some contractor payments. The joint task force established after our previous audit[22] has supported making the due process for the federal payment levy program a postlevy process.[23] This would allow IRS to levy payments when first identified and provide contractors with procedural due process remedies afterward. To further reduce the payments lost to levy because of the time required for the collection due process to run its course, IRS officials stated that they had begun matching new DOD contracts valued at over $25,000 against tax debt and sending out collection due process notifications at that time rather than waiting until payments are made. The task force is also exploring avenues to combine the collection due process notice with the last of its initial notification letters sent to tax debtors.

[22] In response to recommendations made in our audit of DOD contractors with unpaid federal tax debt, the Federal Contractor Tax Compliance Task Force was established with representatives from DOD, the Defense Finance and Accounting Service, IRS, FMS, the General Services Administration, the Office of Management and Budget, and the Department of Justice. The joint task force agreed to work together to ensure that federal contractors pay their taxes and that appropriate enforcement actions, including levies, are taken to collect delinquent tax accounts.

[23] Federal Contractor Tax Compliance Task Force, *Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations* (Washington, D.C.: Oct. 26, 2004).

FMS's Management and Oversight of FPLP Resulted in Missed Opportunities to Levy Billions in Contractor Payments

We found that FMS disbursed tens of billions of dollars in payments without subjecting them to the levy process because of a lack of proactive oversight. As shown in table 1, the reasons for payments not being subjected to the levy process were that (1) agency payment station codes were not loaded into TOP, (2) payments contained blank or obviously inaccurate TINs, (3) payments contained blank or invalid names, and (4) payments contained invalid payment types. In general, FMS was not aware of these omissions until we brought them to its attention.

Table 1: Payments Submitted to TOP That Could Not be Levied

Dollars in billions

Types of payments	Amount
Payments where the agency payment station has not been loaded in TOP	$40
Payments containing blank or obviously inaccurate TINs	17
Payments containing blank or invalid names	4
Payment containing invalid payment types	5

Source: GAO's analysis of FMS data.

Notes: The categories above cannot be added together to derive the total amount of excluded payments because many payments had multiple deficiencies, each of which would have prevented the payment from being levied. For example, some payments without TINs also have invalid names.

First, we found that FMS did not update the TOP database to accept $40 billion in payments from about 150 agency paying stations.[24] If a paying station is not in the TOP database, that location is excluded from the levy program; thus payments from that location are not matched against unpaid federal taxes for potential levy. Of the $40 billion not sent to TOP, we determined that approximately $9 billion in payments was made to civilian contractors with tax debts, none of which could be or were levied.

[24] These stations are generally referred to by their Treasury Agency Location Codes (ALC). The ALC is used to identify transactions, documents, and reports processed through the Treasury Department by a specific accounting point or station within an agency or bureau of a federal department or independent agency. Using the ALC enables Treasury to reconcile deposits and disbursements.

Second, FMS disbursed over $17 billion to civilian agency contractors without TINs or with obviously inaccurate TINs in the payment files submitted to it by civilian agencies. Valid TIN information is critical to the levy program because payments lacking this information cannot be matched against tax debts. The Debt Collection Improvement Act of 1996[25] requires executive agencies to obtain TINs from contractors and to include TINs on certified payment vouchers submitted to the Treasury Department for payment.[26] While Treasury has exempted as a matter of policy a limited number of vendors from the TIN requirements, the exemptions are rare and are generally limited to foreign companies providing goods and services for federal agencies in a foreign country or companies performing classified work. According to FMS officials, FMS tabulates certain payment records with obviously inaccurate TINs by agency and encourages agencies to send payment files with valid TINs in case of noncompliance.[27] However, FMS does not enforce the TIN requirement by rejecting agency payments with blank or obviously inaccurate TINs or requiring the agencies to certify that such payments meet one of the TIN exclusion criteria. As a result, agencies continue to submit payment requests without TINs, and consequently, these payments cannot be levied to collect unpaid federal taxes.

Third, FMS disbursed nearly $3.8 billion in fiscal year 2004 to contractors whose name was not properly contained in the agency-submitted payment files. Instead, the name field in the payment file was either blank or contained numeric characters only.[28] The lack of a proper name could have been detected if FMS had conducted a cursory review of the payment files

[25] Pub. L. No. 104-134, 110 Stat. 1321-358, Apr. 26, 1996.

[26] 31 U.S.C. §7701(c) and (d).

[27] Tabulation is performed for the standard payment types sent through the levy program, that is, payments known as type B. Type A and Fedwire payments are not tabulated or monitored. Type A payments are payments where the agency certifies the payment in the same file that contains detailed payment information. For type B payments, agencies send FMS the certification for the payment separately from the detailed payment information. ACH-CTX payments (a specific kind of type B payment) are payments whereby agencies can pay multiple invoices to a single contractor using a single ACH-CTX payment. Fedwire is a processing system designed for high-dollar, low-volume payments that must be received by payees the same day as originated by the agency.

[28] In addition, we identified numerous payee names that contained only a single alphabetic character in the name field. We did not include these in our analysis of payments with improper name fields.

submitted by the agencies. For example, our review readily identified that most of the payment files submitted by the Department of State (State) did not contain valid contractor names. About $3.2 billion of the nearly $3.8 billion we identified as payments made to contractors without names in the payment files were made on behalf of State. According to a State Department official, State likely had names on its payment files since the 1980s, but a programming error had resulted in the names not being in the disbursement file sent to FMS. While disbursements could be made without a name—as disbursements are made electronically via direct deposit into the contractor's bank account—valid name information is critical because the levy program requires a match between both the name and TIN for a levy to occur.

Last, during fiscal year 2004, FMS disbursed about $5 billion via checks to civilian agency contractors on the basis of agency-submitted payment files that did not contain data in the payment-type field. FMS uses the payment-type field to determine if the payment is subject to the levy program. If the payment-type field is blank, FMS does not attempt to match the payment to unpaid tax debts for potential levy. As a result, none of the $5 billion in payments we identified as having a blank payment-type field could have been levied to collect the contractors' unpaid federal taxes. After we brought this to FMS's attention, an official stated that FMS planned to establish a new centralized program to monitor the completeness of agency information.

Management Decisions Excluded Tens of Billions More in Payments from the Levy Program

In addition to payments not included in the levy program because oversight was lacking, FMS and IRS also made decisions that caused tens of billions of dollars more in contractor payments not to be subject to potential levy collection. Specifically, we found that while FMS disbursed funds using a number of payment mechanisms—including payments known as type A, type B (including ACH-CTX), and Fedwire—FMS has taken actions to include only disbursements made via type B in the levy program. Even then, ACH-CTX—a specialized type B payment—is excluded from the levy program. We also found that FMS does not levy payments to collect the unpaid federal taxes owed by individuals because a small possibility exists that an individual TIN and name may be the same as the TIN and name of an unrelated business. Consequently, IRS instructed FMS not to levy contractor payments to individuals because it did not want to mistakenly levy payments of individuals to pay the debt of an unrelated business.

Although it is responsible for administering the levy program, FMS could not quantify the magnitude of federal contractor payments excluded from the levy program, nor could FMS estimate the amount of levy collections it was missing because it had not included all payment categories in the program. Our work, based on limited data, indicates that at a minimum, $26 billion in payments was made via type A and ACH-CTX that were not subject to the levy process. The $26 billion, although likely understated, represents almost 11 percent of all contractor disbursements recorded in FMS's PACER database. In addition, FMS disbursed approximately $191 billion in Fedwire payments,[29] but was not able to identify the value of payments made to contractors via Fedwire that it did not send to the levy program.

FMS excluded these payments from the levy program because including them would require programming changes to its automated systems or other efforts. Although FMS had performed some preliminary studies in 2001 regarding how to send type A payments to TOP, officials were unable to provide information regarding the cost of making system corrections.[30] At that time, FMS was developing a new payment system that it estimated would be completed as early as 2003 and therefore decided not to make the system changes. However, at the time of our audit, the new system was still not fully deployed. Consequently, over the last 4 years, the federal government has lost an unknown amount of collections that could have been levied from those payments. FMS officials stated that FMS is continuing to focus on completing the deployment of a new disbursement system, which it now estimates will be fully operational in 2006, rather than including type A payments in its current system. FMS tentatively plans to incorporate type A payments into TOP in calendar year 2006 when its new system is scheduled to be operational.

[29] This amount does not include $66 billion in certain benefit payments.

[30] FMS officials stated that it could take additional programming time to prepare TOP to receive type A payment information from other systems. For example, FMS conducted a study in 2001 and estimated that it would take about 6 hours of programming and 1 to 3 days of testing to make the system changes necessary to one system to include type A payments in TOP for levy.

FMS Faces Challenges in Addressing Other Program Limitations

FMS faces other management challenges in matching TINs and names, levying purchase cards, and implementing the 100 percent levy provision of the American Jobs Creation Act of 2004. Specifically, almost $2 billion of contractor payments could not be levied because the TIN and payee name in the payment files did not match with the TIN and "control name" with which IRS provided TOP. In general, the control name is the first four characters of an individual's last name or the first four characters of the business name. If TOP finds a TIN match between the payment file and the file provided by IRS, but cannot find the control name (first four characters of the IRS name) anywhere within the name field of the payment file, TOP reports only the mismatch to IRS, but does not levy payments to collect delinquent tax debts. After we brought this to FMS's and IRS's attention, IRS began working with FMS to increase the number of control names—up to 10 additional control names per business—it sends to TOP. IRS officials believed that this should increase the number of matches available under the levy program. IRS is also evaluating additional changes to increase the number of name controls that it sends to FMS for matching with payments to individuals.

We also found that nearly $10 billion in federal payments made via purchase cards to contractors in fiscal year 2004 are not subject to levy because the government payment is made to the bank that issues the purchase card instead of the contractor doing business with the government. FMS officials have acknowledged the need to address this challenge but stated that FMS faces both operational and legal issues to incorporate such payments into TOP and that the process of paying the purchase-card-issuing bank may prevent FMS from using TOP to collect from contractors paid with a purchase card. In the meantime, the use of purchase cards for federal acquisition purposes continues to increase. Until this challenge is thoroughly examined by FMS and IRS and until solutions are identified, the federal government will continue to be unable to levy or otherwise collect from tens of billions of dollars in payments made to civilian contractors through this mechanism.

Finally, FMS has not fully implemented a new provision, authorized by Congress in October 2004, which increased the maximum levy percentage from 15 percent to 100 percent of payments to contractors with unpaid taxes. Our analysis indicated that if no legal or procedural provisions excluded tax debts from the levy program, a levy of up to 100 percent on all contractor payments would result in FMS's collecting as much as

$800 million[31] annually from civilian contractors. However, because the provision provides for increasing the levy percentage on payments to vendors for "goods and services" sold or leased to the government, IRS has determined that the legal language excluded real estate, such as rent payments, from the new levy requirement. This exclusion presents significant implementation challenges for FMS because the civilian agencies' payment systems at present do not separately identify real estate transactions from other contractor payments. Without the ability to distinguish between these payments, FMS could not implement the new law for civilian payments in such a way as to exempt real estate transactions from the 100 percent levy. FMS officials stated they had recently been able to implement the 100 percent levy provision for certain DOD payments but were unable to do so for disbursements made directly by FMS. According to FMS and IRS officials, a specific legislative change is being sought to subject real estate payments to the new 100 percent levy requirement.

FMS Has Not Taken Action to Establish Reciprocal Agreements with States

As discussed in a separate product,[32] developed at the request of this committee and transmitted to FMS for review and comment on June 7, 2005, FMS has not pursued agreements with the states that could result in the federal and state government's collecting—through the offset of contractor payments—unpaid tax debts on behalf of each other. The Debt Collection Improvement Act of 1996 authorizes these collections if a state enters into a reciprocal agreement with FMS that allows the state and FMS to collect unpaid debt from each other's payments, including payments to their contractors. Despite the potential benefits, the federal government has not yet established any reciprocal agreements with states to offset contractor payments. According to FMS officials, states have not expressed interest in executing such agreements. In fact, the state debt collection officials we contacted,[33] and officials at the Federation of Tax Administrators and at the National Association of State Auditors,

[31] This assumes that the tax debts and payment amount remain constant in future years.

[32] GAO-05-697R.

[33] We contacted debt collection officials of the following 17 states: California, Connecticut, Georgia, Illinois, Hawaii, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Virginia. Collectively, the 17 states received over 75 percent of FMS's collections from the federal tax refund offset program as well as over 75 percent of the federal collections from the State Income Tax Levy Program.

Comptrollers, and Treasurers, informed us that they had not pursued reciprocal agreements because they were not aware that this debt collection avenue exists. The state officials all expressed interest in obtaining more information on potential agreements and in assessing the potential benefits of such agreements.

Our review indicated that many federal contractors paid through FMS have unpaid state tax debt. Our analysis of FMS's payment records found that FMS disbursed a total of about $1.8 billion to over 4,600 federal contractors with state tax debt—primarily tax debt owed by individuals—in fiscal year 2004. These contractors owed approximately $17 million in state tax debt. According to our analysis, if states had reciprocal agreements with FMS, the states could have collected over half of the outstanding state tax debt from these federal contractors in a single year.

Civilian Agency Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

We found abusive and potentially criminal activity related to the federal tax system for all 50 cases that we audited and investigated. The 50 case-study contractors typically operate in wage-based industries, providing security, building maintenance, professional services, health care, and personnel services for the Departments of Homeland Security, Justice, and Veterans Affairs, and the National Aeronautics and Space Administration, to name a few. The contractors are mostly small—many of them, closely held by the owners and officers. In table 2, and on the following pages, we summarize 10 of these businesses. The amount of unpaid taxes associated with these 10 case studies ranged from nearly $400,000 to over $18 million. We found that some case-study contractors had large amounts of unpaid taxes because they were "multiple abusers," i.e., they were one of a group of related companies that owed taxes. Several "multiple abusers" among these 10 cases studies owed taxes for more than 50 tax periods; in one case, a group of about 20 related businesses owed nearly $13 million over more than 300 tax periods. It was also not surprising to find that a few of the business owners among these case studies also owed individual income taxes. Furthermore, we determined that 9 of the 10 case studies had unpaid state and local taxes significant enough that state and local tax taxing authorities had filed tax liens against them.

Our investigations revealed that some owners had substantial personal assets—including commercial real estate, a sports team, or multiple luxury vehicles—yet their businesses failed to remit the payroll taxes withheld from employees' salaries. Several owners owned homes worth over $1 million—one owner had over $3 million and another had over

$30 million in real estate holdings. Others informed our agents that they diverted payroll taxes they had not remitted to IRS for personal gain or to fund their business, while others were engaged in activities that also indicated that they might have diverted payroll taxes for personal gain. For example, one owner transferred the payroll taxes he withheld from employees to a foreign bank account and was using the money to build a home in that country, while another contractor doubled the salary of an officer in a 5-year period to over $750,000 at the same time that the business failed to remit payroll taxes and declared losses for income tax purposes of more than $2 million. In one case, even though the business owed IRS for unpaid payroll taxes withheld from employees' salaries, the business was involved in a joint venture to spend millions on additional facilities and new technologies, some of which will take place outside the United States. In addition, we found that 3 of the 50 case studies involved owners or officers who had been either convicted or indicted for non-tax-related criminal activities or were under IRS investigation. We are referring the 50 cases detailed in our report to IRS so that it can determine whether additional collection action or criminal investigation is warranted.

Table 2: Civilian Agency Contractors with Unpaid Federal Taxes

Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments
1	Health-care-related services to Departments of Veterans' Affairs and Health and Human Services	Over $300,000	Over $18 million	• Business is affiliated with many other health-care-related facilities, including nursing and convalescent homes. • Taxes owed by related entities cover over 80 tax periods. • Since failing to fully remit all the taxes withheld from employees' paychecks starting in the late 1990s, the owner purchased • multimillion-dollar properties, • an unrelated business, and • a number of luxury vehicles. • Other real estate holdings include residential and commercial properties valued in the tens of millions.
2	Waste collection services to the Department of Justice	Over $700,000	Over $2 million	• Company and several other entities share the same address or executives. • Taxes owed by related entities cover over 40 tax periods and include individual income tax debt of one owner. • Since the late 1990s, about the same time that the company failed to pay all of its payroll taxes, the company regularly withdrew cash from its bank accounts. These withdrawals totaled several million dollars. • Since failing to fully remit all the payroll taxes withheld from employees' paychecks, one owner sold his residence for more than $1 million.

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Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments

3	Health-care-related services to the Department of Veterans Affairs	Nearly $250,000	Over $9 million	• Business is affiliated with three other related companies.
				• Taxes owed by related entities cover over 60 tax periods and include the owner's individual income tax debt, totaling hundreds of thousands.
				• One entity is under IRS investigation. In addition, owner suspected of fraudulent banking activity.
				• Since failing to pay taxes
				  • officer spent tens of thousand of dollars on gambling and
				  • one of the three companies had multiple withdrawals of cash from bank accounts—each totaling tens of thousands of dollars.

4	Waste collection services to the Department of Veterans Affairs	Over $10,000	Nearly $13 million	• Company is one of almost 20 related entities, all of which owed unpaid taxes—primarily payroll taxes.
				• Taxes owed by related entities cover over 300 tax periods.
				• The owner also owns
				  • a residential property located near a golf course and
				  • other commercial properties in several states with an assessed value of over $2 million.

5	Payroll and temporary employment services to the Department of Housing and Urban Development	Over $1 million	Nearly $900,000	• Business related to three other entities.
				• Taxes owed by two related entities cover over 20 tax periods.
				• Some tax debts of remaining entities were not paid for so long that IRS is now legally prohibited from seeking collection.
				• The owner's history of delinquency stretches nearly 20 years and covered multiple businesses. Specifically, the owner typically
				  • incurs payroll taxes for one company,
				  • is assessed trust fund penalty on that company but makes no or little payments,
				  • closes company,
				  • starts another company, and
				  • repeats the same pattern.
				• For example, the owner filed for bankruptcy protection in the late 1990s. In the early 2000s, after the court denied the owner's request for bankruptcy protection, the owner closed the company and immediately established a new business with a similar name at the same address that provides the same services.
				• The owner
				  • rents office space in an expensive area of a major metropolitan city and
				  • purchased a luxury automobile at the same time the company had filed for bankruptcy protection and was not remitting all of the payroll taxes.

6	Health-care-related services to Department of Veterans Affairs	Nearly $300,000	Over $10 million	• The company's delinquent taxes—primarily payroll taxes—cover 20 tax periods from the late 1990s. • IRS is investigating the company for potential criminal activity. • Since failing to pay payroll taxes in the late 1990s, the officer who had been assessed the trust fund violation purchased several vehicles totaling nearly $200,000. • Since the late 1990s, the company reported cumulative losses on its tax returns totaling about $5 million. • Despite these continued losses and accumulated tax debt, the company is involved in a multimillion-dollar joint venture.

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Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments
7	Security guard services to Departments of Homeland Security and Veterans Affairs	Over $200,000	Over $400,000	• The company had not filed all required tax returns since the early 2000s, and had been delinquent in payroll taxes almost continuously since the late 1990s. • Delinquent tax debts cover over 25 tax periods and include the owner's individual income taxes totaling tens of thousands. In addition, the owner repeatedly failed to file personal income tax returns. • The owner diverted unpaid payroll taxes to a foreign bank account to build a house overseas.
8	Consulting services to the Smithsonian Institution	Over $200,000	Over $1 million	• The business's unpaid federal taxes are primarily payroll taxes incurred in late 1990s and early 2000s. • Unpaid tax debt balance covers more than 20 tax periods and includes hundreds of thousands of dollars in individual income tax debts owed by two officers. • During the same period that tax debt was incurred, the company also declared large losses but doubled the salary of one officer to over $750,000. • Officers own several luxury vehicles and multimillion-dollar properties in exclusive areas of a major metropolitan area. • The company is making payments on current installment agreement.
9	Armed security guard services to several agencies, including the Department of Justice and the Environmental Protection Agency	About $500,000	Nearly $400,000	• Tax debt balance includes over $200,000 in payroll taxes owed for almost 10 tax periods. • In the early 2000s, company did not file income tax returns. • In the mid-2000s, an officer of the company was convicted for stealing hundreds of thousands of dollars from the company. • The owner is under indictment for embezzlement and money laundering.
10	Building maintenance, lawn and garden, and sanitary services to Department of Transportation	Over $300,000	Nearly $400,000	• This business did not make any payroll tax deposits for several years from the late 1990s through the early 2000s. • Tax debt balance covers more than 30 tax periods and includes nearly $100,000 in personal tax debt of the officer. • The company is a chronic nonpayer of corporate tax debts and has not made any voluntary income tax payments since the mid-1990s. • The officer is also a chronic nonfiler of his individual income taxes. In one of those years, the officer reported net income of about $100,000 but paid no taxes.

Source: GAO's analysis of civilian agency, IRS, FMS, public, and other records.

Notes: Dollar amounts are rounded for the tax debt, estimated maximum levy, and government payments. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes.

[a] Civilian agency vendor payments provided by FMS from its PACER system.

[b] Unpaid tax amount as of September 30, 2004.

The following provides illustrative detailed information on several of these cases.

Case 1: This case includes many related companies that provide health care services for the Department of Veterans Affairs, for which they received over $300,000 in payments during fiscal year 2004. The related companies have different names, operate in a number of different locations, and use at least several other TINs. However, they share a common owner and contact address. The businesses collectively owed more than $18 million in tax debts—of which nearly $17 million is unpaid payroll taxes dating back to the mid-1990s. IRS has assessed a multimillion-dollar trust fund penalty for willful failure to remit payroll taxes on each of two officers. During the early 2000s, at the time when the owner's business and related companies were still incurring payroll tax debts, the owner purchased a number of multimillion-dollar properties, an unrelated business, and a number of luxury vehicles. Our investigation also determined that real estate holdings registered to the owner totaled more than $30 million.

Case 2: This case comprises a number of related entities, all of which provide waste collection and recycling services. These entities received fiscal year 2004 payments from the Department of Justice totaling over $700,000, about half of which is from purchase card payments, while owing in aggregate over $2 million in tax debt. These taxes date to the late 1990s and consist primarily of payroll taxes. Despite the fact that the company reportedly used legally available means to repeatedly block federal efforts to file liens against the company, liens totaling more than $1 million exist against the company. IRS has also assessed trust fund penalties against the two officers. At the same time that the entities were incurring the tax debt, cash withdrawals totaling millions of dollars were made against the business's bank account. Furthermore, since the company started owing taxes, the owner had sold real estate valued at over $1 million. The executives of these entities drive late-model luxury or antique automobiles. Recently, the company started to make payments on its taxes.

Case 3: This case includes several nursing care facilities, three of which owed taxes—primarily payroll—totaling nearly $9 million. In addition, the owner's individual income tax debt totaled more than $400,000, bringing the total tax debt of this case study contractor to over $9 million. One business provides nursing care services for the Department of Veterans Affairs, for which it was paid over $200,000 during fiscal year 2004. An officer of the company has been assessed a multimillion-dollar trust fund

penalty for willful failure to remit payroll taxes and was recently arrested on fraud charges. Our investigative work indicates that an owner made multiple cash withdrawals, each valued at tens of thousands of dollars, in the early 2000s while owing payroll taxes and that these cash withdrawals were used for gambling. We further determined that cash transfers totaling over $7 million were made in a 7-month period in the early 2000s.

Case 7: This contractor provided guard and armed security services for the Department of Homeland Security and the Department of Veterans Affairs, for which it was paid over $200,000 during fiscal year 2004. This business has a history of noncompliance with federal tax laws. Specifically, the business was consistently delinquent in paying its taxes since the late 1990s and has not filed all its income and payroll tax returns for a number of years in the late 1990s. In the last 1-year period that the business made payroll tax deposits, the business reported that it owed nearly $80,000 in payroll taxes but made payments totaling less than $4,000—about one-twentieth of the taxes owed. At the same time that the owner withheld but failed to remit payroll taxes, the owner diverted the money into a foreign bank account to build a house overseas.

Case 8: During fiscal year 2004, this company provided consulting services for the Smithsonian Institution, for which it received over $200,000. Starting in the late 1990s, the company did not remit to the government all the money it withheld from its employees' salaries. However, at about the time the company was failing to remit the taxes, it nearly doubled one officer's salary to over $750,000. IRS assessed a trust fund penalty on the officers of this company for willfully failing to remit payroll taxes withheld from their employees' salaries. Those officers own homes valued at millions of dollars in exclusive neighborhoods in a large metropolitan area and several late-model luxury vehicles.

Concluding Comments

In the current environment of federal deficits and rising obligations, the federal government cannot afford to leave hundreds of millions of dollars in taxes uncollected each year. However, this is precisely what has been occurring with respect to the FPLP. The levy program has thus far been inhibited from achieving its potential primarily because substantial tax debt is not subject to levy and because FMS, the nation's debt collector, has not exercised effective and proactive oversight and management of the program. Overall, the problems we discuss throughout our companion report issued today paint a picture of a program badly in need of management overhaul. Until FMS takes decisive actions to improve

oversight and management of the program, there will be a persistent loss of collections and contractors will continue to be able to abuse the tax system with little consequence.

Furthermore, by failing to pay taxes on their income or diverting the payroll taxes withheld from their employee's salaries to fund business operations or their own personal lifestyles, contractors with unpaid tax debts effectively decrease their operating costs. The lower operating costs provide these individuals and their companies with an unfair competitive advantage over the vast majority of companies that pay their fair share of taxes. Over time, this could lead to further erosion in taxpayers' confidence in the fairness of the nation's tax system, leading to increased rates of noncompliance with the nation's tax laws. Federal contractors should be held to a high degree of responsibility to pay their fair share of taxes owed because they are being paid by the government, and the failure to effectively enforce the tax laws against them encourages noncompliance among other contractors as well. The federal government will continue to lose hundreds of millions of dollars in tax collections annually until actions are taken to send all payments to the levy program, ensure that all payments have the information necessary to allow them to be levied, and establish a proactive approach toward managing the levy program.

Our companion report includes 18 recommendations to FMS and one to IRS. Our recommendations to FMS address the need to improve implementation of the FPLP so that FMS can increase by tens of millions of dollars annually the amount levied from payments to contractors with unpaid federal taxes, including the need to identify and correct payments made to contractors without valid taxpayer identification numbers and implement procedures to provide reasonable assurance that all eligible payments are submitted for levy. Our recommendation to IRS calls for it to investigate and, if warranted, pursue collection or criminal investigation of the 50 case study contractors identified in the report. In written comments on a draft of the companion report, IRS agreed with our findings and recommendations, and pointed to efforts that it has taken to deal with contractors who abuse the federal tax system. FMS partially agreed with our recommendations. However, while not disputing the substance of our findings, FMS disagreed that its management of the program was ineffective. FMS stated that it believed that it had provided excellent leadership of the levy program, that the weaknesses we cited in the companion report were the result of difficult management choices, and that the responsibility for managing the levy program rests with IRS. FMS also disagreed with our conclusion that it had not fully implemented the

100 percent levy provision. FMS also did not agree with two of our recommendations, specifically, that it should withhold payments to vendors without names in the agency payment files and that it work with IRS to explore options to levy payments or otherwise collect outstanding tax debt from contractors paid by purchase card vendors.

We continue to believe that the problems we discuss throughout the companion report paint a picture of a program badly in need of management overhaul. Although IRS has a key responsibility to refer tax debts, FMS has an equally key responsibility to make all payments available for levy. We continue to believe that all of our recommendations constitute valid and necessary courses of action, especially in light of the identified weaknesses and the slow progress that FMS has made to maximize collections since the passage of the Debt Collection Improvement Act more than 8 years ago.

Mr. Chairman; Members of the Subcommittee; and Senators Collins, Levin, and Akaka, this concludes our prepared statement. We would be pleased to answer any questions you may have.

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PREPARED TESTIMONY OF
MARK W. EVERSON,
COMMISSIONER OF INTERNAL REVENUE,
BEFORE THE SENATE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
ON
COLLECTING TAXES FROM CIVILIAN CONTRACTORS
JUNE 16, 2005

INTRODUCTION AND SUMMARY

Chairman Coleman, Senator Levin, and distinguished members of the Subcommittee, I want to thank you for the opportunity to testify before your Subcommittee today on collecting taxes from civilian contractors. I testified before this Subcommittee last year on Department of Defense (DoD) contractors who owed taxes. With the Subcommittee's support, we have made good progress on bringing these delinquent taxpayers into compliance. As with the DoD contractors from last year's hearing, it is unfair for hardworking, honest contractors to be placed at a disadvantage because their competitors are avoiding paying taxes.

Our working equation at the Internal Revenue Service (IRS) is Service plus Enforcement equals Compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes. This is not an issue of Service OR Enforcement, but Service AND Enforcement. As you know, IRS service lagged in the 1990s. In response, we took important and necessary steps to upgrade service; to name just a couple areas, we significantly improved the answering of taxpayer telephone inquiries and electronic filing of tax returns. Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. After 1996, the number of IRS revenue agents, officers, and criminal investigators dropped by over 25 percent.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four Servicewide enforcement priorities.

ENFORCEMENT PRIORITIES

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year – double the number from 2000.

- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.

- In 2004, the number of audits of the largest businesses – those with assets of $10 million or more – finally increased after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past twelve months.

We have continued our program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. In May 2004, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed, plus payment of a penalty. I am pleased with the response to the offer. So far, $3.7 billion in taxes, interest and penalties have been collected from the 1,231 taxpayers who are participating in the settlement initiative. The typical taxpayer payment was almost $1 million, with 20 taxpayers paying more than $20 million each and one paying over $100 million.

In February 2005, we announced a second important settlement initiative – this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. It is now more likely non-compliant taxpayers will have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like "How much am I going to have to pay the lawyers and expert witnesses to litigate this thing?" Moreover, going to court is a public matter. Damage to one's reputation is a potential factor.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the U.S. working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions that, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global economy, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

The government stepped up its use of civil injunctions in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars, or through other means. Since that time, the courts have issued injunctions against more than 100 abusive scheme promoters. They have issued injunctions against 17 abusive return preparers – all permanent injunctions. And an additional 49 suits have been filed by the Justice Department seeking injunctions – 28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer's name while retaining control;
- Misusing "corporation sole" laws to establish phony religious organizations;
- Using frivolous "Section 861" arguments to evade employment taxes;
- Claiming personal housing and living expenses as business expenses;
- Filing tax returns reporting "zero income"; and
- Misusing the Disabled Access Credit.

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice for an injunction action, and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners, including return preparers. The vast majority of these practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax

shelters. The IRS standards set forth detailed requirements for what an independent opinion about a tax shelter must say.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted, and the President signed into law, the American Jobs Creation Act of 2004. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement priority is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity. Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year.

We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters – both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that in the past, our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway.

Our fourth enforcement priority is to discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, certain credit counseling agencies. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

Some shelter promoters use tax-exempt organizations to create abusive shelters. In some cases, the organization receives a fee for allowing the promoter to exploit its

tax-free status. A tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status.

It is heartening to see leading members of the nonprofit community taking steps to address abuses. I particularly want to salute the Independent Sector, which recently delivered a constructive report to the Senate Finance Committee. The report states that "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be as enthusiastic about confronting abuses and the erosion of professional ethics as the nonprofit community. An interesting point to note is that the report supports mandatory electronic filing of annual information returns by all nonprofits.

The focus on problems with compliance we are now encountering in the tax-exempt sector should not overshadow the inspiring work the charitable community does day-in and day-out. The overwhelming majority of these organizations try hard to comply with the letter and spirit of the tax law. But where tax abuse is present in the sector, we intend to address it. We are augmenting our resources in the nonprofit area. By the end of September, we will have increased the number of our personnel who audit tax-exempt organizations by over 30 percent from two years earlier. If we do not act expeditiously, there is a risk that bad actors who abuse tax benefits for charities will tarnish those charities that do good work. If that happens, Americans may be more reluctant to give and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within our Fiscal Year (FY) 2006 budget request.

COLLECTING TAXES FROM DELINQUENT CONTRACTORS

Let me now turn to the Government Accountability Office (GAO) report and collecting taxes from delinquent civilian contractors.

Let me say upfront that I agree with GAO that we must continue to enhance the use of the Federal Payment Levy Program (FPLP) as a tool to deal with contractors who abuse the federal tax system. I will discuss in the body of my testimony the steps already taken to enhance the FPLP and increase the number of tax debts available for levy. Regarding the 50 cases identified by GAO, our Criminal Investigation Division is in the process of reviewing these cases to determine whether there is evidence of potential criminal tax evasion or failure to pay that would warrant opening a formal criminal investigation. In addition, my headquarters collection leadership has reviewed each case, validated that FPLP inclusion or exclusion decisions were correct, and directed local executives to become involved to ensure appropriate case direction and action.

When I appeared before this Subcommittee in February 2004 to discuss collecting taxes from DoD contractors, I spoke about the establishment of a joint task force that would make recommendations on short-term operational improvements, mid- and long-term operational changes, and potential statutory proposals that could improve the collection of taxes from federal contractors. In March 2004, the IRS, the Financial Management Service (FMS), and DoD established the Federal Contractor Tax Compliance Task Force (FCTC), which also included representatives from the General Services Administration (GSA), the Office of Management and Budget (OMB), and the Department of Justice.

I am pleased to report that since that time, the task force has made several recommendations and has implemented actions to ensure federal contractors pay their taxes and that we take appropriate enforcement actions, including levies, to collect unpaid taxes. The collaborative efforts of the federal agencies represented on the FCTC task force have already resulted in tremendous benefits as evidenced by the improved program results. I will discuss these results later in my testimony.

The FCTC provides an excellent forum to identify opportunities for continued improvement, work cross-agency implementation plans, and expedite resolution of issues. While much of the initial work of the task force focused on DoD issues, most recommendations and planned future actions benefit both the DoD and civilian contractor programs. We will continue to use this task force to address the issues that GAO identifies in its most recent report and to pursue further enhancements to the FPLP.

We agree, as GAO discusses in its report, that there are challenges to collecting unpaid taxes of contractors paid using purchase cards. As GAO notes, the purchase card program yields significant savings and efficiencies for the governmentwide procurement system. However, due to the complexity of the purchase card payment process, vendors are paid in a manner that prevents the offset of other debts, including taxes. We will partner with FMS and the other agencies through the FCTC to conduct further analysis of this issue. Members of the task force from FMS, the IRS, and the Defense Finance and Accounting Service have already held initial meetings with GSA.

In its report, GAO indicates that hundreds of millions of dollars could be collected if all unpaid taxes were made available for levy. This figure includes debts that cannot legally be levied due to statutory safeguards or that are excluded from the program for operational reasons. For example, GAO notes that many cases were excluded from levy, or levy was delayed, because taxpayers had not yet been afforded their Collection Due Process rights. Collection Due Process, referred to as CDP, is a statutory provision of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98), the purpose of which is to ensure taxpayers are fully informed about their liability, the delinquency, and the government's intention to pursue enforcement action. It provides taxpayers an opportunity to have his or her case reviewed by the IRS Office of Appeals and to have the case reviewed by a court if no resolution can be reached.

Protecting all taxpayer rights, including CDP rights, is a cornerstone of our collection process, even when it means collection action is delayed.

I believe all federal contractors should be held to high standards. Compared to contractors in the private sector, for instance, federal contractors face stiffer penalties and more regulations involving equal opportunity and other laws. Contractors receiving taxpayer dollars should not cheat these very same taxpayers by passing their tax bills onto them. While we recognize that taxpayers may have legitimate differences with the IRS regarding their tax obligations, there are specific mechanisms for addressing those differences. Simply ignoring, or actively evading, one's tax obligations should not be acceptable.

FEDERAL PAYMENT LEVY PROGRAM

As part of the overall collection process, we agree that the FPLP can become a more effective tool to collect delinquent federal taxes owed by businesses and individuals who receive federal payments, including the cited civilian contractors. We continue to explore additional ways to take full advantage of the FPLP and speed the collection of delinquent taxes.

The FPLP program provides an automated process for serving tax levies and collecting unpaid taxes through FMS. The FMS uses its Treasury Offset Program (TOP) to match certain types of federal payments against federal tax debt records. As a result, the program applies a portion of these federal payments to the outstanding tax liabilities. The Administration has proposed improving the FPLP program by allowing FMS to retain directly a portion of the levied funds as payment for FMS's fees.

I would now like to outline the steps we have taken to enhance the FPLP. The IRS removed many of the operational exclusions that had prevented tax debts from being available for levy through the FPLP. Consequently, as of April 2005, $98 billion in tax debts were included in the FPLP, an increase of over $28 billion from the prior year. Total FPLP collections in FY 2005 through May exceeded $126 million, compared to $66 million during the same period of FY 2004. A similar comparison for collections from federal contractors shows an even more significant increase – $26 million through May 2005, compared to $8.1 million through May 2004. From civilian contractors, we have collected $14 million in FY 2005, compared to $6.7 million in the same period of FY 2004.

We have taken several steps to improve the timing of the CDP notice. We implemented a monthly data exchange with the DoD that enables issuance of the CDP notice at the time of contract award rather than after a contract payment is made. As a result, the IRS will be in a position to levy an increased number of contractor payments without a delay. Through May 2005, we have accelerated over 7,000 CDP notices. This process will be expanded later this year to all federal contractors awarded contracts over $2,500 when the GSA Federal Procurement Data System – Next Generation replaces the existing DoD system.

In addition, working with the Treasury Department, we are considering whether to recommend a legislative proposal to allow a post-levy CDP process on federal payments to contractors. This change could further improve our ability to levy earlier on an increased number of contractor payments. We are also working to change our business tax collection process to combine the CDP notice with the final notice, making more debts ready for levy at the time of inclusion in the TOP. These changes provide an opportunity for taxpayer relief and appropriate judicial review, while improving our efficiency in the collection process. This will also enhance our ability to improve the timeliness of the FPLP levy process.

On April 15, 2005, we implemented the recently enacted 100 percent levy provision on certain DoD contracts paid through the largest DoD payment system. The remaining DoD vendor payment systems will be implemented in July 2005. Full implementation of this provision has been complicated because it only permits a 100 percent continuous levy in the case of payments for "goods and services" and does not appear to apply to payments made for other kinds of property. We will continue to partner with FMS on full implementation of this provision.

We agree with GAO and this Subcommittee that the Central Contract Registration (CCR) database should be a repository for correct Taxpayer Identification Numbers (TINs), which may then be used by all federal agencies for making payments to contractors (and, where required, for information reporting to the IRS on these payments). We also support the Subcommittee's efforts to improve the accuracy of federal contractor names and TINs. In order to increase the number of name and TIN matches with FMS, in January 2006, the IRS will begin sending FMS up to ten additional historical business control names for each account to be matched against payment data. We are also developing, in conjunction with DoD, a TIN-verification system that will require contractors interested in doing business with the federal government to consent to validation of their name and TIN as a condition of registration in the CCR. Implementation of this process is planned for October 2005. If, after the program is up and running, we identify problems that cannot be addressed under current law, we will consider whether to recommend statutory changes that should be made to further enhance the TIN-validation process. Ensuring accuracy of TINs in the CCR will improve our ability to match tax debts and payments for levy and increase the collection of contractor's unpaid taxes, as well as enhance the accuracy of information reporting.

GAO notes that we have only recently decided to match individual tax debts against vendor payment files. That match will begin in November 2005. The approach we took to making this decision illustrates the great care we have taken since the inception of FPLP to ensure that our automated levy process can sufficiently distinguish among taxpayers and does not mistakenly seize a payment to collect a debt owed by another taxpayer. We decided to go forward with this change only after we determined that the risk of a wrongful levy occurring was extremely low. As we review other categories of

cases excluded from FPLP, we expect to proceed with the same care in order to protect all individuals and businesses to whom federal payments are being made.

We are also reviewing cases in our exclusion categories to identify potential coding errors in our systems that may prevent or delay cases from entering the FPLP. Some of the potential coding errors cited by GAO result from systems and coding implemented to ensure no taxpayer's rights are violated, and no taxpayer is levied inappropriately. We are reviewing our processes to identify systemic and manual corrections that may be needed.

While we have taken significant actions to increase the dollars available for levy, as GAO acknowledges in its report, a substantial amount of tax debt ($71 billion) is excluded from the levy program for statutory reasons. These excluded debts include those for taxpayers who are in bankruptcy, have an installment agreement, or have not yet received their appeal rights prior to levy. The IRS must continue to honor these statutory taxpayer rights as enacted by Congress. Another $99 billion is excluded from the levy program due to IRS policy including, as an example, tax debts of taxpayers who are experiencing a financial hardship. We continuously evaluate these policy exclusions to ensure that they are no broader than necessary.

COLLECTION CHALLENGES AND EARLY PREVENTION

Over the last year, we have taken several steps to improve our collection efforts on complex cases like the 50 cases cited by GAO. We have reorganized our SB/SE Operating Division in a manner that provides top-down executive leadership focused on the collection function. The Internal Revenue Manual has been revised to provide clearer guidance on when to file notices of federal tax lien, to place greater emphasis on field contact with delinquent taxpayers, and to require additional managerial oversight and direction on specific cases. We are providing revenue officers with several new training opportunities to improve the quality and effectiveness of field casework. These include new training on maximizing effective contacts and actions on cases involving continued trust fund tax non-compliance, training designed to refine investigation and research techniques, and training to promote better analysis of the financial condition of a delinquent taxpayer. Field managers have access to training "toolkits" for use in improving the quality of work in their groups. Subjects include financial analysis, streamlined procedures for seeking injunctions, and working employment tax cases in which taxpayers have little or no assets from which to collect. We recently stood up a web site to support the use of on-line research to research taxpayers' ability to pay. All of these efforts are enhanced by a new system of structured consultation between managers and revenue officers. We hope this will help revenue officers leverage the knowledge of their field managers throughout the life of a collection case.

The complexities found in the 50 contractor cases cited by GAO illustrate both the limits of an automated levy program and the need to fully fund the Administration's enforcement budget request. These types of cases can only be sufficiently addressed through hard work by our field collection function. The Administration's budget request

must be fully funded in order to keep revenue officers on the front line and give them the tools they need. I am committed to improving our use of available electronic research techniques to improve nonfiler case creation processes and to help detect the kind of inter-related tax delinquencies cited in the report.

TAXPAYER PROTECTION AFFECTING ACCOUNTS ELIGIBLE FOR FPLP

Although we are examining ways in which the FPLP can be made more effective, important statutory protections limit the number of outstanding accounts that may be eligible for referral to the FPLP at any given time. In general, these provisions prohibit levy action when a taxpayer takes actions either to attempt to resolve an outstanding tax liability or to challenge a collection action such as a proposed levy.

When enacted in 1997, the use of the new continuous levy authority, as with all levies, was generally limited under the Internal Revenue Code only by certain notice provisions, such as the notice and demand for payment under section 6303 and the notice of intent to levy under section 6331(d)(1). These automated notices gave taxpayers the opportunity to pay prior to levy and the opportunity to propose alternative payment arrangements but did not erect significant barriers to collection should a taxpayer neglect to do so.

In RRA '98, Congress added additional taxpayer protections that can significantly postpone use of the federal payment levy:

- Section 6330 generally prohibits the use of any levy (including continuous levies by FMS as part of the FPLP) unless the IRS has notified the taxpayer of his or her right to a CDP hearing. If the taxpayer requests a CDP hearing, then the proposed levy cannot proceed until the resolution of that hearing, which may involve judicial review. The IRS must give taxpayers an opportunity to respond to the CDP notice, and suspends levy action during this period, even if the taxpayer ultimately does not request a CDP hearing.

- Section 6331(k) generally prohibits levy action when a taxpayer has proposed to compromise a tax liability or seeks to enter into an installment agreement (IA). A taxpayer may appeal the rejection of an offer in compromise (OIC) or proposed installment agreement to the IRS Office of Appeals, and the prohibition on levy continues while this appeal is pending.

- Section 6331(*i*) prohibits the making of levies during the period that a taxpayer's refund suit for a divisible tax (such as employment taxes) is pending in federal district court. Thus, if such a suit were pending with respect to employment taxes relating to a particular employee and a particular tax period, the IRS generally could not commence a levy to collect from that employer. In some cases, the IRS will be prohibited from collecting unpaid taxes not directly involved in the refund action, such as taxes relating to other tax period or different employees.

Some of the other statutory provisions that affect the eligibility of an account for FPLP include those relating to Innocent and Injured Spouse claims and Taxpayer Assistance Orders by the National Taxpayer Advocate. Military personnel serving in a designated combat zone are further excluded.

Mr. Chairman, the IRS has and must continue to honor these statutory taxpayer rights. Although these provisions may limit the accounts that may be eligible for the FPLP, Congress enacted these provisions to provide important protections to taxpayers. Although we are continually examining how we can make all of our operations, including the collection process, more efficient, the changes we make cannot be at the expense of taxpayer protections.

At the same time, we are aware that some taxpayers are abusing the safeguards enacted by Congress and are using these provisions to improperly delay and impede tax administration. Some taxpayers, for example, are basing offers to compromise a liability or CDP hearing requests on frivolous arguments that are utterly lacking in merit. Although we deal with these frivolous submissions, doing so takes time and provides these taxpayers with protection from levy in the interim. This not only is a waste of IRS resources but also is unfair to the vast majority of taxpayers who do their best to pay their fair share and to those taxpayers who are using these procedures as a legitimate attempt to address their tax obligations.

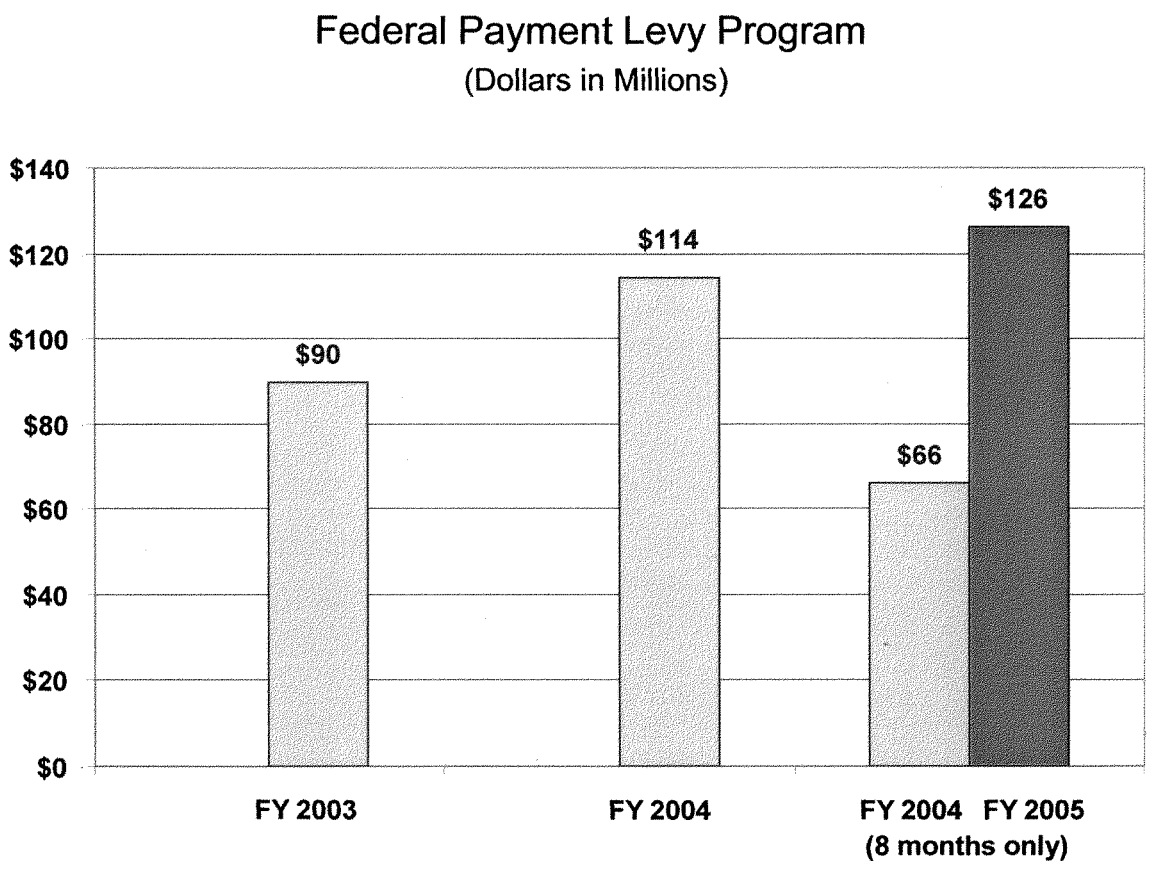
Pending legislation (H.R. 3) will permit IRS to levy despite CDP or OIC filings or applications for installment agreements in cases where it can be shown the CDP, OIC, or the IA request is frivolous. This provision also increases the penalty for filing frivolous tax returns from $500 to $5,000, and expands this penalty to apply to OICs, CDP requests, and other documents.

CONCLUSION

Mr. Chairman, the IRS welcomes the findings and recommendations made by the Government Accountability Office. We will work with the Subcommittee, the Financial Management Service, the GAO and all other affected parties to deal with these specific contractor cases and to improve and revise the way we work future cases.

The FPLP is an effective automated process for serving tax levies and collecting unpaid taxes. We will continue to work with the FCTC to pursue further enhancements to the FPLP. The FCTC provides an excellent forum to identify opportunities for continued improvement, work cross-agency implementation plans, and expedite resolution of issues.

Lastly, I once again urge the Congress to support the Administration's FY 2006 budget request for the IRS. It is critical to ensuring that we have an effective enforcement program and to maintaining the public's confidence in the fairness of our system. Thank you, and I would be happy to answer any questions you have.


Federal Payment Levy Program
(Dollars in Millions)
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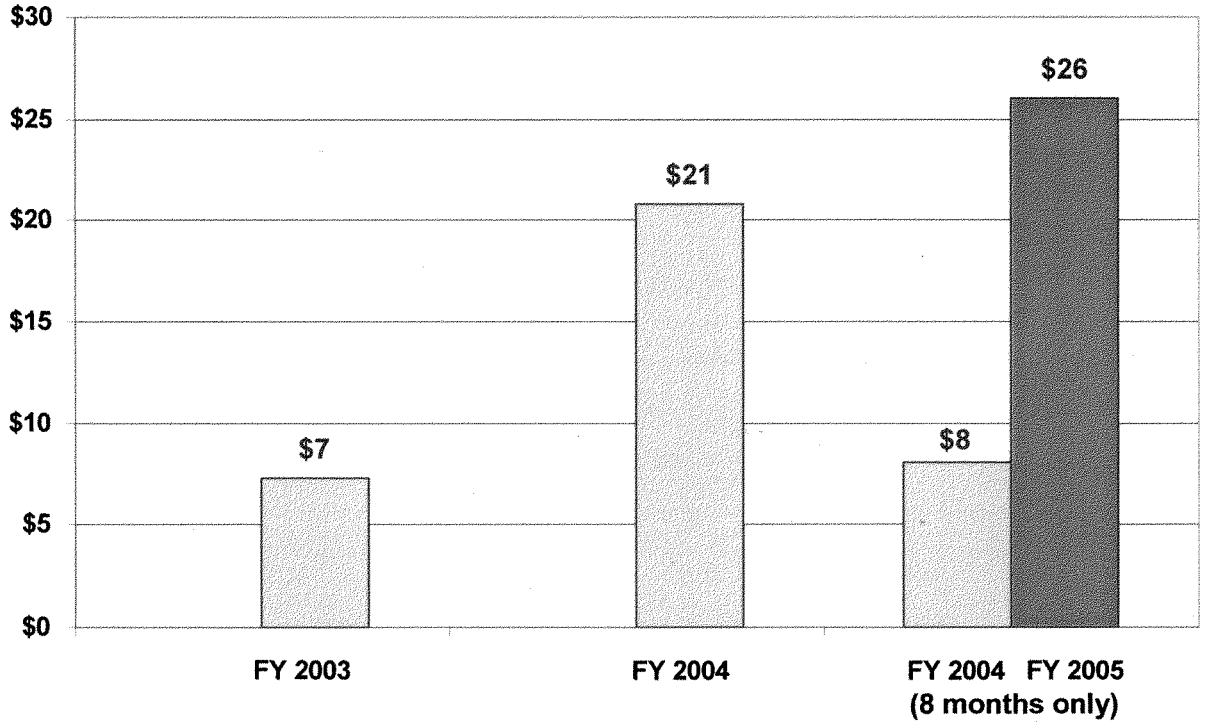
$120
$100
$80
$60
$40
$20
$0
$90
$114
$66
$126
FY 2003
FY 2004
FY 2004
(8 months only)
FY 2005

Levy Program – Federal Contractors Only
(Dollars in Millions)



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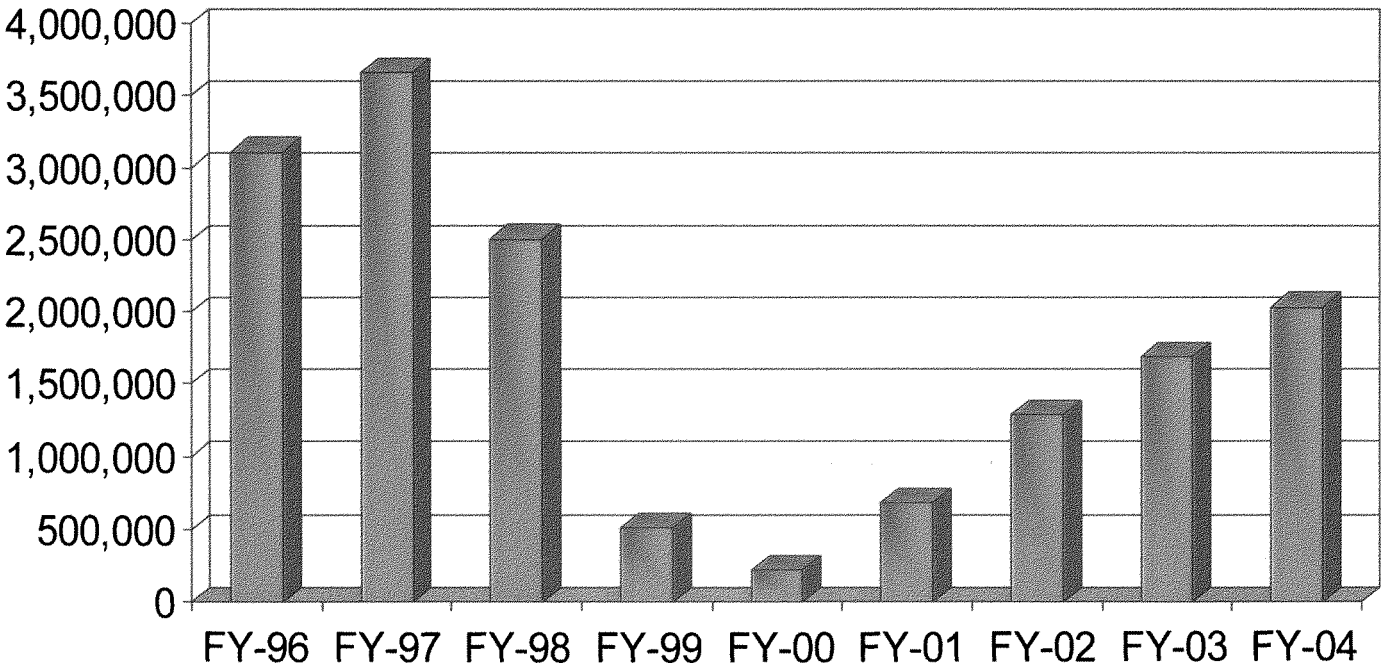
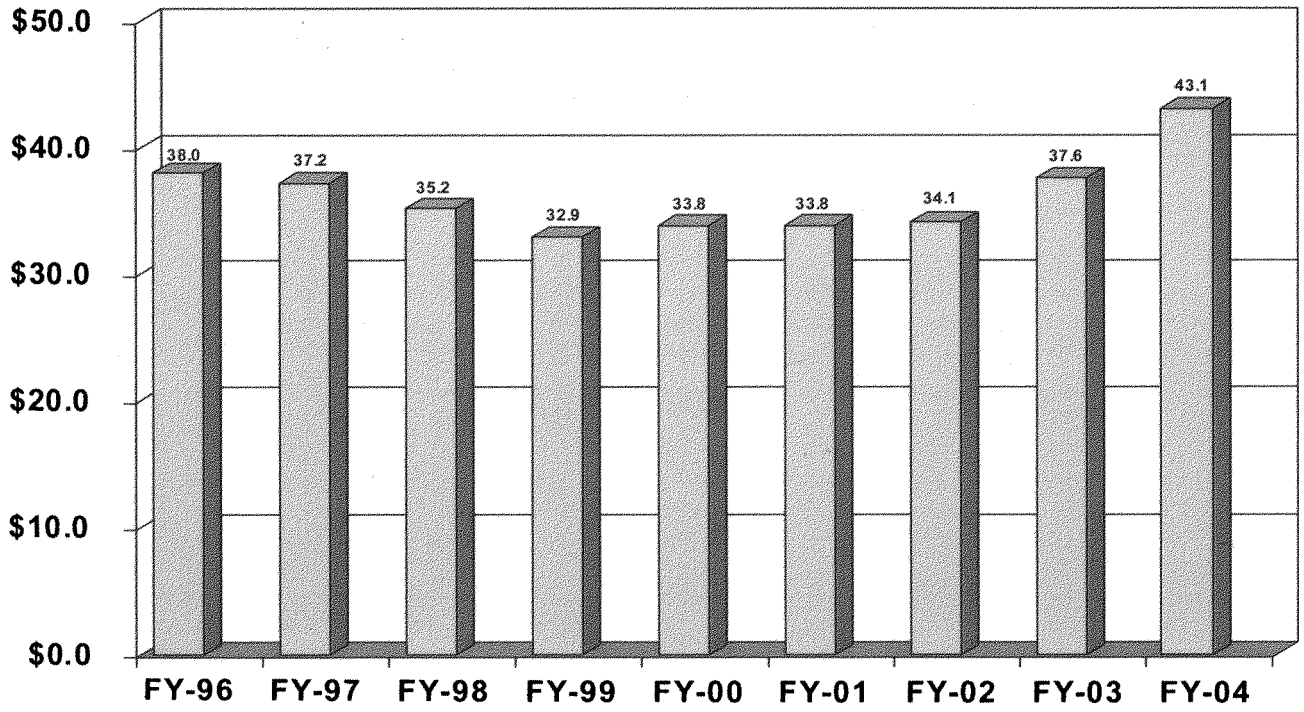


IRS Enforcement Revenue

Dollars in Billions



STATEMENT OF COMMISSIONER RICHARD GREGG
U.S. DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
BEFORE THE UNITED STATES SENATE
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Thursday, June 16, 2005
Washington, DC

Chairman Coleman, Ranking Member Levin, and Subcommittee members, I welcome the opportunity to discuss the role of the Financial Management Service (FMS) in the collection of delinquent federal tax debt owed by federal contractors conducting business with civilian agencies.

Mr. Chairman, I believe that FMS has a track record that clearly demonstrates excellent leadership and program management with respect to the government wide collection of debts, both non-tax and tax. Since the inception of the Debt Collection Improvement Act of 1996, FMS has collected over $24 billion in delinquent debts that would otherwise not have been recovered. More importantly, for the past several years, virtually every trend line shows strong increases in collections, with more than $400 million collected in the tax levy program alone.

Our effective management of the levy program is demonstrated by the fact that through the first eight months of this fiscal year, FMS has collected more tax debts ($126 million) on behalf of the Internal Revenue Service (IRS) than in any previous fiscal year. Of key interest to this subcommittee, the collection of tax debts by levying vendor payments has increased to $26 million in the first eight months of FY 2005 compared to $20.8 million in all of FY 2004.

We will continue to make improvements in fulfilling our responsibilities, recognizing, of course, that managing any program involves making choices and setting priorities. FMS has made such choices in managing our limited, but nonetheless important, complex part of the tax levy program. We have allocated resources to the highest management priorities to maximize collections and ensure that proper management controls are in place. The growth of the debt collection program in general and the levy program in particular is a result of setting plans and priorities and then maintaining the focus and discipline to execute them.

In my statement this morning, I will use my time to discuss the actions FMS is taking in response to four key recommendations made by the Government Accountability Office (GAO) regarding the tax levy program and its use in the collection of tax debts owed by civilian agency contractors. Specifically, I will address GAO's recommendations regarding: improving agency compliance with providing valid taxpayer identification

numbers (TINs) and names on payments made to contractors; implementing procedures to ensure that all eligible payments to contractors with unpaid federal taxes are included in the federal payment levy process; the levy of purchase card payments; and our implementation of recent legislation authorizing IRS to levy up to 100 percent of certain federal vendor payments. Finally, I will share my thoughts on the work of the Federal Contractor Tax Compliance Task Force.

Valid Taxpayer Identification Numbers and Names

GAO has recommended that FMS reject payment requests that do not contain the information necessary to carry out the levy process. Such action on the part of FMS has great potential to interfere with the timely disbursement of federal funds to *contractors who do not owe delinquent taxes,* but even more important, it would blur important legal authorities and responsibilities.

As the federal government's chief disbursing office, FMS ensures that certified payments submitted to FMS are disbursed in a timely and accurate manner. The certifying officials at federal program agencies are responsible for ensuring the accuracy and validity of the payment information (name, TIN, payment type) and for ensuring that the payment is legally authorized. Federal law provides that the certifying official is responsible for the information contained on a certified voucher. Putting FMS in a position of "picking and choosing" which payments to disburse would blur the critical distinction between the agency certification authority and FMS disbursement authority.

I believe a better approach is to step up our efforts to monitor and ensure agency compliance. A major step forward relates to a recommendation by the Federal Contractor Tax Compliance Task Force (Task Force). In October, a program will be implemented whereby, as part of the contractor registration process, a registering contractor's TIN number will be validated. If the TIN cannot be validated, with very few exceptions, the contractor will not be eligible to conduct business with DOD or any other federal agency.

As part of our stepped-up efforts, FMS has also begun sending reports on a monthly basis to all CFOs providing updates on their agency TIN, name and payment type compliance. We will work closely with those agencies whose payment requests continue to contain incomplete information. This will also help to improve compliance.

In addition, FMS is working with the Federal Credit Council, a group of top executives of creditor agencies, and the Council's debt collection subcommittee regarding TIN, name, and payment type compliance issues.

We will evaluate this multi-faceted approach after one year and determine, at that time, whether withholding payments should be reconsidered.

All Contractor Payments in the Levy Process

GAO has recommended that FMS develop and implement procedures to include Type A, Automated Clearing House-Corporate Trade Exchange (ACH-CTX) and Fedwire payments in the levy process. FMS fully agrees with the goal of including all eligible contractor payments and I would like to update you on the actions we have taken to levy Type A payments and our plans to address ACH-CTX and Fedwire payments.

Type A payments are often unanticipated payments typically made by agencies that do not have the payment volume to support sending large-scale bulk payment files. Disaster relief payments are an example of Type A payments. FMS is currently implementing system changes that will allow for the levy of these payments. We will begin levying these payments later this year and expect to be fully operational next year.

The Fedwire payment system is used for low-volume, high dollar transactions that are deposited into recipients' bank accounts on the same business day. This same-day payment requirement for Fedwire is in contrast to our normal electronic and check payments where FMS has more time to match the payment file against our debtor data base. Because of Fedwire's same-day payment requirement, operational and program changes to include these payments in the levy process would be extremely difficult and would increase the risk of late or erroneous payments. While the dollar value of payments that run through Fedwire is large, federal agencies have advised us that only a small percentage of these payments are disbursed to federal contractors. In the last several weeks, FMS has begun to work with agencies to identify more precisely the payments in the Fedwire portfolio. In the near future, FMS will make systems changes which will require agencies to identify in all instances the types of payments being made by Fedwire.

In addition, we are developing new guidelines for all federal agencies to submit contractor payment requests to payment systems that can be levied. We will notify agencies about these new guidelines in the next monthly letter to agency CFOs.

Our approach should help to minimize the number of contractor payments going through Fedwire, but it does not resolve the larger issue of whether FMS' overall debt collection program can offset or levy the remaining Fedwire payments. Within the next year we will conduct an analysis of the payments going through Fedwire; the potential delinquent debts that could be collected if we were able to offset or levy those payments; and a determination of whether the additional amounts of debt that could be collected warrant the program changes that would be needed to the Fedwire application.

ACH-CTX payments are used for multiple payments to the same payee or one payment with multiple invoices and allow for transmitting with the payment complete remittance information. While this system is an appropriate and cost-effective way for agencies to

make vendor payments, given the relatively small volume of payments going through ACH-CTX, the complexity of those payment files, and FMS' need to set priorities, we have not yet decided how to levy these payments. We will conduct an analysis of ACH-CTX payments to determine the feasibility and potential benefits of modifying the system for levy.

Purchase Card Program

I would also like to address the matter of the collection of unpaid taxes of contractors that are paid using purchase cards. Simply stated, the purchase card model does not fit the federal payment levy process. When FMS is in receipt of a levy from IRS, our legal obligation is to surrender any property in our possession that is subject to levy. When a purchase is made using a purchase card, however, FMS never has in its possession property belonging to the vendor. Credit card payments to vendors are not processed through FMS or any other authorized disbursement official. Mr. Chairman, FMS agrees with GAO's recommendation that a thorough review of the purchase card program geared toward exploring options for incorporating the collection of both tax and non-tax debt is warranted. However, since the purchase card program is not an FMS program and FMS does not disburse purchase card payments to vendors or have information regarding what vendors receive credit card payments, FMS is not the proper government agency to lead such a review. Government credit card programs are under the authority of the General Services Administration (GSA). FMS believes GAO's recommendation should be re-directed to GSA, and we are willing to work with GSA and IRS to support this effort.

100 Percent Levy

The American Jobs Creation Act of 2004, enacted last October, authorized IRS to levy up to 100 percent of certain vendor payments. FMS modified its systems in November 2004, one month after the law was enacted, to implement this authority where 100 percent levy is available. For example, IRS recently levied 100 percent of some Defense Finance and Accounting Service (DFAS) vendor payments and collected $432,000 compared to $100,000 that would have been collected prior to the law's enactment. However, full use of this new statutory authority has been delayed because the provision only permits 100 percent continuous levy for payments for "goods and services" and does not appear to apply to payments made for other kinds of property. FMS stands ready to work with IRS as it attempts to reach a solution to this issue.

Federal Contractor Tax Compliance Task Force

Finally, I would like to acknowledge the good work of the Task Force, mentioned earlier, on which FMS actively participates. The work of the Task Force in increasing both the number of tax debts included in the levy process and the number of payments being matched against those tax debts has resulted in a surge in collections. It is also worth noting, Mr. Chairman, that the Task Force has contributed to many significant ongoing improvements. For example, on a monthly basis, FMS is now matching tax debts against

contractor registration information and informing IRS when there is a match. IRS uses the information to send due process notices to debtor contractors, increasing the possibility that the payments of these debtors can be levied without delay. To the extent possible, we are applying these improvements to the levy process for contractors for civilian agencies.

Conclusion

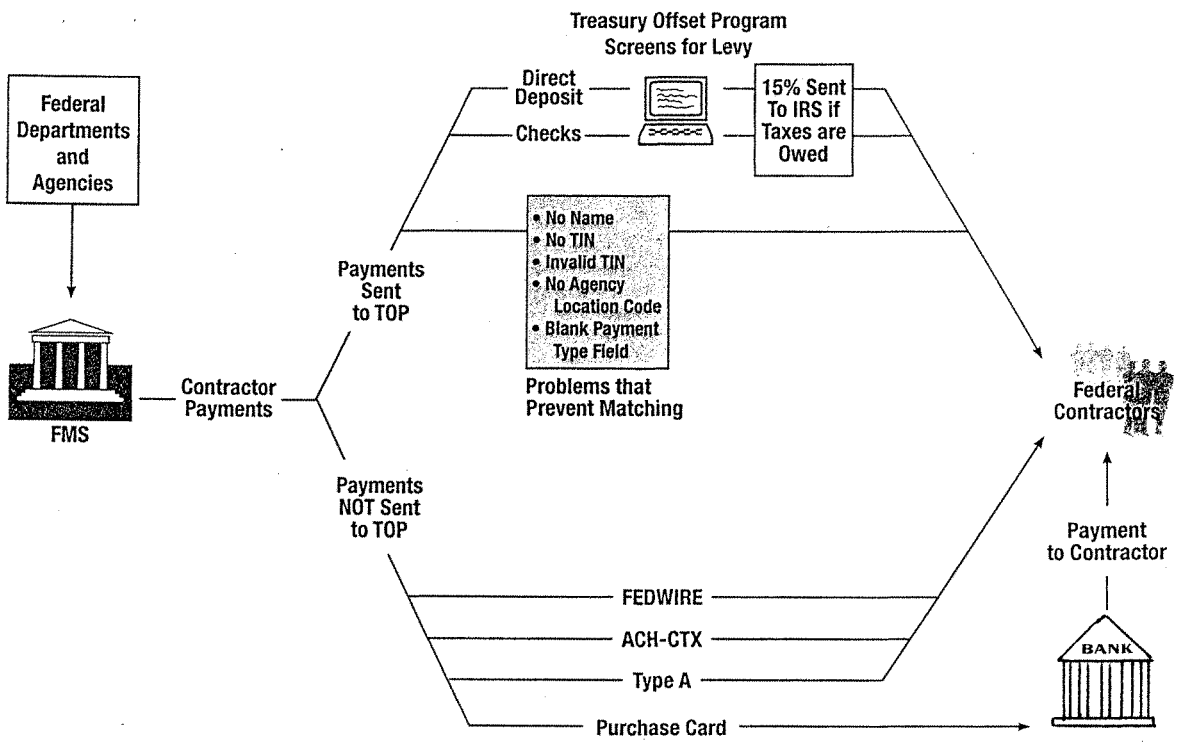
Mr. Chairman, once more, I appreciate the invitation to discuss and clarify the important role of FMS in the collection of unpaid tax debts through the levy program. I am committed to meeting our responsibilities for tax levy and the overall debt collection program, which has collected since 1996 $24 billion in delinquent federal, state and child support debts.

This concludes my remarks and I would be happy to answer any questions.

Permanent Subcommittee on Investigations

EXHIBIT #1

The Federal Payment Levy Program Does Not Screen All Contractor Payments



United States Government Accountability Office

GAO

Report to Congressional Requesters

June 2005

FINANCIAL MANAGEMENT

Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence

GAO-05-637

Permanent Subcommittee on Investigations
EXHIBIT #2

GAO
Accountability·Integrity·Reliability
Highlights

Highlights of GAO-05-637, a report to congressional requesters

Why GAO Did This Study

Tax abuses by contractors working for the Department of Defense, on which GAO previously reported, have led to concerns about similar abuses by those hired by civilian agencies. GAO was asked to determine if similar problems exist at civilian agencies and, if so, to (1) quantify the amount of unpaid federal taxes owed by civilian agency contractors paid through the Financial Management Service (FMS), (2) identify any statutory or policy impediments and control weaknesses that impede tax collections under the Federal Payment Levy Program (FPLP), and (3) determine whether there are indications of abusive or potential criminal activity by contractors with unpaid tax debts.

What GAO Recommends

GAO makes 18 recommendations to FMS to improve the FPLP and increase by tens of millions of dollars annually the amounts levied from payments to contractors with unpaid federal taxes. GAO also recommends that the Internal Revenue Service (IRS) review and, if warranted, pursue collection or criminal investigation of the 50 case study contractors identified in this report. IRS agreed and FMS partially agreed. FMS did not agree that it should withhold payments to contractors without names or work with IRS to address challenges related to levying purchase card payments. GAO disagrees with FMS's assessment and reiterates support for all of its recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-05-637.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Greg Kutz at (202) 512-9095 or Steven Sebastian at (202) 512-3406.

June 2005

FINANCIAL MANAGEMENT

Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence

What GAO Found

FMS and IRS records showed that about 33,000 civilian agency contractors owed over $3 billion in unpaid federal taxes as of September 30, 2004. All 50 civilian agency contractors we investigated had abusive and potentially criminal activity. For example, businesses with employees did not forward payroll taxes withheld from their employees to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Further, several individuals own multiple businesses with unpaid federal taxes—one individual owns about 20 businesses that did not fully pay taxes related to over 300 returns. Some contractors purchased or owned millions of dollars of property while they did not remit payroll taxes. These activities were identified for contractors at the Departments of Justice, Homeland Security, and Veterans Affairs; the National Aeronautics and Space Administration; and others agencies.

Examples of Abusive and Potentially Criminal Activity

Business	Unpaid tax amount	Fiscal year 2004 FMS payments	Contractor activity
Health care	$18 million	$300,000	Purchased multimillion-dollar properties while not paying millions in payroll taxes
Consulting	$1 million	$200,000	Doubled salary of one officer/owner to over $750,000 while not remitting payroll taxes
Temporary help	$900,000	$1 million	A pattern of nearly 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts
Security	$400,000	$200,000	Diverted payroll taxes to a foreign bank account to build a house overseas

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

GAO's analysis indicates that if all tax debts owed by, and all payments made to, the 33,000 contractors were included in the FPLP, FMS could have collected hundreds of millions of dollars in fiscal year 2004. However, because only a fraction of all unpaid taxes and a portion of FMS payments are subjected to the levy program, FMS actually collected only $16 million from civilian contractors. For example, about $171 billion of unpaid federal taxes were not sent to the levy program to be offset against payments because of specific statutory requirements or IRS policy exclusions, such as debtors' claims of financial hardship or bankruptcy.

Tens of billions of dollars in federal payments were not compared against tax debts for potential levy because FMS did not proactively manage and oversee the levy program. Until we brought it to FMS's attention, FMS did not know that it did not submit $40 billion of contractor payments from some civilian agencies for potential levy. FMS also did not identify payment files that did not contain contractor tax identification numbers, names, or both, resulting in $21 billion in payments to contractors that could not be levied. FMS also excluded billions of dollars from levy because of what it considered programming limitations without taking proactive steps to overcome those limitations. Further, civilian agency purchase card payments to contractors totaling $10 billion could not be levied. Improvements at FMS could result in tens of millions of dollars of additional levies annually.

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Abbreviations

ACH	Automated Clearing House
ACH-CTX	Automated Clearing House-Corporate Trade Exchange
ACS	Automated Collection System
DCIA	Debt Collection Improvement Act of 1996
DOD	Department of Defense
EFT	electronic funds transfer
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FPLP	Federal Payment Levy Program
IRS	Internal Revenue Service
NASA	National Aeronautics and Space Administration
PACER	Payments, Claims, and Enhanced Reconciliation
TFRP	trust fund recovery penalty
TIN	taxpayer identification number
TOP	Treasury Offset Program

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United States Government Accountability Office
Washington, D.C. 20548

June 16, 2005

Congressional Requesters

The success of our tax system hinges on the public's perception of its fairness, including the extent to which taxpayers believe their friends, neighbors, and business competitors are complying with the tax laws and are actually paying their taxes. The Internal Revenue Service's (IRS) own data in this regard are not encouraging. IRS reported that the federal government does not receive hundreds of billions of dollars in taxes owed annually. Recent IRS data, released in March 2005, showed that the estimated net annual tax gap—the difference between what taxpayers should pay on a timely basis and what IRS collected through voluntary compliance and enforcement activities—ranged from $250 billion to nearly $300 billion.[1]

A portion of the tax gap is owed by contractors receiving payments from the federal government. For example, in February 2004, we reported that some Department of Defense (DOD) contractors abuse the federal tax system with little consequence.[2] In our report and during a related congressional hearing,[3] we pointed out that based on our analysis of a limited number of DOD disbursement systems, more than 27,000 DOD contractors owed nearly $3 billion in unpaid federal taxes. We also reported that some of these contractors were engaged in abusive[4] and

[1] These data were released to the public as part of a National Research Program sample of 46,000 individual tax returns for calendar year 2001. The tax gap amount also includes an estimate for corporate tax debt based on IRS's 1988 compliance research.

[2] GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (Washington, D.C.: Feb. 12, 2004).

[3] GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-414T (Washington, D.C.: Feb. 12, 2004).

[4] We considered activity to be abusive when a contractor's actions or inactions, though not illegal, took advantage of the existing tax enforcement and administration system to avoid fulfilling federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable.

potentially criminal[5] activities. Due to the significance of the issues raised at that hearing, you asked us to provide additional information about whether contractors for other federal agencies were engaged in similar tax abuses and to provide recommendations to increase the effectiveness and efficiency of tax revenue collections from federal contractors under the Federal Payment Levy Program (FPLP).

This is the first in a series of reports to respond to your request. The specific objectives of this first audit and investigation were, to the extent possible, to (1) quantify the magnitude of unpaid taxes of contractors at federal civilian agencies that are paid through the Department of the Treasury's (Treasury) Financial Management Service (FMS); (2) identify some statutory or policy impediments and control weaknesses that impede tax collections under the FPLP; and (3) determine, using case studies, whether indications exist that federal contractors with unpaid taxes are engaged in abusive or potentially criminal activities. To identify the extent of such activities, we analyzed the tax debt and activity of entities with either the same owners or officers, common taxpayer identification numbers (TIN) or addresses, or other relationships as a group to identify patterns of abusive or potentially criminal activities. We will address issues surrounding the amount of tax debt IRS sends to the FPLP in subsequent reports.

To meet our first two objectives, we (1) identified civilian agency contractors receiving federal payments that owe taxes by comparing the database of FMS contractor payments with the IRS database of unpaid taxes, (2) estimated the potential dollar amount that could be collected if all unpaid taxes owed by civilian contractors and all FMS payments to civilian contractors were subject to the FPLP, (3) reviewed major federal laws and regulations and FMS policies on the FPLP, and (4) interviewed FMS and IRS officials on processes and procedures related to the FPLP. To avoid overstating the tax debt and potential levy amount, we limited the population of tax debts from which we performed our analysis to tax debts that have been agreed to by the taxpayers or confirmed by the courts, tax debts for periods prior to calendar year 2004, tax debts of more than $100, and fiscal year 2004 civilian contractor payments paid through FMS of

[5] We characterized as potentially criminal any activity related to federal tax liability that may be a crime under a specific provision of the Internal Revenue Code. Depending on the potential penalty provided by statute, the activity could be a felony (punishable by imprisonment of more than 1 year) or a misdemeanor (punishable by imprisonment of 1 year or less).

more than $100. We used data mining techniques to meet our third objective—identifying civilian agency contractors engaged in abusive or potentially criminal activity.

Although we were able to validate that the payment data provided by FMS reflected disbursements to contractors, we were unable to confirm that the disbursement data we received reflect all payments made to contractors. Specifically, FMS was unable to provide us with electronic disbursement data related to payments made to contractors through Fedwire, a large system used for payments requiring same-day settlement. Further, IRS's databases do not identify all unpaid federal taxes caused by a contractors' underreporting of income or failure to file taxes. Because of these problems, the FMS and IRS data we used will likely understate the magnitude of contractors with unpaid federal taxes and the potential levy collection. Further details on our scope and methodology are included in appendix I.

Our work was performed from May 2004 through May 2005 in accordance with generally accepted government auditing standards. The investigative portion of our work was completed in accordance with investigative standards established by the President's Council on Integrity and Efficiency. The results of 10 case studies we investigated are shown in table 3. The results of another 40 case studies are included in appendix II. We requested comments on a draft of comments on a draft of this report from the Commissioner for Internal Revenue or his designee and from the Commissioner, Financial Management Service or his designee. We received written comments from the Internal Revenue Service and the Financial Management Service, which are reprinted in appendixes III and IV of this report.

Results in Brief

As was the case at DOD, many contractors of civilian agencies throughout the federal government abuse the federal tax system with little consequence. Our analysis of FMS and IRS records showed that about 33,000 contractors that received substantial federal payments from civilian agencies during fiscal year 2004 owed a total of more than $3 billion in unpaid taxes. The unpaid taxes included corporate income, excise, unemployment, individual income, and payroll taxes.[6] We estimate that if there were no legal or procedural impediments to levying contractor payments to satisfy unpaid federal taxes, IRS and FMS could collect hundreds of millions of dollars annually. Since FMS collected $16 million in levies[7] from civilian contractors through the FPLP during fiscal year 2004, there is a significant tax levy collection gap. We also found evidence of abusive and potentially criminal activity on the part of contractors with unpaid tax debts.

A substantial portion of the levy collection gap is attributable to legal requirements and policy decisions at IRS. Of IRS's approximately $269 billion in unpaid federal taxes as of April 2005, about $171 billion is excluded from the levy program. Of this amount, about $71 billion was excluded because of statutory provisions while another $100 billion was excluded due to IRS policy decisions. This leaves approximately $98 billion in tax debt potentially subject to collection through the levy program. However, for 70 percent of the amount that IRS forwards to FMS for potential levy, IRS had not yet completed all of the legal notifications necessary for FMS to begin levying payments. As a result, only a small fraction of all unpaid federal taxes are eligible to be collected through the levy program. While the exclusion of unpaid federal taxes from the levy program is justified depending on the circumstances, it nevertheless results in the potential loss of hundreds of millions of dollars in tax collections. We will examine in detail in a later report the accuracy and reasonableness of the IRS exclusions.

[6] Payroll taxes are amounts that businesses withheld from employees' wages for federal income taxes, Social Security, and Medicare but failed to remit to IRS, as well as the related employer matching contributions for Social Security and Medicare taxes.

[7] Levy generically refers to seizure of property to collect a debt. For tax debt, it is the legal process by which IRS orders a third party (e.g., FMS) to turn over property in its possession (e.g., the federal payment) that belongs to the tax debtor named in a notice of levy. Overall, the reduction of federal payments to satisfy debt is referred to as an offset.

Weaknesses in internal controls and lack of proactive management at FMS further restricted the levy potential and contributed to the levy collection gap. We estimate that if the FMS deficiencies we identified were corrected, FMS could have collected at least $50 million more than it did in fiscal year 2004. Specifically, lack of oversight led to FMS's failure to update its levy database to include all agency paying stations, resulting in $40 billion in contractor payments—16 percent of all fiscal year 2004 contractor payments recorded in FMS's payment database—being inappropriately excluded from the levy program. Lack of oversight also resulted in payments being sent to the levy program without the necessary data required for levy. Payments with missing data included $17 billion in payments made to contractors without TINS and with obviously erroneous TINs,[8] nearly $4 billion without valid contractor names, and $5 billion without proper payment type coding. A cursory review could have identified these deficiencies in agency-submitted payment files. With the exception of payments without TINs, FMS was not aware of these omissions until we brought them to its attention. Further, although FMS was aware that payments were made to contractors without TINs, FMS had not taken action to address this deficiency. FMS's failure to identify and enforce information requirements for disbursements reduced the amount of unpaid federal taxes that was collected through the FPLP.

FMS has not been proactive in making changes necessary to maximize levy collections by adding tens of billions of dollars in payments that are currently excluded from the FPLP. These exclusions include about $26 billion (11 percent of FMS's 2004 contractor disbursements) of certain categories of payments that FMS recorded in its payment database during fiscal year 2004, and an unknown but potentially material amount of Fedwire payments—payments requiring same-day settlement. FMS has not taken actions to include these payments in the levy program because of what it considers programming limitations. Similarly, FMS does not levy any contractor payments to collect taxes owed by individuals, including self-employed individuals and those with sole proprietorships. IRS and FMS decided not to levy contractors' payments to collect the unpaid federal taxes of contractors that file individual tax returns to avoid the possibility of mistakenly levying an individual's payment to satisfy an

[8] A TIN is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number assigned by IRS serves as the TIN. For individuals, the Social Security number assigned by the Social Security Administration serves as the TIN.

unrelated business's tax debt. Such an error could occur because a business and an individual could have identical TINs and similar names, and FMS's disbursement files do not distinguish between payments to businesses and payments to individuals. While FMS and IRS officials recognized that the potential risk of an improper levy resulting from an erroneous match of an individual's payment with a business's tax debt is probably small, they have only recently begun to take steps to allow the unpaid federal taxes of individuals to be collected under the levy program.

Finally, FMS has not addressed other challenges in the levy program that further limit its effectiveness at collecting unpaid taxes. These challenges include (1) matching the contractor name on the payment record to the name in IRS's tax records, (2) levying contractors paid with government purchase cards, and (3) implementing the increased 100 percent levy provision authorized in 2004. We found that nearly $2 billion of payments to contractors with unpaid taxes could not be levied because of the requirement to match both the name and TIN in the payment records to the unpaid federal taxes in the Treasury Offset Program (TOP) database. FMS does not subject to levy the nearly $10 billion of fiscal year 2004 federal payments to contractors made with purchase cards because the government payment is made to the bank that issued the purchase card, not the contractor doing business with the government. FMS officials stated that although they had met with certain bank officials and another federal agency regarding this issue, they had not yet determined how to collect federal debts from contractors paid with the purchase cards. Finally, FMS faces a significant challenge in implementing a provision of the American Jobs Creation Act of 2004, which allows the federal government to levy up to 100 percent—up from a maximum of 15 percent—of specified payments for goods and services provided by contractors with unpaid federal taxes. FMS faces difficulty because civilian payment systems presently do not distinguish goods and services, which are subject to the increased 100 percent levy provision, from real estate payments, which IRS has determined are not. Overall, until FMS improves its oversight and management of the FPLP and addresses these challenges, it will not be able to realize the full potential of the program.

Our audit and investigation of 50 case study contractors[9] paid through FMS identified numerous instances of abusive or potentially criminal activity. The subjects of the 50 case studies are mostly small companies—many of them closely held by the owners and officers—operating in wage-based industries. These companies provided building maintenance, computer, consulting, health care, personnel, security, and other services at numerous federal agencies, including agencies tasked with national security and law enforcement, such as the Departments of Homeland Security, Justice, and State. The 50 case studies included businesses that had unpaid payroll taxes (as well as corporate income, personal income, and other types of unpaid taxes). One group of related businesses had unpaid taxes in over 300 tax returns. Rather than fulfilling their role as "trustees" and forwarding these amounts as required by law to IRS, these contractors diverted the money for personal gain or to fund their businesses. Willful failure to remit payroll taxes is a felony.

Some owners or officers of businesses with unpaid taxes also have individual tax debts and are associated with other businesses that have unpaid federal taxes. One case study contractor has a 20-year history of opening a business, failing to remit taxes withheld from employees to IRS, and then closing the business, only to start the cycle all over again and incur more tax debts almost immediately. We also found that a number of owners or officers in our case studies have significant personal assets, including a sports team, commercial properties, houses worth over $1 million, and luxury vehicles. Despite owning significant assets, the owners or officers did not ensure the payment of the delinquent taxes of their businesses, and sometimes did not pay their own individual income taxes.

Through our case studies, we also found that some owners or officers of civilian agency contractors with unpaid federal taxes had been convicted or indicted of criminal conduct, such as embezzlement and money laundering. For example, an officer of one case study contractor was convicted for stealing hundreds of thousands of dollars from the company, and the company's owner was indicted for embezzlement. Some

[9] In instances where our work indicates that the owners or officers of the business are involved in other related entities that have unpaid federal taxes, we performed detailed audit and investigation on the related entities, the owners or officers, and not just the original business we identified. In instances where related entities exist, we defined a case study to include all the related entities, and reported on the combined unpaid taxes and combined fiscal year 2004 payments for all the related entities.

contractors included in our investigation stated that they diverted the payroll taxes that they did not remit to IRS for personal gain or to fund their businesses. One of the owners was using the payroll taxes not remitted to IRS to build a house overseas.

Finally, to improve collections under the FPLP, we are making 18 recommendations to the Commissioner of the Financial Management Service, including recommendations to include all payment categories in the levy program; ensure payments from all agency paying stations are subjected to potential levy; and verify that all payment files contain information needed to levy contractor payments, such as payment type, name, and TIN (where required). We are also recommending that FMS work with IRS to determine how to collect unpaid taxes from sole proprietors and contractors paid with government purchase cards and to determine the steps needed to implement the 100 percent levy authorized by the American Jobs Creation Act of 2004. In addition, we are making a recommendation to the Commissioner of Internal Revenue to review the 50 case study companies and determine whether additional collection action or criminal investigation is warranted.

IRS agreed and FMS partially agreed with our recommendations. FMS did not agree with our recommendations that it should withhold payments to contractors without names or work with IRS to explore options to levy or otherwise collect from purchase card payments. FMS also disagreed with our characterization of its management of the levy program but did not dispute the factual basis on which we based our findings and recommendations. We disagree with FMS's assessment and reiterate support for our recommendations. See the "Agency Comments and Our Evaluation" section of this report for a more detailed discussion of the agency comments. We have reprinted the IRS and FMS written comments in appendixes III and IV.

Background

In its role as the nation's tax collector, IRS is responsible for collecting taxes, processing tax returns, and enforcing the nation's tax laws. Treasury's FMS is the central disbursing authority for civilian agencies. With limited exceptions,[10] FMS processes most disbursements for civilian agencies in the executive branch. FMS is also the federal government's central debt collection agency. Since fiscal year 2000, FMS has operated the FPLP in conjunction with IRS to collect unpaid federal taxes, including tax debt owed by federal contractors.

IRS's Collection of Unpaid Taxes

Since 1990, we have designated IRS's enforcement of tax laws as a governmentwide high-risk area.[11] In attempting to ensure that taxpayers fulfill their obligations, IRS is challenged on virtually every front. While IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased, until fiscal year 2005, the resources IRS has been able to dedicate to enforcing the tax laws have declined. Enforcement efforts are designed to increase compliance and reduce the tax gap. However, IRS recently reported that the gross tax gap, that is, the difference between what the taxpayers should pay on a timely basis and what they actually pay, exceed $300 billion annually. IRS estimated the gross tax gap to be between $312 billion and $353. IRS further reported that its enforcement activities, coupled with late payments, recover just $55 billion of that amount, leaving a net tax gap of from $257 billion to $298 billion. Preliminary IRS estimates indicate that noncompliance is from 15 percent to 16.6 percent of taxpayers' true tax liability, which further fuels congressional and public concern that declines in IRS compliance and collections programs are eroding taxpayer confidence in the fairness of our federal tax system.

[10] A few civilian agencies, such as the U.S. Postal Service, have their own disbursing authority and do their own disbursements. Although DOD has its own disbursement authority, some DOD payments are made through FMS.

[11] Additionally, we designated IRS's financial management and systems modernization as high-risk areas in 1995. See GAO, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: February 1995). In 2005, two of IRS's high-risk areas—collection of unpaid taxes and earned income credit noncompliance—were consolidated to make a single high-risk area called enforcement of tax laws. Also in 2005, IRS's high-risk areas of business systems modernization and financial management were merged into a single high-risk area called business systems modernization. See GAO, *High-Risk Series, An Update*, GAO-05-207 (Washington, D.C.: January 2005).

FMS Disbursements

In fiscal year 2004, FMS made over 940 million disbursements totaling over $1.5 trillion. FMS's major disbursing activities include paying Social Security benefits, veterans' compensation, federal tax refunds, federal salaries and pensions, and contractor and miscellaneous payments. For statutory and logistical reasons, a limited number of other governmental agencies, such as DOD and the U.S. Postal Service, have their own authority to disburse funds. Those agencies that have the authority to disburse federal funds are referred to as Non-Treasury Disbursing Offices.

Although FMS is the disbursing agent for most of the federal government, that is, it physically writes the checks or sends the electronic payments, it does so on the behalf of, and at the direction of, the various federal agencies. Federal agencies may have multiple offices or locations that perform accounting for and preparation of payment information, referred to by FMS as agency locations or paying stations.[12] To generate a payment, an agency payment location sends FMS a payment file, along with an accompanying payment certification requesting that FMS disburse funds. Agencies typically send the certification and detailed payment information in an automated form, and FMS loads the payment data into its payment system. Once loaded, FMS verifies that all payment requests were properly authorized and certified and that the amount on the payment file agrees with the certification amount before processing the payments for disbursement.

FMS disburses federal funds via three main mechanisms: electronic funds transfer (EFT) via Automated Clearing House (ACH), Fedwire, and checks. Fedwire is also an EFT that provides for immediate transfers of funds from the government's account in the Federal Reserve to the contractors' bank accounts. According to FMS records, of the approximately $1.5 trillion disbursed by FMS in fiscal year 2004, about 66 percent was disbursed using ACH, 17 percent via Fedwire, and the remaining 17 percent as checks.

Once payments are disbursed, payment information related to ACH and checks are sent to FMS's Payments, Claims, and Enhanced Reconciliation (PACER) system, which maintains payment data and provides federal

[12] The Treasury agency location code (ALC) is used to identify transactions, documents, and reports processed through Treasury by a specific accounting point or station, within an agency or bureau of a federal department or independent agency. The use of the ALC, also referred to as the accounting station symbol, enables Treasury to reconcile deposits and disbursements.

payment agencies online access to these data. Among other payments, PACER contained about 12.9 million contractor payments valued at $247 billion for fiscal year 2004. Unlike checks and ACH payments, detailed information regarding Fedwire payments is not sent to the PACER payment database.

Treasury Offset and Federal Payment Levy Programs

In 1996, Congress passed the Debt Collection Improvement Act 1996 (DCIA) to maximize the collection of delinquent nontax debts owed to federal agencies. As part of implementing its responsibilities under DCIA, Treasury established the TOP, to be administered by FMS, to centralize the process by which certain federal payments are withheld or reduced (offset) to collect delinquent nontax debts owed to federal agencies.[13] Under the regulations implementing DCIA, FMS and other disbursing agencies are required to compare their payment records with debt recorded in the TOP database. If a match occurs, the disbursing agency must offset the payment, thereby reducing or eliminating the nontax debt.

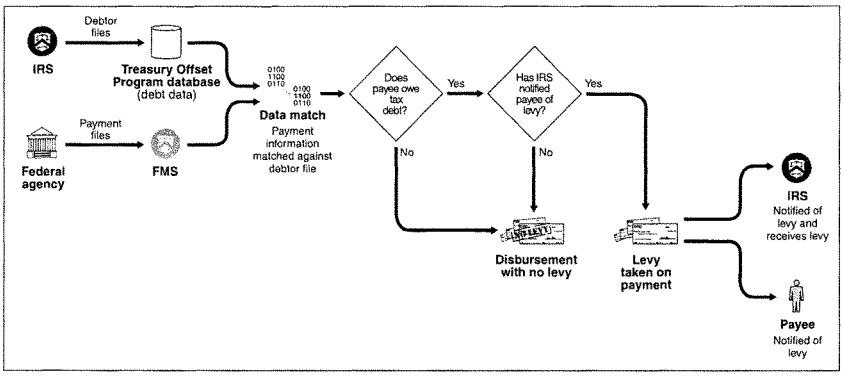
To improve collection of unpaid taxes, the Taxpayer Relief Act of 1997 authorized IRS to continuously levy up to 15 percent of specified federal payments made to businesses and individuals with unpaid federal taxes.[14] The continuous levy program, now referred to as FPLP, was implemented in July 2000. The FPLP provides for the levy of various federal payments, including federal employee retirement payments, certain Social Security payments, selected federal salaries, and contractor payments. For payments disbursed by FMS on behalf of most federal agencies, the amount to be levied and credited to IRS is deducted before FMS disburses the payment. In fiscal year 2004, IRS received $114 million through the FPLP for delinquent taxes, $16 million of which was from payments to civilian contractors.

[13] In addition, for certain federal payments, TOP collects child support debts and state income tax debts on behalf of the states.

[14] Taxpayer Relief Act of 1997 § 1024, 26 U.S.C. § 6331(h) (2000).

IRS coordinated with FMS to utilize the TOP database as the means of collecting taxes under the FPLP. Each week IRS sends FMS an extract of its tax debt files containing updated account balances of tax debts that are already in TOP, the new tax debts that need to be added to TOP, and all taxes in TOP that need to be rescinded.[15] These data are uploaded into TOP. For a payment to be levied through the FPLP, a debt has to exist in TOP and a payment has to be available. Figure 1 provides an overview of this process.

Figure 1: Levy Process



Source: GAO.

[15] Debts are rescinded for a variety of reasons. For example, IRS will rescind a debt if the debtor is subject to a bankruptcy stay or if other reasons justify the rescission (such as when debt is paid in full, compromised, or otherwise satisfied).

FMS sends payment data to TOP to be matched against unpaid federal taxes. TOP electronically compares the names and TINs on the payment files to the control names (first four characters of the names) and TINs of the debtors listed in TOP. If there is a match and IRS has updated TOP to reflect that it has completed all legal notifications, the federal payment is reduced (levied) to help satisfy the unpaid federal taxes.

Federal Contractor Tax Compliance Task Force

To address issues raised by our February 12, 2004, report and testimony, a multi-agency task force was established to help improve the FPLP. The task force includes representatives from the Department of Defense, Defense Finance and Accounting Service, IRS, FMS, General Services Administration (GSA), Office of Management and Budget, and Department of Justice.

The objectives of the task force were to (1) identify and implement short-term and long-term operational changes to improve federal tax compliance of DOD contractors, including increasing the number of tax debts and the number of DOD contractor payments available for matching through TOP, and (2) identify potential changes that would enhance efforts to address federal contractor tax delinquencies and prevent future occurrences of tax abuse by federal contractors.

The task force issued its report in October 2004. In its report, the task force identified actions and made recommendations to improve tax compliance of federal contractors, including maximizing the number of delinquent tax debts that IRS makes available for matching, maximizing DOD payment information available for matching, increasing the effectiveness of the matching and levy processes, and preventing federal contract awards to those who abuse the tax system. A number of the improvements identified by the task force have already been implemented.

Civilian Contractors Have Billions of Dollars in Unpaid Federal Taxes

Our analysis indicates that the failure to pay taxes among DOD contractors also exists among civilian agency contractors and totaled billions of dollars. Our analysis of FMS and IRS records indicates that during fiscal year 2004, FMS made payments on behalf of civilian agencies to about 33,000 federal contractors with over $3.3 billion in unpaid federal taxes as of September 30, 2004.[16] We estimate that if there were no legal or administrative impediments to the levy program—if all unpaid federal taxes were considered and all payments to these 33,000 contractors with unpaid federal taxes were subjected to the 15 percent levy—FMS could have collected as much as $350 million in unpaid federal taxes from civilian contractors during fiscal 2004.[17] Because some unpaid federal taxes are excluded due to statutory requirements, IRS and FMS would never be able to collect the entire amount. Over half of the $3.3 billion in tax debt was coded by IRS as being excluded from the levy program for statutory reasons, including contractors being in bankruptcy, having installment payment agreements, or awaiting the completion of the required legal notifications regarding the tax debt. However, many improvements can be made to lessen the tax levy collection gap. As will be discussed later in the report, the American Jobs Creation Act of 2004[18] increased the maximum levy to 100 percent of any specified payments to contractors for goods and services provided the federal government. When implemented, the maximum levy amount that could be collected is even greater.

[16] Our initial matches of civilian contractor payments made during fiscal year 2004 with IRS tax debt as of September 30, 2004, identified about 63,000 contractors that had tax debt totaling $5.4 billion. We excluded from our preliminary estimates tax debts that have not been agreed to by the tax debtor or affirmed by the court, tax debts from calendar year 2004, tax debts of $100 or less, and fiscal year 2004 FMS payments of $100 or less.

[17] This figure represents the potential levy that could be collected if there were no legal or administrative impediments, that is, if all payments, for which we have information, could be levied against all IRS tax debt. This potential amount is likely understated because of data limitations in the payment files and other issues, some of which are discussed in this report.

[18] Pub. L. No. 108-357,§. 887(a), 118 Stat. 1418, October 22, 2004, to be codified at 26 U.S.C. § 6331 (h)(3).

Characteristics of Contractors' Unpaid Federal Taxes

The amount of unpaid taxes for these contractors paid through Treasury FMS ranged from a small amount owed by an individual for a single tax period[19] to a group of related businesses owing about $13 million for over 300 tax periods.[20] Unpaid taxes owed by these contractors included payroll, corporate income, excise, unemployment, individual income, and other types of taxes.

In the case of unpaid payroll taxes, employers withheld federal taxes from employees' wages, but did not send the withheld payroll taxes or the employers' matching amounts to IRS as required by law, instead diverting the money for personal gain or to fund their businesses. One IRS official acknowledged that frequently small businesses are undercapitalized and use the tax money as operating capital. However, employers are subject to civil and criminal penalties if they do not remit payroll taxes to the federal government. When an employer withholds taxes from an employee's wages, the employer is deemed to have a responsibility to deposit in a separate bank account these amounts held "in trust" for the federal government until making a federal tax deposit in that amount.[21] To the extent these withheld amounts are not forwarded to the federal government, the employer is liable for these amounts, as well as the employer's matching Social Security contributions. Individuals within the business (e.g., corporate officers) may be held personally liable for the withheld amounts not forwarded, and they can be assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).[22]

[19] A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is generally one quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, although payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year. As described later in this report, a case study consists in some cases of multiple related entities, some or all of which owe tax debts. The number of tax periods and the accumulated tax debts we are reporting reflect the accumulated tax periods and tax debts of all related entities.

[20] IRS and FMS cannot collect from payments made to one related company to satisfy the unpaid federal taxes of another related company.

[21] The law further provides that withheld income and employment taxes are to be held in a separate bank account considered to be a special fund in trust for the federal government. 26 U.S.C. § 7512(b).

[22] 26 U.S.C. § 6672.

Willful failure to remit payroll taxes is a criminal felony offense[23] punishable by imprisonment of not more than 5 years, while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense[24] punishable by imprisonment of up to a year. The employee is not responsible for the employer's failure to remit payroll taxes since the employer is responsible for submitting the amounts withheld. The Social Security and Medicare trust funds are subsidized or made whole for unpaid payroll taxes by the general fund, as we discussed in previous reports.[25] Over time, the amount of this subsidy is significant.

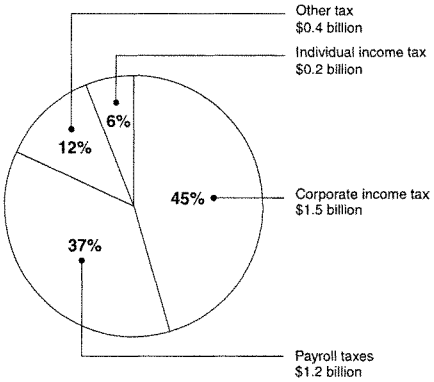
As shown in figure 2, over a third of the total tax amount owed by civilian contractors was for unpaid payroll taxes and over 40 percent was for corporate income taxes. The remainder consisted of individual income taxes, and other taxes. As discussed later in our case studies, some of these contractors also owe state tax debts.

[23] 26 U.S.C. § 7202.

[24] 26 U.S.C. § 7215 and 26 U.S.C. § 7512 (b).

[25] GAO, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000); *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, GAO/AIMD-99-12 (Washington, D.C.: Oct. 29, 1998); and *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AIMD/GGD-99-211 (Washington, D.C.: Aug. 2, 1999).

Figure 2: Type of Debt Owed by Civilian Contractors as of September 30, 2004

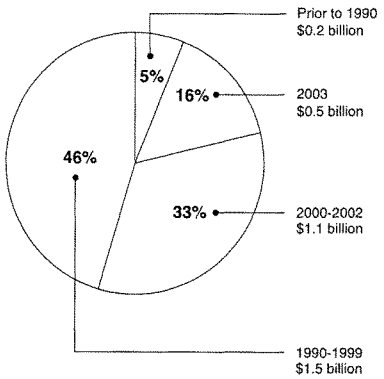


Source: GAO analysis of IRS and FMS data as of September 30, 2004.

A substantial amount of the unpaid federal taxes shown in IRS records as owed by civilian contractors had been outstanding for several years. As reflected in figure 3, over half of the unpaid taxes owed by civilian contractors were for tax periods prior to calendar year 2000.[26]

[26] Tax period may not always correspond to the age of the tax debt, as when a tax form is filed years after the due date or when IRS assesses additional taxes to earlier tax periods.

Figure 3: Civilian Contractors' Unpaid Federal Taxes by Tax Periods through 2003 by Calendar Year



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Prompt collection of unpaid taxes is vital because, as our previous work[27] has shown, as unpaid taxes age, the likelihood of collecting all or a portion of the amount owed decreases. This is due, in part, to the continued accrual of interest and penalties on the outstanding federal taxes, which, over time, can dwarf the original tax obligation. The amount of unpaid federal taxes reported above does not include all tax debts owed by the civilian agency contractors due to statutory provisions that give IRS a finite period under which it can seek to collect on unpaid taxes. Generally, there is a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect tax debt. [28] Consequently, if the contractors owe federal taxes

[27] GAO/AIMD/GGD-99-211.

[28] The 10-year time may be suspended including for periods during which the taxpayer is involved in a collection due process appeal, litigation, or a pending offer in compromise or installment agreement. As a result, Fig. 3 includes taxes that are for tax periods from more than 10 years ago.

beyond the 10-year statutory collection period, the older tax debt may have been removed from IRS's records. We were unable to determine the amount of tax debt that had been removed.

While Substantial, the Amount of Unpaid Taxes of Civilian Contractors Is Likely Understated

The amount of unpaid federal taxes we identified among civilian agency contractors—$3.3 billion—is likely understated for three main reasons: (1) we intentionally limited our scope to contractors with agreed-to[29] federal tax debt for tax periods prior to 2004 that had substantial amounts of both unpaid taxes and payments from civilian agencies; (2) FMS disbursement files did not always contain the information we needed to determine whether the contractors owed federal taxes; and (3) the IRS taxpayer account database contains errors, and the database reflects only the amount of unpaid taxes either reported by the taxpayer on a tax return or assessed by IRS through its various enforcement programs. The IRS database does not reflect amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed tax amounts due.

To avoid overestimating the amount owed by government contractors, we took a number of steps to exclude unpaid federal taxes that federal contractors recently incurred or that are not individually significant. For example, some recently assessed tax debts that appear as unpaid taxes through a matching of PACER and IRS records may involve matters that are routinely resolved between the taxpayer and IRS, with the taxes paid, abated, or both[30] within a short period. We attempted to eliminate these types of debt by focusing on unpaid federal taxes for tax periods prior to calendar year 2004 and eliminating tax debt of $100 or less. We also eliminated all tax debt identified by IRS as not being agreed to by the

[29] We eliminated from our analysis all tax debt coded by IRS as not having been agreed to by the taxpayer (by filing a balance due return) or a tax court. For financial reporting, those cases are referred to as compliance assessments.

[30] Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. 26 U.S.C. § 6404.

contractor. Additionally, we eliminated contractors with tax debt that received payments of $100 or less during fiscal year 2004.[31]

Regarding the completeness of FMS disbursement information, we found that some contractors paid through FMS could not be identified due to blank or obviously erroneous TINs, such as TINs made up of all zeros or all nines. The lack of TINs prevented us from determining whether contractors had unpaid federal taxes and, if so, the amount of unpaid taxes owed by the contractors. Additionally, as will be discussed in more detail in a later section of this report, FMS does not maintain detailed electronic payment information for a large disbursement system—Fedwire—that also makes disbursements to contractors, and thus the value of unpaid taxes associated with contractors paid through that system could not be determined.

As we have previously reported,[32] IRS records contain errors that affect the accuracy of taxpayer account information. Consequently, some of the $3.3 billion may not reflect true unpaid taxes, although we cannot quantify this amount. Nonetheless, we believe the $3.3 billion represents a conservative estimate of unpaid federal taxes owed by civilian contractors paid through FMS.

Also limiting the completeness of our estimate of the unpaid federal taxes of civilian contractors is the fact that the IRS tax database reflects only the amount of unpaid taxes either reported by the contractor on a tax return or assessed by IRS through its various enforcement programs. The IRS database does not reflect amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed tax amounts due. During our review, we identified instances in which civilian contractors failed to file tax returns for a particular tax period and, therefore, were listed in IRS records as having no unpaid taxes for that period. Further, our analysis did not attempt to account for businesses or individuals that purposely underreported income and were not specifically

[31] The $3.3 billion shown in our analysis includes only amounts of tax debt owed by civilian contractors paid through FMS's PACER database. Amounts owed by the owners, officers, or related business entities that were not paid through FMS are not included in the $3.3 billion estimate of tax debt. We include this additional tax debt in later discussions of our case study contractors.

[32] GAO, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002).

identified by IRS. According to IRS, underreporting of income is the largest component of the roughly $300 billion tax gap. Preliminary IRS estimates show underreporting accounts for more than 80 percent of the total tax gap. Consequently, the true extent of unpaid taxes for these businesses and individuals is not known.

Actual Levy Collections Significantly Less Than Maximum Potential Levy Amount

There is a large tax levy collection gap between the maximum potential levy we calculated and the amount FMS actually collected under the FPLP. We estimate that if there were no legal or administrative provisions that remove some tax debt from the levy program and if all PACER contractor payments were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, FMS could have collected as much as $350 million in fiscal year 2004. However, during fiscal year 2004, FMS collected about $16 million from civilian contractors—or about 5 percent of the approximately $350 million maximum levy collection estimate we calculated. As discussed earlier in this report, because some unpaid federal taxes are excluded due to statutory requirements, IRS and FMS will never be able to close the levy collection gap completely. For example, over half of the $3.3 billion in tax debt was coded by IRS as being excluded from the levy program for statutory reasons, including contractors being in bankruptcy, having installment agreements, or awaiting the completion of the required initial legal notifications. However, many improvements can be made to narrow the tax levy collection gap.

We found that a vast majority of the collection gap is attributable to debts that are excluded from TOP because of current law and IRS policies. While we will provide an overview of the exclusions later in this report, we will examine in detail in a later report the accuracy and reasonableness of the exclusions and IRS's applications of those exclusions. The remaining gap—to be covered in detail in this report—between what could be collected and what was actually collected is attributable to the fact that not all FMS payments could be matched against unpaid federal taxes for levy. We estimate that the federal government could have collected at least $50 million more in unpaid federal taxes in fiscal year 2004 using the FPLP if all PACER contractor payments could be matched against tax debts in TOP.

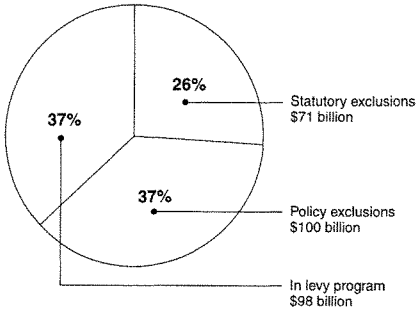
Legal Requirements and IRS Policy Decisions Contribute to the Levy Collection Gap

The actual collection of unpaid federal taxes from the levy program does not approach our maximum estimate largely because IRS excludes—either for statutory or policy reasons—almost two-thirds of unpaid federal taxes from potential levy collection. Since we last reported on DOD contractors that abused the federal tax system,[33] IRS has added about $28 billion in unpaid federal taxes to the levy program from categories it formerly excluded (from its total population of all tax debts). Despite these efforts, the amount that is excluded from the levy program is significant. Our analysis of all tax debt recorded by IRS—$269 billion[34] in unpaid taxes—including amounts owed by civilian contractors, indicates that $171 billion was excluded from potential levy collection as of April 2005. For the civilian contractors in fiscal year 2004, these exclusions accounted for over 80 percent of the levy collection gap. As shown in figure 4, $71 billion (26 percent) of all unpaid federal taxes are excluded from the levy program as a result of statutory requirements, while another $100 billion (37 percent) of unpaid federal taxes are excluded due to IRS policy decisions, leaving approximately $98 billion (37 percent) potentially subject to collection through the levy program. While the exclusion of unpaid federal taxes from the levy program is justified depending on the circumstances, it nevertheless results in the loss of potentially hundreds of millions of dollars in tax collections from the levy program.

[33] GAO-04-95.

[34] IRS's 2004 financial statements reported $237 billion in total unpaid assessments. IRS eliminates from financial reporting certain tax debt, including, among others, TFRP assessed against officers or owners of companies to collect the federal taxes withheld by the business from their employees but not remitted to the federal government. IRS does not report these debts to eliminate double counting both the business tax debt and the officer's assessment of those taxes.

Figure 4: Levy Status of Unpaid Federal Taxes as of April 2005



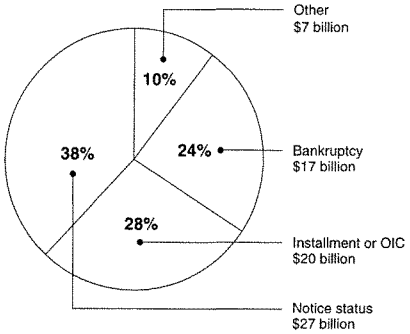
Source: GAO analysis of unaudited IRS data as of April 2005.

In addition to not sending the majority of unpaid federal taxes to the levy program, FMS records indicate that as of September 30, 2004, about 70 percent of the unpaid taxes that IRS submitted to TOP had not yet completed the collection due process requirements necessary to allow the levying of payments to begin. As a result, only a small portion of unpaid federal taxes is available for immediate levy. We will examine in detail in a later report the accuracy and reasonableness of the IRS exclusions and IRS's applications of those exclusions. What follows is a more detailed description of the amounts and types of unpaid taxes excluded from the FPLP for statutory and policy reasons, as well as a detailed discussion of the limitations associated with much of the unpaid federal taxes that are referred to the FPLP.

A Substantial Portion of Unpaid Federal Taxes Are Legally Excluded from the Levy Program

According to IRS records, as of April 2005, IRS had coded about $71 billion of unpaid federal taxes as being legally excluded from the levy program. As shown in figure 5, IRS records indicate that bankruptcy and taxpayer agreements—including installment or offer in compromise (OIC)[35] agreements—each account for about a quarter of all statutory exclusions. Another $27 billion (38 percent) of the $71 billion in statutory exclusions is due to IRS not having completed all initial taxpayer notifications required by law before a tax debt could be referred to TOP—these are cases that IRS refers to as being in notice status.

Figure 5: IRS Statutory Exclusions as of April 2005



Source: GAO analysis of unaudited IRS data as of April 2005.

[35] Installment agreements allow for payments on the debt in smaller, more manageable amounts. An offer in compromise approved by IRS allows a tax debtor to settle unpaid tax debt for less than the full amount due.

For tax debt in notice status—the first phase of IRS's collection process—IRS sends a series of up to four separate notices to tax debtors asking them to pay their tax debt. Upon receipt of each of the notices, the debtors have a minimum of 30 days to respond in various ways:

- disagree with IRS's assessment and collection of tax liability and appeal the tax debt;
- negotiate with IRS to set up an alternative payment arrangement, such as an installment agreement or an offer in compromise;
- apply to IRS for a hardship determination, whereby tax debtors demonstrate to IRS that making any payments at all would result in a significant financial hardship; or
- elect to pay off the debt in full.

Each time the debtor responds to a notice, the matter must be resolved before IRS can proceed with further notices or other collection actions. For example, IRS must determine whether to accept or reject an installment agreement or determine that the tax debtor is in financial hardship before proceeding with the collection process. During this entire notice phase, IRS is required to exclude the tax debt from the levy program. IRS does not begin further collection action, for example, the unpaid federal taxes are excluded from levy, until the series of initial notifications are complete. IRS also sends out an annual notification letter requesting payment of the unpaid federal taxes.

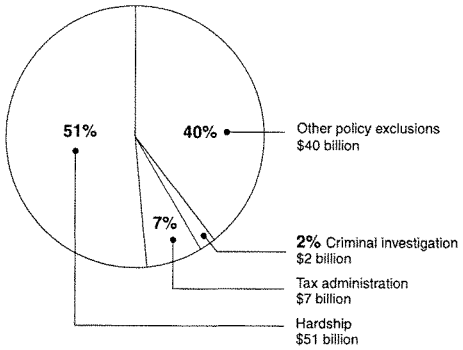
IRS Policy Decisions Exclude Many Tax Debts from the Levy Program

In addition to legal restrictions, IRS makes policy and operational decisions that exclude about $100 billion in unpaid tax debts from the levy program. Categories of unpaid tax debts IRS has coded as being excluded due to policy decisions include those of tax debtors with financial hardship,[36] tax debtors working with IRS to voluntarily comply, and tax debtors under active criminal investigation. Figure 6 shows that slightly over half ($51 billion) of all policy exclusions are due to IRS's determination that the

[36] According to IRS, financial hardship can be either a statutory exclusion (under 26 U.S.C. 6343(e)) or policy exclusion, depending on when and who makes the determination. For reporting on the FPLP, IRS categorizes hardship cases as policy exclusions.

tax debtor is in financial hardship. Another 40 percent ($40 billion) of the policy exclusions include tax debtors who are deceased and those tax debtors that have filed appeals, claims, or amended returns. About 7 percent ($7 billion), referred to as tax administration exclusions, is excluded from the levy program because an IRS official is working to encourage the affected tax debtor to voluntarily pay the federal taxes owed. About 2 percent ($2 billion) are excluded due to active criminal investigations.

Figure 6: IRS's Policy Exclusions from the Levy Program as of April 2005



Source: GAO analysis of unaudited IRS data.

Since our 2004 report on DOD contractors who abuse the tax system,[37] in which we recommended that IRS change or eliminate policies that prevent businesses and individuals with federal contracts from entering the levy program, IRS has taken specific actions to include more tax debt in the levy program. Specifically, IRS submitted an additional $28 billion to the levy program by removing many of the systemic exclusions for cases

[37] GAO-04-95.

being actively pursued by IRS officials for collection (i.e., those excluded for tax administration purposes).[38] As a result of these and other improvements (including DOD submitting more of its payments in the levy program), collections from contractor payments under the levy program increased over 200 percent in fiscal 2004 over fiscal 2003. Collections continued to increase in the first half of fiscal year 2005.

Our past audits have indicated that IRS records contain coding errors that affect the accuracy of taxpayer account information—including exclusion categories. While we did not evaluate the appropriateness of the exclusion categories in this report, the categories used by IRS are only as good as the codes IRS has input into its systems.[39] In our previous work on DOD contractors with tax debt, we found that inaccurate coding at times prevented both IRS collection action and cases from entering the levy program. Therefore, the effective management of these codes is critical because if these exclusion codes (such as codes identifying a contractor as being in bankruptcy or having an installment agreement) remain in the system for long periods, either because IRS delays processing taxpayer agreements or because IRS fails to input or reverse codes after processing is complete, cases may be needlessly excluded from the levy program.

Most Tax Debt IRS Submits to the Levy Program Is Not Legally Ready for Levy

FMS records indicate that as of September 30, 2004, about 70 percent of the tax debt IRS sent to the levy program is not available for immediate levy because IRS has not completed all the necessary legal notifications before the levying of payments can begin. In addition to the initial series of notice letters that are sent out at the beginning of IRS's collection efforts, IRS is required to send the debtor an additional notice of intent to levy that includes information regarding the tax debtor's right to a hearing prior to levy action—also referred to as a collection due process notice. Although

[38] This was done automatically within IRS's tax database based on various transaction and status codes. IRS previously blocked all cases assigned to its Automated Collection System (ACS) and its field collection function. The ACS process consists primarily of telephone calls to the tax debtor to arrange for payment. Cases assigned to field collections are those for which a revenue officer attempts face-to-face contact and collection. Even though unblocked as a group, IRS officials who work on ACS and field collection inventories can manually block individual cases they are working in order to remove them from the levy program.

[39] The process of sending cases to the levy program is driven by the various status codes IRS enters into its tax records—such as codes identifying a case as being in bankruptcy or having an installment agreement.

the tax debtor has up to 30 days to respond to this notice under the law, IRS has chosen to wait 10 weeks before proceeding with collection actions, such as levying. Until the due process notification and waiting period have been completed, a tax debt may be submitted to TOP but is not subject to immediate levy. For civilian contractors, IRS generally does not initiate the collection due process notifications until FMS identifies that the contractor is to receive a federal payment.

Once the debtor receives the notice of impending levy, IRS gives the debtor up to 10 weeks to respond to the notice. As in the initial notice process, the debtor can respond to IRS by disagreeing with IRS's assessment (in this case, filing for a due process hearing), negotiating with IRS to set up an alternative payment arrangement, applying for a hardship determination, or making payment in full. If a tax debtor does not respond to IRS and take advantage of those options within the notification period, IRS will instruct FMS to start levying future payments. The tax debt in the levy program is then coded for immediate levy. For future payments, FMS will proceed with the continuous levy by reducing each scheduled payment to the tax debtor by 15 percent—or the exact amount of tax owed if it is less than 15 percent of the payment—until the tax debt is satisfied.

Not having tax debt ready for levy results in the loss of millions of dollars of tax revenue for the federal government. For example, for our 50 case studies we identified payments totaling $1.6 million in which the TIN of the contractor matched an IRS tax debt, but no levy was taken because IRS had not yet completed the collection due process activities. This situation contributes to these contractors facing little or no consequences for their abuse of the federal tax system. IRS has an automated process in place by which, once a match is made against a tax debt in the levy program, a due process notice is automatically sent to the contractor. However, the payments made between the time of the initial match and when IRS completes its due process notification process—usually 10 weeks—cannot be levied and the potential collections are lost to the federal government. Additionally, if the tax debtor files for a due process hearing once it receives the notice, the tax debt will continue to be excluded from levy until the process—which could take months—is complete.

Prior to 1998, IRS was authorized to levy a payment immediately upon matching a tax debt with a federal payment so long as the collection due process notice had been sent. At that time, IRS did not have to wait before proceeding with the levy. This allowed the levy program to capture the payment before it was made to preserve the government's right to the

payment while providing the contractor a postlevy due process. However, the IRS Restructuring and Reform Act of 1998 requires that debtors be afforded an opportunity for a collection due process hearing before a levy action can take place. To comply with this provision, IRS has chosen to wait a minimum of 10 weeks for the tax debtor to respond to the collection due process notice. However, IRS's 10-week waiting period causes the federal government to miss levying some contractor payments.

IRS has acknowledged that the delay in initiating the due process notice can result in lost collections and is investigating ways to begin the process earlier. The joint task force established after our previous audit has supported making the due process for the FPLP a postlevy process.[40] This would allow IRS to levy payments when first identified and provide contractors with procedural due process remedies afterwards. To expedite the notification, IRS officials stated that they had begun matching new DOD contracts valued at over $25,000 against tax debt and sending out collection due process notifications at that time rather than waiting until payments are made. To address this same issue, the task force is also exploring avenues to combine the collection due process notice with the last of its initial notification letters sent to tax debtors. This would allow IRS to have all tax debt legally ready for levy prior to it being sent to TOP to be matched against federal payments. We fully support the task force's and IRS's efforts to increase the amount of tax debt that is ready for immediate levy.

[40] Federal Contractor Tax Compliance Task Force, *Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations* (Washington, D.C.: Oct. 26, 2004).

Lack of FMS Oversight and Proactive Management Further Contribute to the Levy Collection Gap

FMS has contributed to the tax levy collection gap by not taking a proactive stance in overseeing and managing the levy program. GAO's Standards for Internal Controls in the Federal Government considers a positive control environment—which includes the establishment of mechanisms to monitor or oversee program operations—to be the foundation for all other standards. For FMS, such management control and oversight is critical in its role as the federal government's debt collector and chief money disburser. However, because of a lack of oversight, FMS did not detect and have agencies correct obviously inaccurate information for tens of billions of dollars in payments to contractors, and therefore was not able to match these payments against tax debts for potential levy. Further, because of a lack of proactive management, FMS did not send tens of billions of dollars more in payments to the levy program. We estimate that these deficiencies resulted in at least $50 million in lost levy collections from civilian agency contractors during fiscal year 2004.[41] Table 1 provides a breakdown of the deficiencies that result in payments not being subject to levy. Further discussion of these deficiencies will be provided in detail later in this report.

[41] This estimate is based on all contractor payments recorded in PACER during fiscal year 2004 being sent to TOP to be matched against the tax debt in TOP as of September 2004. Due to the unavailability of information at FMS, our estimate does not include an estimate of the amount that could be collected from sending Fedwire payments to TOP. Additionally, we were unable to estimate collections against many payments because of blank or invalid TIN information in FMS's payment records. The estimate of a minimum of $50 million represents our total estimate of potential levy collections from civilian contractors less FMS's actual collections during fiscal year 2004.

Table 1: Payments Not Matched against Tax Debts for Potential Levy

Dollars in billions	
Cause of payment not being levied	**Amount excluded**
Payments submitted to TOP that could not be levied	
Payments where the agency payment station has not been loaded in TOP	$40
Payments containing blank or obviously inaccurate TINs	17
Payments containing blank or invalid names	4
Payments containing invalid payment types	5
Payments FMS does not submit to TOP	
Certain categories of payments (at least $26 billion in certain types of payments and an unknown amount in Fedwire payments[a])	Unknown amount
Payments to individuals	2

Source: GAO analysis of FMS data.

Notes: The exclusion categories above cannot be added together to derive the total amount of excluded payments because many payments had multiple deficiencies, each of which would have prevented the payment from being levied. For example, some payments without TINs also have invalid names, and some payments originating from agency payment locations that were not entered into the TOP database were also payment categories FMS was not sending to the levy program.

[a]During fiscal year 2004, Fedwire disbursed $191 billion, some of which was to contractors. FMS does not maintain detailed historical records and could not determine the value of contractor payments paid with Fedwire.

In addition to these deficiencies, FMS also faces design challenges in the levy program that limit its effectiveness at collecting unpaid taxes. These challenges include the difficulty in matching the name of the contractor recorded in the payment files to the name recorded in IRS's tax records and the difficulty in levying vendors paid with government purchase cards. FMS also has not implemented a provision of the American Jobs Creation Act of 2004, which allows the federal government to levy up to 100 percent of payments to contractors with unpaid federal taxes.

FMS Did Not Include All Agency Payments in the Levy Program

FMS has not updated its TOP database to capture payments from about 150 agency paying stations,[42] resulting in $40 billion of fiscal year 2004 civilian agency contractor payments being excluded from potential levy. Although effective internal control would generally include oversight of key agency functions, FMS did not perform the management oversight necessary to identify that a significant portion of all its disbursements were not included in the levy program. Of the $40 billion not sent to TOP, we determined that approximately $9 billion in payments were made to civilian contractors with tax debts, none of which could be levied.

Federal agencies may have multiple offices or locations that perform accounting for and preparation of payment information, referred to as agency payment locations or paying stations. For a payment to be matched against tax debts for the purpose of levy, the paying station from which the payment originates needs to be programmed into the TOP database. If a paying station is not in the TOP database, TOP considers that location to be excluded from the levy program, and thus payments from that location will not be matched against unpaid federal taxes for potential levy. The approximately 150 paying stations not included in TOP are paying stations for portions of a majority of federal departments, including the Departments of Homeland Security, the Interior, Justice, State, the Treasury, and Health and Human Services.

An FMS official stated that at the time FMS implemented TOP in the 1990s, it had a centralized monitoring system to verify that payments from all payment locations were included in TOP. According to the official, after the initial group of paying units was incorporated into TOP, FMS did not take steps to ensure that the TOP database was up to date and that payments from new payment locations were incorporated into TOP. FMS was unaware that a large percentage of its disbursements were being excluded from potential levy. Since we brought the problem to their attention, FMS officials stated that efforts are under way to update TOP for the paying

[42] These stations are generally referred by their Treasury Agency Location Code (ALC). The ALC is used to identify transactions, documents, and reports processed through Treasury by a specific accounting point or station, within an agency or bureau of a federal department or independent agency. Using the ALC enables Treasury to reconcile deposits and disbursements.

stations we identified as being excluded from the levy program.[43] The officials also stated that they plan to reinstate the centralized monitoring to ensure that paying stations are updated in TOP so that payments from these stations would be available for potential levy.

FMS Disbursed Payments to Contractors without Proper TINs

During fiscal year 2004, FMS disbursed over $17 billion in payments to civilian agency contractors without TINs or with obviously inaccurate TINs. Valid TIN information is critical to the levy program[44] because payments lacking this information cannot be matched against tax debts. The DCIA[45] requires executive agencies to obtain TINs from contractors and to include TINs on certified payment vouchers, which are submitted to Treasury.[46] Without a proper TIN, payments cannot be levied.

We found that payment records with blank or obviously inaccurate TINs in the TIN fields are prevalent in the payment files submitted to FMS by some agencies. For example, over half of payments at one agency and over three-quarters of payments at another agency were made to contractors that had blank or obviously erroneous TINs, such as TINs made up of all zeros or all 9s. While certain vendors are exempt from the requirements to have a TIN, the exemptions are rare and are generally limited to foreign companies providing goods and services to federal agencies in a foreign country or companies performing classified work. However, FMS does not gather information to determine whether the payments to contractors without TINs or with obviously inaccurate TINs are exempt from the TIN requirement or that all nonexempt payments include TINs. FMS officials stated that the responsibility for gathering and submitting TIN information was solely that of the paying agency. In subsequent audit efforts, we will evaluate selected agencies' controls over obtaining and submitting TIN information for all nonexempt payments.

[43] An FMS official also noted that some of the agency paying stations we identified only disbursed categories of payments that FMS does not currently submit to the levy program, such as type A and ACH-CTX payments.

[44] GAO, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*. GAO-04-74 (Washington, D.C.: Dec. 5, 2003).

[45] Pub. L. No. 104-134, 110 Stat. 1321-358, April 26, 1996.

[46] 31 U.S.C. § 7701(c) and (d).

FMS officials stated that FMS tabulates payment records with obviously inaccurate TINs by agency[47] to compile a monthly TIN Compliance Report. This report is used to monitor agencies that send in payment requests with obviously inaccurate TINs.[48] According to FMS officials, in cases of significant noncompliance, FMS encourages agencies to send payment files with valid TINs. However, FMS does not enforce the TIN requirement by rejecting agency payments without TINs or requiring the agencies to certify that the payments not containing TINs meet one of the TIN exclusion criteria. As a result, agencies continue to submit payment requests without TINs, which cannot be levied to collect unpaid federal taxes.

We found that some civilian agency contractors without TINs or with obviously inaccurate TINs in the agency payment files received payments during fiscal year 2004 and had unpaid federal taxes. For example, FMS paid about $700,000 to one contractor with an invalid TIN. Based on investigative work, we were able to determine that this contractor had failed to pay all its payroll taxes and owed more than $50,000 in unpaid taxes. Had the payment file contained a TIN and if the tax debt were subject to immediate levy, the government could have collected the full amount of unpaid taxes from this contractor during fiscal year 2004.

[47] Tabulation is performed for the standard payment types sent through the levy program, that is, payments known as type B. Type A payments—which are payments that the agency certifies the payment in the same file that contains detailed payment information—and Fedwire payments are not tabulated or monitored.

[48] In 1997, Treasury proposed a rule that would require disbursing officials to reject agency payment requests that do not contain TINs. Upon review of the comments received in response to the proposed rule, FMS rescinded the proposed rule, and instead required agencies to submit to FMS implementation plans to achieve compliance with the TIN requirement. FMS's responsibility includes monitoring payment vouchers to ensure that agencies are meeting compliance goals and time frames as identified in the implementation reports.

FMS Made Disbursements to Contractors without Proper Names

FMS made disbursements of nearly $3.8 billion in fiscal year 2004 to contractors whose payment files did not contain the name of the contractor receiving the payment. We found that instead of the contractor's name, the disbursement file name field was either blank or contained only numeric characters.[49] The lack of a name on the payment file does not prevent the payment from occurring because FMS made these disbursements electronically via direct deposit into the contractors' bank accounts. However, valid name information is critical because the levy program requires a match between both the name and TIN for a levy to occur.[50] The lack of a proper name could have been detected if FMS had conducted a cursory review of the payment files submitted by the agencies.

For example, our review readily identified that most of the payment files submitted by the State Department did not contain valid contractor names. In addition, about $3.2 billion of the nearly $3.8 billion we identified as payments made to contractors without names in the payment files were made on behalf of the State Department. Until we brought the matter to their attention, senior officials at both the State Department and FMS were not aware that the State Department's contractor payments did not contain valid names. At our request, a State Department official investigated and found that the department's payment systems did contain valid names but that a programming error resulted in the wrong field being sent to FMS as the name field. The official told us that the error in the payment file is not new because the structure of the payment file sent to FMS had remained the same since the 1980s. Once we brought this to the attention of State Department officials, they were quickly able to identify corrective actions, and according to the State Department, they have since corrected the deficiency.

Our analysis of FMS payment data found that FMS made disbursements without contractor names, totaling approximately $400 million, to about 2,000 companies that had about $370 million in unpaid federal taxes. FMS's failure to detect and correct missing names had a direct impact on the levy program. For example, one contractor with unpaid taxes received from the

[49] In addition, we identified numerous payee names that contained only a single alphabetic character in the name field. We did not include these in our analysis of payments with improper name fields.

[50] GAO, *Tax Administration: Millions of Dollars Could Be Collected If IRS Levied More Federal Payments*. GAO-01-711 (Washington, D.C.: July 20, 2001).

State Department payments totaling over $400,000, which could not be levied because of the missing name. The same contractor also received payments from other civilian agencies. However, because the contractor's name was included in the payment files from the other agencies, the levy program collected over $50,000 from those payments. If FMS or the State Department had identified and corrected the name problem, an additional $60,000 in unpaid federal taxes from this contractor could have been collected through the levy program.

FMS Made Payments without Proper Payment Type Codes

FMS disbursed $5 billion in payments using checks based on agency-submitted payment files that did not contain data in the payment type field during fiscal year 2004. FMS uses the payment type field in the agency-submitted payment files to determine if the payment is required to be included in the levy program. If a payment file record has a blank payment type field, it is not matched in the levy program to collect unpaid federal taxes. As a result, none of the $5 billion in payments we identified as having a blank payment type field could have been levied to collect the contractors' unpaid federal taxes. FMS lacked the oversight to detect that the payment files submitted by agencies were not adequately coded. After we brought this to management's attention, an FMS official stated that FMS planned to establish a new centralized program to monitor the completeness of agency information.

FMS Has Not Taken Action to Include All Categories of Contractor Payments in the Levy Program

FMS has not been proactive in including many categories of payments in the levy program, and has therefore kept tens of billions of dollars in contractor payments from being subject to potential levy collection. FMS uses several payment mechanisms to make its disbursements. FMS payment mechanisms (payment categories) include what it refers to as type A, type B, which includes Automated Clearing House-Corporate Trade Exchange (ACH-CTX), and Fedwire.[51] However, FMS has only taken action to include a portion of type B payments in the levy program. FMS has not taken action to include the other categories of payments due to what it

[51] For type B payments, agencies send FMS the certification for the payment separately from the detailed payment information. Type A payments are payments in which the agency certifies the payment in the same file that contains detailed payment information. ACH-CTX payments (a specific kind of type B payment) are ones whereby agencies can pay multiple invoices to a single contractor using a single ACH-CTX payment. Fedwire is a processing system designed for high-dollar, low-volume payments that must be received by payees the same day as originated by the agency.

considers to be programming limitations. Therefore, none of those payments can be levied to collect unpaid federal taxes.

Although it is responsible for the levy program, FMS also could not quantify the magnitude of federal contractor payments that it was not sending to the levy program, nor could FMS estimate the amount of levy collections it was missing because it had not included all payment categories in the program. FMS officials estimated that FMS paid about $11 billion in contractor payments via ACH-CTX in fiscal year 2004, and our analysis identified at least $15 billion in type A contractor payments.[52] The combined amount of those two categories—$26 billion, though likely understated—represents almost 11 percent of all contractor disbursements recorded in FMS's PACER database. In addition, FMS disbursed approximately $191 billion[53] in Fedwire payments, but FMS could not identify the value of Fedwire contractor payments that were not sent to the levy program.

Type A Payments

FMS officials stated FMS had not included type A payments in the levy program because it is waiting for a new disbursement system to be deployed. Type A payments are payments whereby the agency certifies the payment in the same file that contains detailed payment information.[54] Although FMS had performed some preliminary studies in 2001 regarding how to send type A payments to TOP, officials were unable to provide information regarding the cost of making system corrections.[55] At that time, FMS was developing a new payment system that it estimated would be completed as early as 2003 and therefore decided not to make the system

[52] FMS officials could not identify type A or ACH-CTX payments in its disbursement databases and therefore could not determine the amount disbursed during fiscal year 2004 through type A. Based on data provided by FMS on the payment locations that make only type A payments, we determined that type A payments totaled at least $15 billion during fiscal year 2004. This number is understated because a number of other locations made both type A and type B payments, but the amount of type A payments made by these locations is not estimable.

[53] This amount does not include $66 billion in certain benefit payments.

[54] The typical payment mechanism involves the certification being sent to FMS separately from detailed payment information. This type of payment, known as type B, is sent to TOP for levy.

[55] FMS estimated that it would take about 6 hours of programming and 1 to 3 days of testing to make changes necessary in one system to send type A payments to TOP. FMS officials stated that it could take additional programming time to prepare other systems to send type A payment information to TOP. However, FMS officials stated they did not know what additional programming might be required or the potential cost thereof.

changes. However, at the time of our audit, the new system was still not fully deployed. Consequently, over the last 4 years the federal government has lost the collections that could have been levied from those payments. FMS officials stated that FMS is continuing to focus on completing the deployment of a new disbursement system, which it now estimates will be fully operational in 2006, rather than including type A payments in its current system. FMS tentatively plans to incorporate type A payments into TOP in calendar year 2006 when its new system is scheduled to be operational.

ACH-CTX Payments

FMS officials stated that FMS does not send ACH-CTX payments to TOP for levy. According to FMS officials, ACH-CTX can be used to pay multiple invoices to a single contractor. However, the structure of the ACH-CTX payments requires that the total payment amount disbursed to the contractor match exactly the total of the invoices that the payment is to cover. If a levy were to take place, the total payment amount would differ from the total amount of the invoices that support the payment. Consequently, FMS officials stated that they cannot levy a portion of the payment. Officials stated that although they could not separately identify them in the PACER database, FMS made about $11 billion in ACH-CTX payments to contractors during fiscal year 2004.

FMS officials stated they had not developed an implementation plan or timeline to incorporate ACH-CTX contractor payments into the levy program.

Fedwire Payments

As with type A payments, FMS officials stated that FMS is currently focused on completing a new disbursement system prior to incorporating Fedwire payments—payments requiring same-day settlement—into TOP. FMS officials recognized that Fedwire payments, as a whole, are not specifically exempt from levy, though individual Fedwire payments may be exempt. FMS officials stated that the decision to exclude Fedwire payments from the levy program was also based on the limited time window FMS has to send Fedwire payments to the Federal Reserve and the operational and system changes necessary to send those payments to TOP.[56] FMS's TOP implementation plan, dated January 2005, called for

[56] FMS officials stated that they performed a statistical match on Fedwire payments for 1 month in 2003. FMS officials stated that because few of these Fedwire payments had valid TINs, a small amount would have been offset. FMS did not maintain the detailed transactions for this statistical match for our review.

incorporating Fedwire payments into TOP in calendar year 2007, over 10 years after DCIA first required the establishment of a centralized offset program. However, FMS officials recently informed us that they are going to study the costs of submitting Fedwire payments to TOP and may not attempt to include them in the levy program. As a result, FMS officials stated that they no longer have a timeline to incorporate Fedwire payments into TOP. We recognize that submitting Fedwire to the levy program could result in a delay in disbursement, but until FMS fully explores and identifies options for submitting Fedwire payments through TOP, potentially billions of dollars may be disbursed to contractors with unpaid federal taxes without the possibility of being levied.

FMS Does Not Offset Contractor Payments to Collect Tax Debts of Individuals

Because payment systems do not identify whether the payment is being made to a business or individual, FMS does not offset contractor payments to collect the unpaid federal taxes owed by individuals. Our analysis determined that civilian agency contractors with unpaid federal taxes who are individuals received payments totaling nearly $2 billion while owing over $290 million in unpaid federal taxes.

Agency payment records do not distinguish payments made to individuals, such as those who are self-employed or sole proprietors, from payments made to businesses. IRS decided that due to the lack of distinction between these two types of payments in FMS's system and the possibility of improperly levying payments, contractor payments should not be levied to satisfy the unpaid federal taxes of individuals. According to IRS, an improper levy could occur because a business's TIN could be the same as an individual's Social Security number (the individual's TIN). According to FMS officials, IRS instructed FMS not to match any contractor payments against unpaid federal taxes owed by individuals for potential levy following discussions between FMS and IRS.

However, both FMS and IRS officials have indicated that the potential risk of an improper levy is small. For a levy to occur, a match must exist between the TIN and name in the payment files and the TIN and name control in the tax debt file. FMS indicated it has performed a study and found that only a small number of cases potentially have a business TIN and name that would match with an individual's TIN and name. After we met with IRS and FMS officials regarding this issue, IRS directed FMS to begin levying contractor payments against tax debts owed by individuals. FMS officials stated that they will need to make system changes to implement this action.

FMS Faces Challenges in Addressing Other Program Limitations

FMS faces management challenges in addressing certain limitations in the levy program that result in reduced collections. Specifically, almost $2 billion of contractor payments could not be levied due to difficulties in matching both the name and TIN in the payment records to the tax debt in the TOP database. Additionally, nearly $10 billion in federal payments made via purchase cards to contractors are not subject to levy because the government payment is made to the bank, not the contractor doing business with the government. Finally, FMS faces challenges in implementing a provision contained in the American Jobs Creation Act of 2004, which provides for increasing the amount of levy to a maximum of 100 percent of payments to contractors with unpaid tax debts.

Limitations in TIN/Name Match Reduces Levy Collections

Potentially thousands of payments are not levied every week because the TINs and names from the payment records do not match against the names and TINs in TOP for potential levy. Data from FMS's PACER and TOP databases indicate that about $1.7 billion of payments made to contractors with unpaid federal taxes in TOP could not be levied because the control name supplied by IRS did not match the payee name in PACER. As a result, none of these payments could be levied to collect delinquent tax debt.

IRS provides TOP with both a TIN and a "control name" of both companies and individuals with unpaid federal taxes. In general, the control name is the first four characters of an individual's last name or the first four characters of the business name. TOP analyzes the name in the payment files to determine if it contains the IRS control name. If it identifies the control name (first four characters of the IRS name) anywhere within the name field of the payment file, TOP levies the payment to collect the unpaid taxes. If the control name is not found in the payment record's name field, TOP records the mismatch on a report that it sends to IRS to identify the mismatches.

We reviewed an example of the report containing approximately 2,400 different payments that could not be levied to identify some of the causes for the mismatches. We found that a number of payments were not levied because the payments were made using an individual's name and the business's TIN. The following hypothetical example based on an actual case illustrates the difficulty in matching names under the levy program. In one case, the payment was made to an individual doctor, J. Doctor, MD. However, the TIN provided was to the doctor's practice, Jenny Doctor, MD PA. For IRS, the control name of the business TIN was "JENN." As a result, although the TIN of the payment matched the TIN of the tax debt, the

control name "JENN" did not appear within the payment name "J Doctor." Because the names did not match, the payments to this contractor were not levied.

After we brought this to FMS's and IRS's attention, IRS began working with FMS to increase the number of control names it sends to TOP. According to IRS officials, IRS is taking action to begin sending up to 10 additional business control names to FMS to be matched against payment data.[57] IRS officials believed that this should increase the number of matches available under the levy program. IRS is also evaluating additional changes to increase the number of name controls that it sends to FMS for matching with payments to individuals.

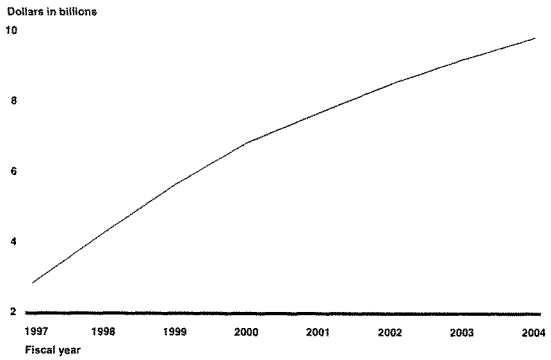
Billions of Dollars in Purchase Card Payments Are Not Levied

Due to the structure of the credit card program, whereby payments are made to the government purchase card bank and not directly to contractors with unpaid tax debts, none of the $10 billion in purchase card payments made during fiscal year 2004 were able to be offset or levied. FMS officials have acknowledged the need to address those challenges and stated that FMS has met with certain bank officials and another federal agency regarding how to approach the issues. However, they have not yet determined how to collect federal debts from contractors paid with the government purchase card.

The Governmentwide Commercial Purchase Card Program was established to streamline federal agency acquisition processes by providing a low-cost, efficient vehicle for obtaining goods and services directly from contractors. Governmentwide efforts to promote increased use of purchase cards for small and routine purchases have dramatically increased purchase card spending. As shown in figure 7, purchase card expenditures by civilian agencies increased from nearly $3 billion in fiscal year 1997 to nearly $10 billion in fiscal year 2004. The use of purchase cards has accrued significant benefits to the federal government; however, contractors receiving payments through purchase cards are not currently subject to the levy program.

[57] Once a match is made against the TIN in a contractor payment, FMS would match the name against all of the control names provided by IRS to determine if there is a match for potential levy.

Figure 7: Purchase Card Expenditures by Civilian Agencies—Fiscal Years 1997-2004



Source: GAO analysis of GSA data.

All purchase card payments are made to one of the five banks that issue government purchase cards—Bank One, Bank of America, CitiBank, Mellon Bank, or US Bank. In accordance with standard credit card payment procedures, those banks are responsible for interfacing with Visa or MasterCard and the contractor's bank to pay for the goods or services provided. This payment process shields the identity of the contractor that is ultimately paid by the civilian agency receiving the goods or services from the levy program. Consequently, the disbursement file contains only the name of the purchase card issuing bank and its TIN and not the contractor that was actually doing business with the government.

Without identifying the contractor doing business with the government, the federal government is unable to collect federal debts from payments to these contractors. To demonstrate the effect of payments to contractors using the purchase card, we obtained the National Aeronautics and Space Administration's (NASA) fiscal year 2004 purchase card transactions and compared the contractors from which NASA purchased goods and services to the IRS unpaid taxes database. During fiscal year 2004, NASA used purchase cards to pay about 12,000 contractors nearly $80 million.

According to IRS's data on unpaid tax debts, over 750 of those contractors had about $440 million in unpaid federal taxes. However, none of the purchase card payments made to these contractors could be levied to collect the unpaid federal taxes. In contrast, in analyzing the TOP database, we found that non-purchase card payments made during fiscal year 2004 to 49 of these same contractors were levied.

FMS recognizes purchase card payments as a significant problem for the government's debt collection and lists the government purchase card program among the payment streams that need to be incorporated into TOP. FMS officials have stated they face both operational and legal issues to incorporate such payments into TOP and that the process of paying the purchase card issuing bank may prevent FMS from using TOP to collect from contractors paid with purchase cards. Until the challenge is thoroughly examined by FMS and IRS and solutions are identified, the federal government will continue to be unable to levy or otherwise collect from tens, if not hundreds, of billions of dollars in payments to civilian contractors.

Statutory Authorization for Increased Levy Has Yet to Be Implemented

FMS has not fully implemented a new provision, authorized by Congress in 2004, that increased the maximum levy percentage on contractor payments. In October 2004, Congress passed the American Jobs Creation Act 2004 to increase the maximum continuous levy from 15 percent to up to 100 percent of payments to contractors with unpaid taxes. The act specifically increased the continuous levy on payments to vendors for "goods and services" sold or leased to the government. According to IRS, the legal language, which specified that goods and services be subject to the 100 percent levy provision, excludes real estate, such as rent payments, from the new levy requirement. This exclusion presents significant implementation challenges for FMS because the civilian agencies' payment systems cannot separately identify real estate transactions from other contractor payments. Without the ability to distinguish between these payments, FMS could not implement the new law for civilian payments in such a way as to exempt real estate transactions from the 100 percent levy. FMS officials stated they had recently been able to implement the 100 percent levy provision for certain DOD payments, but were unable to do so for their own disbursements. According to FMS and IRS officials, a specific legislative change is being sought to make real estate payments subject to the new 100 percent levy requirement.

We estimate that increasing the levy percentage from 15 to 100 could cause a dramatic increase in collections. We performed a separate analysis of our maximum levy potential estimate as if there were no legal or administrative impediments—estimated at $350 million for a 15 percent levy—and found that if a 100 percent levy rate had been applied in fiscal year 2004, FMS could have collected as much as $800 million from civilian contractors if all payments had been matched against all tax debt.[58]

Civilian Agency Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

We found abusive and potentially criminal activity related to the federal tax system for all 50 cases that we audited and investigated. The case studies were selected from the population of about 33,000 contractors that were receiving federal payments during fiscal year 2004 and owed over $3.3 billion in unpaid federal taxes as of September 30, 2004, using a non-probability selection approach. The basis for selecting each of the case study contractors was that they all had unpaid taxes totaling more than $100,000 and federal payments totaling more than $10,000. When our audit and investigative work indicated that the 50 contractors we originally selected were related to other entities—defined as entities sharing the same owner or officer or common addresses—we performed additional work to determine whether the related entities and the owners owed tax debts as of September 30, 2004, and received other federal payments during fiscal year 2004.[59] While we were able to identify some related entities, in some cases other related entities might exist that we were not able to identify. In addition, we found that 3 of the 50 case studies involve owners or officers who had been either convicted or indicted for non-tax-related criminal activities, or were under IRS investigation. We are referring the 50 cases detailed in this report to IRS so that a determination can be made as to whether additional collection action or criminal investigations are warranted. For more information on our criteria for the selection of the 50 case studies, see appendix I.

[58] This estimate is based on all contractor payments recorded in PACER during fiscal year 2004 being matched against all contractor tax debt as of September 30, 2004. Due to the unavailability of information at FMS, our estimate does not include an estimate of the amount that could be collected from sending Fedwire payments to TOP. Additionally, we were unable to estimate collections against many payments due to blank or invalid TIN information in FMS's payment records.

[59] IRS and FMS cannot collect from payments made to one related company to satisfy the unpaid federal taxes of another related company.

Nature of Business for Case Study Contractors

The federal government is a large and complex organization, consisting of 15 cabinet-level agencies—one defense and 14 civilian agencies—and numerous independent agencies, administrations, and other entities that collectively spent more than $2.5 trillion in fiscal year 2004. Civilian agencies operate throughout the country and in more than 250 foreign countries, carrying out a multitude of missions and programs. Because civilian agencies contract for a large variety of goods and services to carry out functions as diverse as guarding the nation's borders, providing medical benefits to veterans, administering justice, and exploring space, it is not surprising that civilian agency contractors with unpaid taxes operate in a large number of industries. The industries are typically wage-based, while the 50 case studies are mostly small, many of them closely held by the owners and officers. Table 2 shows a breakdown for the 50 contractor case studies by the type of goods and services provided.

Table 2: Types of Goods and Services Provided by Civilian Agency Contractors in Case Studies

Type of business	Number
Building maintenance	6
Communications	2
Consulting	2
Health care	12
Manufacturing	5
Personnel services	2
Professional services	6
Sanitation	2
Security services	2
Transportation	3
Other	8
Total	**50**

Source: GAO analysis of civilian agency and public records.

Examples of Abusive or Potentially Criminal Activity Related to the Federal Tax System by Businesses

Our audits and investigations of the 50 case study business contractors showed substantial abuse and potential criminal activity related to the tax system. All 48 of the contractors in our case studies that file business tax returns had tax periods in which the contractors withheld taxes from their employees' paychecks but did not remit them to IRS.[60] Rather, these companies diverted the money to fund business operations, for personal gain, or for other purposes. As discussed earlier in this report, businesses with employees are required by law to remit employment taxes to IRS or face potential civil or potential criminal penalties. Specifically, the act of willfully failing to collect or pay any tax is a felony while the failure to comply with certain requirements for the separate accounting and deposit of withheld income and employment taxes is a misdemeanor.

Six of the case study businesses involved owners or officers who were "multiple abusers," those involved with a group of related companies that owed taxes. The owners or operators of some of these businesses not only failed to have their businesses pay taxes, but several also failed to pay their own individual income taxes, with three individuals having more than $100,000 in unpaid individual income taxes. The related businesses involving these multiple abusers repeatedly failed to pay taxes. For example, several groups of related businesses owed taxes for more than 50 tax periods—one group of about 20 businesses owed taxes for over 300 tax periods. One case study business owner (whose businesses received more than $1 million in federal payments in fiscal year 2004) has a pattern of opening a business, failing to remit at least some payroll taxes, closing the business, and then opening a new business to repeat the same pattern. The owner repeated this pattern for at least three businesses over nearly 20 years.

Table 3 highlights 10 case studies with unpaid payroll tax debts. Nine of the 10 cases have unpaid payroll taxes of 10 tax periods or more. The amount of unpaid taxes associated with these 10 cases ranged from nearly $400,000 to $18 million—6 businesses owed more that $1 million in unpaid federal taxes. Our investigations revealed that some owners have substantial personal assets—including commercial real estate, a sports team, or multiple luxury vehicles—yet their businesses fail to remit the payroll taxes withheld from employees' salaries. Several owners owned

[60] The remaining two case study contractors were either individuals or sole proprietorships that filed personal income tax returns.

homes worth over $1 million—one owner had over $3 million and another had over $30 million in real estate holdings. Others informed our agents that they diverted payroll taxes they did not remit to IRS for personal gain or to fund their business, while others were engaged in activities that indicated potential diversion of payroll taxes for personal gain. For example, one owner transferred the payroll taxes he withheld from employees to a foreign bank account and was using the money to build a home in that country, while another contractor doubled the salary of an officer in a 5-year period to over $750,000 at the same time that the business failed to remit payroll taxes and declared losses of more than $2 million. Another purchased a number of multimillion-dollar properties and an unrelated business at the same time that his many businesses owed taxes, while yet another owner purchased, within a 2-year period, four vehicles totaling nearly $200,000 after the owner's business started accumulating unpaid tax debts.

IRS has taken some collection actions against the contractors in our case studies, but has not been successful at collecting the unpaid taxes. For example, we found that in all 10 cases shown in table 3, IRS has assessed trust fund penalties on the owners or officers for willful failure to remit to the government amounts they withheld from their employees' salaries.[61] However, as we have previously reported, IRS seldom collects on trust fund penalties. As of September 30, 2004, the balance on the trust fund penalties owed by the owners or officers of the 10 case studies was over $19 million. IRS has also taken some collection actions against all 10 contractors, such as placing liens on the assets of the companies or owners. Although some of the owner/officers had substantial assets, including expensive homes and luxury automobiles, the information we reviewed did not identify that IRS has performed seizures of these assets. However, we identified that 3 of the 10 owners or officers had been convicted or indicted for non-tax-related offenses or were under active IRS investigation for tax-related offenses.

[61] Overall, IRS assessed trust fund penalties in 27 of our 50 case studies. See app. II for further details.

Table 3: Civilian Agency Contractors with Unpaid Federal Taxes

Case study	Goods, services, or nature of work and agencies to which they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments
1	Health care related services to Departments of Veterans' Affairs and Health and Human Services	Over $300,000	Over $18 million	• Business is affiliated with many other health care-related facilities, including nursing and convalescent homes. • Taxes owed by related entities cover over 80 tax periods. • Since failing to fully remit all the taxes withheld from employees' paychecks starting in the late 1990s, the owner purchased multimillion-dollar properties, an unrelated business, and a number of luxury vehicles. • Other real estate holdings include residential and commercial properties valued in the tens of millions of dollars.
2	Waste collection services to the Department of Justice	Over $700,000	Over $2 million	• Company and several other entities share the same address or executives. • Taxes owed by related entities cover over 40 tax periods and include individual income tax debt of one owner. • Since the late 1990s, about the same time that the company failed to pay all of its payroll taxes, the company regularly withdrew cash from its bank accounts. These withdrawals totaled several million dollars. • Since failing to fully remit all the payroll taxes withheld from employees' paychecks, one owner sold his residence for more than $1 million.
3	Health care related services to the Department of Veterans Affairs	Nearly $250,000	Over $9 million	• Business is affiliated with three other related companies. • Taxes owed by related entities cover over 60 tax periods and include the owner's individual income tax debt totaling hundreds of thousands. • One entity is under IRS investigation. In addition, owner is suspected of fraudulent banking activity. • Since failing to pay taxes, officer spent tens of thousand of dollars on gambling; and one of the three companies had multiple withdrawals of cash from bank accounts—each totaling tens of thousands of dollars.
4	Waste collection services to the Department of Veterans Affairs	Over $10,000	Nearly $13 million	• Company is one of almost 20 related entities, all of which owed unpaid taxes—primarily payroll taxes. • Taxes owed by related entities cover over 300 tax periods. • The owner also owns a residential property located near a golf course and other commercial properties in several states with assessed value of over $2 million.

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Case study	Goods, services, or nature of work and agencies to which they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments
5	Payroll and temporary employment services to the Department of Housing and Urban Development	Over $1 million	Nearly $900,000	• Business related to three other entities. • Taxes owed by two related entities cover over 20 tax periods. • Some tax debts of remaining entities were not paid for so long that IRS is now legally prohibited from seeking collection. • The owner's history of delinquency stretches nearly 20 years and covered multiple businesses. Specifically, the owner typically incurs payroll taxes on one company, is assessed trust fund penalty on that company but makes no or little payments, closes company, starts another company, and repeats the same pattern. • For example, the owner filed for bankruptcy protection in the late 1990s. In the early 2000s, after the court denied the owner's request for bankruptcy protection, the owner closed the company and immediately established a new business with a similar name at the same address that provides the same services. • The owner rents office space in an expensive area of a major metropolitan city and purchased a luxury automobile at the same time the company had filed for bankruptcy protection and was not remitting all of the payroll taxes.
6	Health care related services to Department of Veterans Affairs	Nearly $300,000	Over $10 million	• The company's delinquent taxes—primarily payroll taxes—cover 20 tax periods from the late 1990s. • IRS is investigating the company for potential criminal activity. • Since failing to pay payroll taxes in late 1990s, an officer assessed a trust fund violation purchased several vehicles totaling nearly $200,000. • Since the late 1990s, the company reported cumulative losses on its tax returns totaling about $5 million. • Despite these continued losses and accumulated tax debt, the company is involved in a multimillion-dollar joint venture.
7	Security guard services to Departments of Homeland Security and Veterans Affairs	Over $200,000	Over $400,000	• The company had not filed all required tax returns since the early 2000s, and had been delinquent in payroll taxes almost continuously since the late 1990s. • Delinquent tax debts cover over 25 tax periods and include the owner's individual income taxes totaling tens of thousands of dollars. In addition, the owner repeatedly failed to file personal income tax returns. • The owner diverted unpaid payroll taxes to a foreign bank account to build a house overseas.

(Continued From Previous Page)

Case study	Goods, services, or nature of work and agencies to which they were provided	Fiscal year 2004 FMS payments[a]	Unpaid federal tax amount[b]	Comments
8	Consulting services to the Smithsonian Institution	Over $200,000	Over $1 million	• The business's unpaid federal taxes are primarily payroll taxes incurred in late 1990s and early 2000. • Unpaid tax debt balance covers more than 20 tax periods and includes hundreds of thousands of dollars in individual income tax debts owed by two officers. • During the same period that tax debt was incurred, the company declared large losses but doubled the salary of one officer to over three-quarters of a million dollars. • Officers own several luxury vehicles and multimillion-dollar properties in exclusive areas of a major metropolitan area. • The company is making payments on current installment agreement.
9	Armed security guard services to several agencies including the Department of Justice and the Environmental Protection Agency	About $500,000	Nearly $400,000	• Tax debt balance includes over $200,000 in payroll taxes owed for almost 10 tax periods. • In the early 2000s, company did not file income tax returns. • In mid-2000s, an officer of the company was convicted for stealing hundreds of thousands of dollars from the company. • The owner is under indictment for embezzlement and money laundering.
10	Building maintenance, lawn and garden, and sanitary services to Department of Transportation	Over $300,000	Nearly $400,000	• This business did not make any payroll tax deposits for several years from the late 1990s through the early 2000s. • Tax debt balance covers more than 30 tax periods and includes nearly $100,000 in personal tax debt of the officer. • The company is a chronic nonpayer of corporate tax debts and has not made any voluntary income tax payments since the mid-1990s. • The officer is also a chronic nonfiler of his individual income taxes. In one of those years, the officer reported net income of about $100,000 but paid no taxes.

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

Notes: Dollar amounts are rounded for the tax debt, estimated maximum levy, and government payments. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes.

[a]Civilian agency vendor payments provided by FMS from its PACER system.

[b]Unpaid tax amount as of September 30, 2004.

The following provides illustrative detailed information on several of these cases.

- **Case 1:** This case includes many related companies that provide health care services to the Department of Veterans Affairs, for which they received over $300,000 in payments during fiscal year 2004. The related companies have different names, operate in a number of different locations, and use at least several other TINs. However, they share a common owner and contact address. The businesses collectively owed more than $18 million in tax debts—of which nearly $17 million is unpaid federal payroll taxes dating back to the mid-1990s. IRS has assessed a multimillion-dollar trust fund penalty for willful failure to remit payroll taxes on each of two officers. During the early 2000s, at the time when the owner's business and related companies were still incurring payroll tax debts, the owner purchased a number of multimillion-dollar properties, an unrelated business, and a number of luxury vehicles. Our investigation also determined that real estate holdings registered to the owner totaled more than $30 million.

- **Case 2:** This case comprises a number of related entities, all of which provide waste collection and recycling services. These entities received fiscal year 2004 payments from the Department of Justice totaling over $700,000, about half of which is from purchase card payments, while owing in aggregate over $2 million in tax debt. These taxes date to the late 1990s and consist primarily of payroll taxes. Despite the fact that the company reportedly used legally available means to repeatedly block federal efforts to file liens against the company, liens totaling more than $1 million exist against the company. IRS has also assessed trust fund penalties against the two officers. At the same time that the entities were incurring the tax debt, cash withdrawals totaling millions of dollars were made against the business's bank account. Further, since the company started owing taxes, the owner had sold real estate valued at over $1 million. The executives of these entities also drive late-model luxury or antique automobiles. Recently, the company started to make payments on its taxes.

- **Case 3:** This case includes several nursing care facilities, three of which owed taxes—primarily payroll—totaling nearly $9 million. In addition, an owner's individual income tax debt totaled more than $400,000. One business provides nursing care services to the Department of Veterans Affairs, for which it was paid over $200,000 during fiscal year 2004. An officer of the company has been assessed a multimillion-dollar trust

fund penalty for willful failure to remit payroll taxes and was recently arrested on fraud charges. Our investigative work indicates that an owner of the company made multiple cash withdrawals, each valued at tens of thousands of dollars, in the early 2000s while owing payroll taxes, and that those cash withdrawals were used for gambling. We further determined that cash transfers totaling over $7 million were made in a 7-month period in the early 2000s.

- **Case 7:** This contractor provided guard and armed security services to the Department of Homeland Security and the Department of Veterans Affairs, for which it was paid over $200,000 during fiscal year 2004. This business has a history of noncompliance with federal tax laws. Specifically, the business was consistently delinquent in paying its taxes since the late 1990s and has not filed all its income and payroll tax returns for a number of years in the late 1990s. The owner of this business also has not filed individual income tax returns for a number of years since the late 1990s. In the last 1-year period that the business made payroll tax deposits, the business reported that it owed nearly $80,000 in payroll taxes but made payments totaling less than $4,000—about one-twentieth of the taxes owed. At the same time that the owner withheld but failed to remit payroll taxes, the owner diverted the money into a foreign bank account to build a house overseas.

- **Case 8:** During fiscal year 2004, this company provided consulting services to the Smithsonian Institution, for which it received over $200,000. Starting in the late 1990s, the company did not remit to the government all the money it withheld from its employees' salaries. However, at about the time the company was failing to remit the taxes, it nearly doubled one officer's salary to over $750,000. IRS assessed a trust fund penalty on the officers of this company for willfully failing to remit payroll taxes withheld from their employees' salaries. Those officers own homes valued at millions of dollars in exclusive neighborhoods in a large metropolitan area and several late-model luxury vehicles.

Contractors Also Had Unpaid State or Local Tax Debt

In addition to problems with paying federal taxes, contractors in at least 9 of the 10 case studies had unpaid state and or local tax debt. We determined that the amount and severity of the unpaid state and or local taxes were significant enough for state and local tax authorities to file liens against those contractors. As we will be reporting in a related product, neither the states nor FMS has pursued potentially beneficial agreements to authorize the levying of federal payments, including contractor payments, to satisfy delinquent state tax debts.[62]

Levy Collection

The 50 case studies we selected illustrate FMS's inability to collect the maximum levy amount. Although we found that payments to a number of contractors were not levied because IRS excluded their tax debts from TOP for at least a part of fiscal year 2004 for statutory or policy reasons, many others were not levied because of FMS's lack of effective oversight or proactive management of the levy program. One case study contractor in particular illustrated the problems associated with the levy program that we discussed earlier in this report. This contractor received $4 million during fiscal year 2004, but only about $600,000 of those payments were levied. Of the remaining $3.4 million that was not levied, about two-thirds was not levied because the tax debt was either not referred to TOP or it was referred to TOP but it was still in the notice process during the first 7 months of fiscal year 2004. The remaining one-third was not levied because the name provided in the payment files did not match the IRS control name in TOP or because payments were made using one of its specialized mechanisms. We estimate that if all the tax debt and all of the payments of the 50 case studies were subjected to a levy of 15 percent, FMS could have collected about $3.8 million in unpaid federal taxes in fiscal year 2004. In contrast, FMS actually collected $240,000 from these case study contractors.

[62] GAO, *Debt Collection: State and Federal Governments Are Not Taking Action to Collect Unpaid Tax Debt through Reciprocal Agreements*, GAO-05-697R (Washington, D.C.: to be issued).

Conclusions

In the current environment of federal deficits and rising obligations, the federal government cannot afford to leave hundreds of millions of dollars in taxes uncollected each year. However, this is precisely what has been occurring with respect to the FPLP, which our work shows has largely failed to approach its potential. The levy program has thus far been inhibited from achieving its potential primarily because substantial tax debt is not subject to levy and because FMS, the nation's debt collector, has exercised ineffective oversight and management of the program.

Further, by failing to pay taxes on their income or diverting the payroll taxes withheld from their employees' salaries to fund business operations or their own personal lifestyles, contractors with unpaid tax debts effectively decrease their operating costs. The lower operating costs provide these individuals and their companies with an unfair competitive advantage over the vast majority of companies that pay their fair share of taxes. Federal contractors should be held to a higher degree of responsibility to pay their fair share of taxes owed because they are being paid by the government, and the failure to effectively enforce the tax laws against them encourages noncompliance among other contractors as well. The federal government will continue to lose hundreds of millions of dollars in tax collections annually until actions are taken to send all payments to the levy program, ensure that all payments have the information necessary to allow them to be levied, and establish a proactive approach toward managing the levy program.

Recommendations for Executive Action

To comply with DCIA, further implement the Taxpayer Relief Act, and support the federal government's efforts to collect unpaid federal taxes, we recommend that the Commissioner of the Financial Management Service take the following 18 actions:

- To obtain reasonable assurance that payments from all paying locations are subjected to potential levy in TOP,
  - update the TOP database to include payments from all agency paying locations in TOP for potential levy and
  - develop and implement a monitoring process to ensure TOP's list of agency paying locations is consistently updated.

- To obtain reasonable assurance that payment files contain a TIN for each payment requiring a TIN,
  - enforce requirements that federal agencies must include TINs on all payment vouchers submitted to FMS for disbursement or expressly indicate that the contractor meets one of the criteria that exempts the contractor from providing a TIN and
  - develop and implement procedures to review payments submitted by paying agencies to verify that each payment has either a TIN or a certification that the contractor is exempt from providing a TIN.
- To obtain reasonable assurance that all payment files submitted by agencies contain a contractor's name, develop procedures to
  - evaluate payment files to identify payments with blank or obviously inaccurate name fields;
  - notify agencies of deficiencies in payment files regarding blank or obviously inaccurate name fields;
  - collaborate with agencies submitting payment files with blank or obviously inaccurate names in the name field, including the State Department, to develop and implement procedures to capture the contractors' names in the payment files; and
  - reject agency requests for payments with blank or obviously inaccurate names.
- To obtain reasonable assurance that payment files contain a payment type and thus, if appropriate, are subject to a levy,
  - instruct all agencies that they must indicate a payment type on all payments and
  - implement monitoring procedures to verify that all payments indicate payment type.
- To obtain reasonable assurance that all categories of eligible payments to contractors with unpaid federal taxes are subjected to the TOP levy process,

- develop and implement procedures to submit type A payments to TOP for potential levy,
- develop and implement procedures to submit ACH-CTX payments to TOP for potential levy, and
- develop and implement procedures to submit Fedwire payments to TOP for potential levy.

- To collect unpaid taxes of individuals, make changes to TOP to levy contractor payments to collect the unpaid federal taxes owed by individuals.
- To ensure that more payments are matched against tax debt in TOP, take actions necessary to incorporate IRS's expanded list of control names into TOP.
- To address challenges of collecting unpaid taxes of contractors paid using purchase cards, in conjunction with IRS, monitor payments to
  - assess the extent to which contractors paid with purchase cards owe federal taxes and
  - assess alternatives available to levy or otherwise collect unpaid taxes from those contractors.
- To address challenges associated with implementing the authorized increase of the levy to 100 percent, work with IRS to determine steps necessary to implement the increased levy percentage.

Finally, we recommend that the Commissioner of Internal Revenue evaluate the 50 referred cases detailed in this report and consider whether additional collection action or criminal investigations are warranted.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Commissioner of Internal Revenue (see app. III) and the Commissioner of the Financial Management Service (see app. IV).

Response from IRS and Our Evaluation

In responding to a draft of our report, IRS agreed that continued efforts are needed to improve and enhance the use of the levy program as a tool to deal with contractors that abuse the tax system. IRS noted that it had taken or was taking a number of actions toward this goal. For example, IRS stated that it had begun, with DOD's assistance, to issue collection due process notices to DOD contractors at the time of contract award rather than after a contract payment is made, thereby allowing IRS to levy more DOD contractor payments without delay. IRS stated that it planned to expand this process to contractors at other agencies later in 2005. IRS also stated that it is working to change its notice process so that more debts can be ready for levy at the time of inclusion in TOP. IRS reiterated the progress it has made to remove systematic exclusions, resulting in an additional $28 billion in tax debts being included in the FPLP, which we noted in our report. These actions have resulted in the federal government collecting, in the first 7 months of fiscal year 2005, $12.2 million in unpaid tax debts from civilian contractors—a nearly threefold increase from the same period in fiscal year 2004. IRS further stated that it would continuously evaluate its policies so that it does not unnecessarily exclude tax debts from the levy program.

IRS concurred with our finding that the matching of the TIN and name of contractor payments against records of unpaid federal taxes could be improved, and stated that it will begin sending a greater number of control names—up to 10 variations of the contractor's name as recorded in IRS's files—to FMS to match against FMS's payment data. IRS also stated that it was working to develop a consent-based TIN verification system for contractors doing business with the federal government and that it anticipated implementation of this system later this year. We believe that the completion of these actions can significantly improve collections of outstanding federal tax debt through the levy program.

With respect to the report's recommendations, IRS agreed to work with FMS and other agencies through the Federal Contractor Tax Compliance Task Force (FCTC) to conduct further analysis of the significant challenge presented by contractors paid with purchase cards. IRS also stated that as of April 2005, the 100 percent levy provision had been implemented with

respect to DOD contractors paid through DOD's largest payment system, and that IRS was working with Treasury on a technical correction to allow the 100 percent levy on all federal contractors. Finally, IRS agreed with our recommendation to review the 50 contractors discussed in our report to determine what additional actions are warranted.

Response from FMS and Our Evaluation

In its response to a draft of our report, FMS generally agreed with many of our findings and recommendations. However, FMS stated that we mischaracterized its role in the levy process, and that primary responsibility rests with IRS. FMS also did not concur with our conclusions that its oversight and management of the program were ineffective. Additionally, FMS disagreed that it had not fully implemented the legislatively authorized increase in the maximum amount of contractor payments subject to levy. FMS also stated that it disagreed with our recommendation that it withhold payments that do not include a valid name and stated that it was not in a position to implement our recommendations with respect to working with IRS regarding issues associated with collecting outstanding federal tax debt from purchase card payments. Finally, FMS stated that the numbers and potential levy collection amounts presented in the report were confusing and could be misleading.

We do not believe we mischaracterized FMS's role in the levy process. On its Web site, FMS states that it "serves as the government's central debt collection agency, managing the government's delinquent debt portfolio." In our opinion, the agency that is responsible for managing the government's delinquent debt portfolio needs to do so in a proactive manner, which we did not always find to be the case. While we agree that IRS has a key role in the levy process, many of the issues in our report touch at the heart of FMS's debt collection responsibilities and most of the weaknesses and challenges discussed in this report can only be addressed by FMS. For example, it was FMS that did not send billions of dollars of payments to the levy program because it had no monitoring mechanism in place to determine that over 100 agency paying locations created since the late 1990s were not included in the levy program. Further, it was FMS that did not identify and inform agencies to correct payment information for tens of billion of dollars in payments that did not have the basic information necessary for the payments to be matched against outstanding federal tax debt for potential levy. These findings form the basis of our conclusion that FMS has not exercised effective oversight and management of the levy program.

Despite the issues raised in our report, which FMS did not dispute, it disagreed that its management of the program was ineffective. FMS pointed to increased collections from the levy program in fiscal years 2003, 2004, and 2005, to date, as evidence of excellent leadership and program management. However, the recent increase in collections in the levy program is primarily the result of actions stemming from the formation of the FCTC, which was created in response to issues we raised in our February 2004 report on DOD contractors that abused the tax system. Further, the actions that have led to the increased collections were taken by DOD and IRS. Finally, while collections have increased in the last 3 years, the annual totals to date have not been significant given the potential of the program and, in the context of the program's 8-year life, the annual increases have come about only very recently.

In its response, FMS stated that it is not normally in a position to mandate changes to agencies. We disagree. FMS is in a unique position to identify and help correct many of the issues we identified in the program, some of which are relatively simple and could be quickly addressed. For example, it took the Department of State (State) about a month to correct the problem we identified with respect to missing names in the payment file it had been submitting to FMS for payment once we brought the matter to the department's attention. A programming error appears to have resulted in the names not being in the disbursement files sent to FMS. According to a State official, the department has likely had names of its payment files since the 1980s, and it did not know that the names were not getting to FMS. Because of State's responsiveness to our finding, FMS is now levying payments from State's contractors with unpaid taxes. Had FMS provided effective oversight and management of the debt collection program, it could have detected the problem years ago and worked with the State Department to correct it long before our audit. While we agree that agencies should be responsible for the completeness and accuracy of the payment files they send to FMS, we believe FMS should take a more proactive role in identifying issues that impede the program's ability to maximize collections and work with agencies to resolve such issues.

In responding to our report, FMS disagreed with our conclusion that it had not implemented the provision of the American Jobs Creation Act of 2004 authorizing an increase in the maximum amount of contractor payments subject to levy of up to 100 percent. FMS noted that it had made the changes necessary in the levy program to allow for levying at 100 percent, but that it was unable to implement the provision because civilian agencies' payment records do not separately identify real estate transactions—which

are not subject to the 100 percent levy—from other contractor payments. Our report clearly indicates that the 100 percent levy provision had not yet been fully implemented because of a number of challenges, including the determination by IRS that real estate transactions are not subject to the 100 percent levy provision, and that agency pay systems are presently unable to identify real estate transactions from other contractor payments. We also acknowledged in our report that a legislative change is being sought to subject real estate payments to the 100 percent levy provision. Our report describes this issue not as a weakness in the program but, rather, as another challenge that FMS faces in maximizing collections under the levy program. Our report also acknowledges that certain DOD payments are already being levied at the 100 percent maximum.

FMS also did not concur with our recommendation to withhold payments that do not include a valid name in the payment record. However, FMS said it would improve monitoring and ensure agencies' compliance with the requirement to include names, TINs, and payment types on certified vouchers. This is in line with our recommendation, and we commend FMS for its willingness to increase efforts to enforce the requirements. As the State Department's prompt response to our findings indicates, when weaknesses are identified, such as records without payee names, agencies can take corrective actions, thereby making it unnecessary to withhold payments. However, FMS has had many years to require agencies to improve the data in their payment records but has, until now, not done so. As we point out in the report, in 1997 FMS proposed a rule that would require disbursing officials to reject agency payment requests that do not contain TINs (that is, withhold the payment), yet later rescinded the proposed rule and instead required agencies to submit to FMS implementation plans to achieve compliance with the TIN requirement. Although FMS requested the implementation plans in 1997, it has not been successful in gaining agency compliance. We believe that if FMS had been more proactive, the intervening years since 1997 would have provided FMS and the agencies ample opportunities to take corrective action. As such, we continue to believe FMS needs to take stronger leadership in enforcing the requirements with respect to the completeness and accuracy of information in agency-submitted payment files.

In its response, FMS accurately summarizes some of the challenges that we described in the draft report regarding levying government purchase card payments. These challenges are precisely why we recommended that FMS work with IRS and arrive at a solution to subjecting to potential levy or other form of collection the roughly $10 billion in annual purchase card

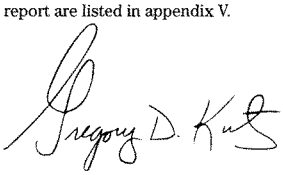
payments made to civilian agency contractors. However, FMS suggested that we instead redirect the recommendation to have GSA work with IRS. In addition, FMS pointed out that the FCTC could also provide valuable assistance in determining the most efficient and effective means of addressing contractors that have unpaid taxes and are being paid via government purchase cards. While we agree that GSA could assist FMS and IRS with this challenge, at the same time, we believe that as the government's central debt collector, FMS should assume a leadership role in emerging issues such as the rise in purchase card payments, as it has significant implications with respect to its debt collection responsibilities. In our opinion, FMS is the only federal entity with the ability to identify which contractors that are receiving federal payments have leviable tax debt. This is a role FMS plays when it compares the TIN and the name on FMS payments to the list of contractors with unpaid taxes to determine whether the payment should be levied. If FMS worked with the five banks that currently issue government purchase cards to routinely obtain electronic files listing the contractors being paid with purchase cards, FMS could determine which government contractors that are paid with a government purchase card have unpaid taxes. Consequently, we continue to believe that FMS, in conjunction with IRS, would be in the best position to monitor purchase card payments and assess the extent to which contractors paid with purchase cards have unpaid federal taxes, and then to identify solutions to the challenges presented by purchase card payments.

Finally, in its response, FMS stated that the numbers and potential levy collection amounts presented in the report are confusing and potentially misleading. Specifically, FMS stated that our reporting of the levy collection gap of $350 million was misleading as it suggested that FMS would be able to collect that amount through the levy program. In our report, we have taken care to clearly note that the levy collection gap is an indicator of the amount of tax debt civilian contractors owe that could be levied from the payments they get from the federal government if all payments for which we have information could be levied against all outstanding federal tax debt. We further note throughout the report that because some tax debts are excluded due to specific statutory requirements, IRS and FMS are presently restricted by law from collecting a significant portion of this estimated amount. We do, however, clearly identify that a portion of the levy collection gap—at least $50 million—that is directly attributable to weaknesses in internal controls and lack of proactive management at FMS. This amount is understated due to the unavailability of Fedwire information at FMS and because we were unable

to estimate collections against many payments that did not contain valid TINs and payment types. FMS's response does not recognize that although IRS has a key responsibility to refer tax debts, FMS has an equally key responsibility—to make all payments available for levy.

As agreed with your offices, unless you announce the contents of this report earlier, we will not distribute it until 30 days after its date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of the Financial Management Service, the Commissioner of Internal Revenue, and interested congressional committees and members. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

Please contact Gregory D. Kutz at (202) 512-9095 or kutzg@gao.gov or Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov if you or your staff have any questions concerning this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



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List of Requesters

The Honorable Susan M. Collins
Chairman
The Honorable Joseph I. Lieberman
Ranking Minority Member
Committee on Homeland Security
and Governmental Affairs
United States Senate

The Honorable Norm Coleman
Chairman
The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Homeland Security
and Governmental Affairs
United States Senate

The Honorable Daniel K. Akaka
Ranking Minority Member
Subcommittee on Oversight of Government Management,
the Federal Workforce, and the District of Columbia
Committee on Homeland Security
and Governmental Affairs
United States Senate

Appendix I

Scope and Methodology

To identify the magnitude of unpaid taxes owed by contractors receiving payments from federal agencies disbursed by the Financial Management Service (FMS), we obtained information from both the Internal Revenue Service (IRS) and FMS. To identify taxes owed, we obtained IRS's unpaid assessment database as of September 30, 2004. To identify disbursements FMS made to contractors, we obtained from FMS extracts of the Payments, Claims, and Enhanced Reconciliation (PACER) database containing data on payments FMS made to contractors via Automated Clearing House (ACH) and by check during fiscal year 2004. PACER contains information such as payee and payment amount for disbursements FMS makes on behalf of federal agencies.[1] To determine the amount of levies that have been collected and the amount of tax debt that has been referred to the Treasury Offset Program (TOP), we obtained from FMS the TOP database as of September 30, 2004. As discussed later in this appendix, we first performed work to assess the reliability of the data provided.

To determine the value of unpaid taxes owed by contractors, we matched PACER disbursements coded as "vendor" to the IRS unpaid assessment database using the tax identification number (TIN) field in both databases. This match resulted in the identification of about 63,000 contractors with more than $5.4 billion in unpaid federal taxes. To avoid overestimating the amount owed by contractors with unpaid tax debts and to capture only significant tax debts, we excluded from our analysis tax debts and payments meeting specific criteria to establish a minimum threshold in the amount of tax debt and in the amount of payments to be considered when determining whether a tax debt is significant. The criteria we used to exclude tax debts and payments are as follows:

- tax debts that IRS classified as compliance assessments or memo accounts for financial reporting,
- tax debts from calendar year 2004 tax periods,
- contractors with total unpaid taxes of $100 or less, and
- contractors with cumulative fiscal year 2004 payments of $100 or less.

[1] PACER data indicated FMS also disbursed about $6 billion on behalf of Department of Defense, primarily to health insurance providers.

The criteria above were used to exclude tax debts that might be under dispute or generally duplicative or invalid, tax debts that are recently incurred, and tax debts and payments that are insignificant for the Federal Payment Levy Program (FPLP). Specifically, compliance assessments or memo accounts were excluded because these taxes have neither been agreed to by the taxpayers nor affirmed by the court, or these taxes could be invalid or duplicative of other taxes already reported. We excluded calendar year 2004 tax debts to eliminate tax debt that may involve matters that are routinely resolved between the taxpayer and IRS, with the taxes paid or abated[2] within a short period. We further excluded tax debts and cumulative fiscal year 2004 payments of $100 or less because they are insignificant for the purpose of calculating potential levy collection. Using the above criteria, we identified about 33,000 contractors with over $3.3 billion in unpaid taxes as of September 30, 2004.

To determine the potential fiscal year 2004 levy collections, we used 15 percent of the payment or total tax debt amount, whichever is less. Our analysis was performed as if (1) all unpaid federal taxes were referred to FMS for inclusion in the TOP database and (2) all fiscal year 2004 disbursements for which FMS maintained detailed information[3] were included in TOP for potential levy. Because some tax debts are excluded from the FPLP due to statutory exclusions, a gap will continue to exist between what could be collected and the maximum levy amount calculated. However, as discussed in the body of the report, the potential levy collection amount of $350 million may be understated because we excluded, by design, specific tax debts and payment amounts from the calculation of levy, and missing data in FMS's disbursement information prevented us from providing the full magnitude of tax debts and potential levy collection. The American Jobs Creation Act of 2004 provided for a 100 percent levy on vendor payments for goods or services sold or leased to the federal government, effective October 2004. If unpaid tax debts and payments to contractors in future years remain consistent with fiscal year 2004 patterns, we determined a potential future levy amount based on a levy ratio of 100 percent of payments or total tax debt amount, whichever is less.

[2] Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. 26 U.S.C. § 6404 (2000).

[3] As discussed earlier in the report, FMS does not maintain historical data on Fedwire payments.

To determine the effect of IRS and FMS policies and procedures on the amounts actually collected through the FPLP, we conducted work at both agencies related to their respective roles in the implementation of the FPLP. At IRS, we interviewed agency officials and obtained documentation that detailed the statutory requirements and policy and administrative decisions that exclude certain tax debts from the FPLP. We did not evaluate the accuracy and reasonableness of these exclusions, which will be examined in detail in a later report. At FMS, we reviewed documentation and interviewed agency officials to obtain an understanding of FMS's FPLP policies, implementing guidance, operating procedures, and internal controls related to the TOP and disbursement operations. We also visited the San Francisco Regional Finance Center where we observed work flow processes. We obtained a copy of the TOP database as of September 30, 2004. The TOP database contains all debt, including tax debt, referred to it by federal agencies, including IRS. FMS uses the TOP database for levying contractor payments. As discussed later, we performed work to assess the reliability of data in TOP.

To identify payments to contractors disbursed through the government purchase card, we obtained from the Bank of America the database of purchase card payments made by the National Aeronautics and Space Administration (NASA). We reconciled control totals for this data with Bank of America and the General Services Administration. We restricted purchase card data to one agency to demonstrate the magnitude and effect of issues surrounding levying purchase card payments.

To identify indications of abuse or potential criminal activity, we selected 50 civilian contractors for a detailed audit and investigation. The 50 contractors were chosen using a nonprobability selection approach based on our judgment, data mining, and a number of other criteria. Specifically, we narrowed the 33,000 contractors with unpaid taxes based on the amount of unpaid taxes, number of unpaid tax periods, amount of FMS payments, indications that owner(s) might be involved in multiple companies with tax debts, and representation of these contractors across government. We specifically included contractors from NASA[4] and the

[4] NASA cases include NASA credit card payments.

Departments of Homeland Security (Transportation Security Administration), Justice, State,[5] and Veterans Affairs. These agencies were selected based on a number of criteria: national security concerns; amount of payments to contractors, especially those with tax debts; amount of payments made without TINs, names, or both; amount of levy collected; and amount of payments made with blank pay types. The reliability of TINs and contractor names, and whether the agencies' payment systems are sufficiently integrated to maximize levy collection, will also be covered in later work.

We obtained copies of automated tax transcripts and other tax records (e.g., revenue officer's notes) from IRS as of December 2004 and reviewed these records to exclude contractors that had recently paid off their unpaid tax balances and considered other factors before reducing the number of businesses to 50 case studies. We performed additional searches of criminal, financial, and public records. In cases where record searches and IRS tax transcripts indicate that the owners or officers of a business are involved in other related entities[6] that have unpaid federal taxes, we performed detailed audit and investigation on the related entities and the owner(s) or officer(s), and not just the original business we identified. In instances where related entities exist, we defined a case study to include all the related entities, and reported on the combined unpaid taxes and combined fiscal year 2004 payments for the original business and all the related entities. We identified civilian agency contract awards using the Federal Procurement Data System. Our investigators contacted some contractors and performed interviews.

In addition, while assessing the reliability of the data provided by FMS, we identified nearly $17 billion in payments that contain either no TIN or an obviously inaccurate TIN.[7] To determine whether contractors with no TINs

[5] Our ability to identify Department of State (State) contractors was significantly limited by the fact that the PACER database did not identify the name of any State contractors. Consequently, we identified only one State contractor for a case study selection. We were able to identify that contractor because the contractor was paid by FMS on behalf of (i.e., conducted work for) another agency.

[6] We define related entities as entities that share common owner(s) or officer(s), a common TIN, or a common address.

[7] We termed obviously inaccurate TINs as those that fail to meet at least some of the TIN validation rules. For example, the TIN contained all the same digits (e.g., 999999999) or an unusual series of digits (e.g., 123456789).

or obviously inaccurate TINs had tax debts, we used investigative techniques to identify some of those contractors' TINs and, through comparison with the IRS records of unpaid taxes, we determined whether those contractors owed tax debts.

On May 9, 2005, we requested comments on a draft of comments on a draft of this report from the Commissioner for Internal Revenue or his designee and from the Commissioner of the Financial Management Service or his designee. We received written comments from Commissioner of Internal Revenue dated May 27, 2005, and from the Commissioner of the Financial Management Service dated May 25, 2005, and reprinted those comments in appendixes III and IV of this report. We conducted our audit work from May 2004 through May 2005 in accordance with generally accepted government auditing standards, and we performed our investigative work in accordance with standards prescribed by the President's Council on Integrity and Efficiency.

Data Reliability Assessment

For the IRS database we used, we relied on the work we perform during our annual audits of IRS's financial statements. While our financial statement audits have identified some data reliability problems associated with the coding of some of the fields in IRS's tax records, including errors and delays in recording taxpayer information and payments, we determined that the data were sufficiently reliable to address the report's objectives. Our financial audit procedures, including the reconciliation of the value of unpaid taxes recorded in IRS's masterfile to IRS's general ledger, identified no material differences.

For PACER and TOP, we interviewed FMS officials responsible for the databases and reviewed documentation provided by FMS supporting quality reviews performed by FMS on its databases. In addition, we performed electronic testing of specific data elements in the databases that we used to perform our work. Based on our review of FMS's documents and our own testing, we concluded that the data elements used for this report are sufficiently reliable for the purpose of this report. In instances where we found problems with the data, such as data with missing TINs and names, we include those in this report. We also compared the PACER data to the President's budget and the TOP data to the IRS unpaid assessment file.

Contractors with Unpaid Federal Taxes

Table 3 provides data on 10 detailed case studies. Table 4 provides details of the remaining 40 businesses we selected as case studies. As with the 10 cases discussed in the body of this report, we also found substantial abuse or potentially criminal activity related to the federal tax system during our review of these 40 case studies. The case studies primarily involve businesses with unpaid payroll taxes, some for as many as 35 tax periods. IRS has imposed trust fund penalties for willful failure to remit payroll taxes on the officers of 17 of the 40 case studies. In addition to owing federal taxes, 28 of these 40 case study contractors owed sufficient state tax debts to warrant state tax authorities to file liens against them. As we have done in the body of the report, in instances where the business we selected also had related entities, we considered the business and all related entities as one case study and reported the civilian agency payments and unpaid federal tax amount for all related entities in the table.

Table 4: Civilian Agency Contractors with Unpaid Federal Taxes

Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
11	Professional and clerical services	Multiple departments, including the Department of Homeland Security (DHS)	Over $1.5 million	Over $1 million	• Filed multiple tax returns late. For several years in the early 2000s, the company remitted no payroll taxes to IRS. • Firm's primary client is the federal government. • Has existing contracts in FY 2005 with the federal government. • Diverted payroll taxes to fund business due to cash flow problems.
12	Consulting service	Multiple agencies including the Department of the Interior (Interior) and the Small Business Administration	Over $200,000	Over $300,000	• Repeatedly under paid its payroll taxes since the late 1990s and owes payroll tax debt for more than 15 tax periods. • Officer has mortgages of over $1 million. • Has existing contracts in FY 2005 with the federal government.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
13	Temporary help	DHS	Nearly $50,000	Over $600,000	• Several other related entities—one of which is bankrupt—also have tax debt. • Not in the FPLP because of IRS exclusion policy. • Invalid name in payment files, thus levy cannot be taken even if debt is unblocked. • The owner attempted to negotiate repayment of IRS taxes so owner could start a new multimillion-dollar business. • FY 2004 maximum levy collections estimated at $7,000.
14	Nursing care facilities	Department of Veterans Affairs (VA)	Nearly $200,000	Over $4 million	• Not in the levy program because of IRS exclusion policy. • Joint target of a federal and state criminal investigation for fraudulent financial activities. • Defaulted on several federal government loans. • Millions in trust fund penalties assessed on officer. • One of the related entities closed by state due to health code violations in 2004. • FY 2004 maximum levy collections estimated at over $25,000.
15	Building maintenance services	Multiple departments including Departments of Agriculture, Homeland Security, the Interior, the Treasury, and Veterans Affairs	Over $4 million	Over $700,000	• Levy not collected on other payments because name different from IRS control name and payments made using specialized payment mechanism not submitted to TOP. • Payroll tax returns frequently filed late. • FY 2004 maximum levy collections estimated at $630,000, compared to nearly $100,000 actually collected.
16	Moving and storage	DHS and the Department of State	Over $200,000	Nearly $700,000	• Not in levy program due to pending appeal against a tax assessment. • The owner has a vacation home as well as a primary residence. • FY 2004 maximum levy collections estimated at over $33,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
17	Business training and support services	Multiple departments including DHS and the Departments of Justice and the Interior	Nearly $130,000	Nearly $1.5 million	• Business generally did not pay payroll taxes. • In the early 2000s, business failed to remit most of taxes owed to IRS. • Levy of $1,500 collected but payments over $100,000 not levied during FY 2004 because the name in the payment database did not match with IRS name. • FY 2004 maximum levy collections estimated at nearly $20,000.
18	Tour services	DHS	Over $20,000	Nearly $800,000	• Business frequently did not pay payroll taxes. • In the FPLP but no levies collected during FY 2004 because FMS does not include the payment category used by the agency in the TOP system. • FY 2004 maximum levy collections estimated at $3,000.
19	Telecom-munications	DHS	Over $400,000	Nearly $300,000	• Officers assessed penalties for willful failure to remit payroll taxes. • Over $1,000 collected from levies in FY 2004, but many payments not levied because they had no name or were made via a payment category FMS does not include in TOP. • FY 2004 maximum levy collections estimated at $60,000.
20	Nonprofit social service	Department of Justice (Justice)	Over $70,000	Nearly $900,000	• Delinquency dates to late 1990s. • Owes taxes for more than 20 tax periods. • Officers have been assessed more than $200,000 for willful failure to remit payroll taxes related to 10 tax periods. • Not in the levy program because of IRS exclusion policy and because FMS had not included the agency paying location in TOP. • FY 2004 maximum levy collections estimated at $11,000.
21	Ministry	Justice	Nearly $1.3 million	Over $400,000	• Owes on more than 10 tax periods. • Typically made partial or no payments on payroll taxes. For example, in 2001, withheld about $180,000 from employees but remitted nothing. • Over $50,000 collected from levies in FY 2004. However, some periods not in TOP due to a pending tax claim. • FY 2004 maximum levy collections estimated at nearly $195,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
22	Freight	Multiple departments including Interior, Justice, and Treasury	Over $300,000	Over $300,000	• Did not file several years of early 2000s tax returns until April 2004. • Did not remit any payroll taxes withheld from employees since early 2000s. • Owes tax debt on more than 20 tax periods. • The owner had drug-related criminal activity. • Levy started in September 2004, but prior to that no levies collected in FY 2004 because of IRS exclusion policy. • FY 2004 maximum levy collections estimated at $46,000.
23	Court reporter	Justice	Over $25,000	Over $400,000	• Consistently owed unpaid payroll taxes from late 1990s through 2002. • Consistently reported losses or no income. • Two owners assessed hundreds of thousands in penalties for willful failure to remit payroll taxes. • New installment agreement in 2004, for which $2,000 had been received. • No levies collected in FY 2004. • FY 2004 maximum levy collections estimated at nearly $4,000.
24	Aircraft and space parts	NASA	Over $100,000	Nearly $200,000	• Owes more than 10 tax periods. • Did not pay any IRS payroll taxes withheld from employees for five periods. • Companies did not file income taxes for several years in the early 2000s. • Over $7,000 collected from levies in FY 2004. Levy less than estimated because some tax debt excluded due to IRS exclusion policy. • FY 2004 maximum levy collections estimated at nearly $17,000.
25	Electro-optic equipment	DHS and NASA	Nearly $700,000	Over $1 million	• Withheld more than $500,000 from employees one year in early 2000s but remitted less than $50,000 to IRS. • Received nearly $900,000 in grants. • Payments not levied due to pending installment agreement. • FY 2004 maximum levy collections estimated at nearly $105,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
26	Acquisition and financial support	Multiple departments, including Health and Human Services (HHS), Transportation (Transportation), as well as NASA	Over $3 million	Nearly $400,000	• Not in the levy program because of IRS exclusion policy. • Has an existing contract in FY 2005 with the federal government. • FY 2004 maximum levy collections estimated at nearly $380,000.
27	Computer software	Multiple agencies including HHS, Justice, Treasury, and NASA	Over $300,000	Over $50,000	• Payments were not levied because of an IRS statutory exclusion. • FY 2004 maximum levy collections estimated at $46,000.
28	Logistics and engineering services	Agriculture and NASA	Over $650,000	Over $2 million	• Payroll taxes owed since early 2000s. • Multiple cash withdrawals totaling tens of thousands of dollars each. • Penalties were assessed on an officer of the company for failure to remit payroll taxes. • FY 2004 maximum levy collections estimated at $98,000.
29	Casino	NASA, Interior, and Agriculture	Over $35,000	Over $1.5 million	• Large penalty for intentional disregard for requirement to file accurate information returns. • Annual net income $6 million to over $30 million over the past 10 years. • One payment not levied because tax debt not turned on for immediate levy in TOP. • FY 2004 maximum levy collections estimated at $5,000.
30	Manufacturing	NASA (including credit cards)	More than $600,000, $30,000 of which is credit card payments	Nearly $200,000	• Subsidiary of international defense-related group. • Taxes owed mostly interest and penalties. • Company noted as having problems with filing tax returns. • Levies totaling nearly $6,600 collected, but maximum levy was not collected because majority of tax debts were not in TOP. • FY 2004 maximum levy collections estimated at nearly $100,000 not including amounts paid to contractor via government purchase card.
31	Medical doctor	VA	Over $180,000	Nearly $700,000	• Tax debt dates back to early 1990s. • Contractor payments not levied to pay tax debt of individuals. • FY 2004 maximum levy collections estimated at $27,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
32	Engineering	Treasury	Over $500,000	Nearly $2 million	• Owner did not file personal income tax return for 2 years in early 2000s. • Payments were not levied because of an IRS statutory exclusion. • FY 2004 maximum levy collections estimated at $75,000.
33	Plumbing, heating, and air conditioning	Multiple departments including Labor, Treasury, and VA	Over $130,000	Over $300,000	• Substantial payments made to IRS in early FY 2005 to settle tax debt. • No levies collected in FY 2004 because of IRS exclusion policy. • FY 2004 maximum levy collections estimated at nearly $20,000.
34	Janitorial	Agriculture and VA	Over $700,000	Over $300,000	• Almost all of the taxes owed are unpaid payroll taxes that company withheld from employees but failed to remit. • No levies collected in FY 2004 because of an installment agreement, which is an IRS statutory exclusion. • FY 2004 maximum levy collections estimated at $107,000.
35	Building construction	HHS and VA	Over $1.5 million	Over $200,000	• Payroll taxes owed since the late 1990s. • No levies collected in FY 2004 because of a tax claim. • FY 2004 maximum levy collections would have completely paid off the tax debt.
36	Health care services	VA	Over $40,000	Nearly $300,000	• Bankruptcy filed in late 1990s dismissed prior to 2004. • Offer-in-compromise not rejected for 2 years, which resulted in payments being excluded from levy program for almost two years. • Installment agreement requested immediately after offer-in-compromise rejected. No levies collected in FY 2004 because of an installment agreement. • FY 2004 maximum levy collections estimated at $6,500.
37	Public relations	HHS	Nearly $280,000	Over $300,000	• Multiple federal and state tax liens and judgments. • Unpaid payroll taxes since early 2000s. • Officer assessed penalty for willful failure to pay payroll taxes; penalty paid in full the year it was assessed. • No levies collected in FY 2004. • FY 2004 maximum levy collections estimated at nearly $42,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
38	Telecommu-nications	Commerce, Treasury, and HHS	Over $1 million	Over $300,000	• Company owed payroll taxes back to the late 1990s. • Over $10,000 collected from levies in FY 2004. • FY 2004 maximum levy collections estimated at $211,000.
39	Building maintenance	HHS and State	Over $1.1 million	Nearly $1 million	• Company owed payroll taxes back to the late 1990s. • Defaulted on installment agreement in early 2000s. • Company filed an offer-in-compromise with IRS, which IRS rejected. • Officers were assessed trust fund penalties for willfully failing to pay payroll taxes withheld from employees. • About $50,000 collected from levies in FY 2004. • FY 2004 maximum levy collections estimated at $176,000.
40	Medical, dental, and hospital equipment	Executive Office of the President and Agriculture	Over $900,000	Nearly $2 million	• In the early 2000s, company collected more than $600,000 in payroll taxes from employees that were not remitted to IRS. • Company filed for bankruptcy in the late 1990s. • About $6,000 collected from levies in FY 2004. • FY 2004 maximum levy collections estimated at $139,000.
41	Health care services	VA	Over $60,000	Over $500,000	• Payroll taxes owed for almost every period since 2000. • In the early 2000s, defaulted on an installment agreement after 10 months. • An officer assessed trust fund penalties for willfully failing to remit payroll taxes withheld from employees. • No payments levied during FY 2004. • FY 2004 maximum levy collections estimated at $10,000.
42	Automotive manufacturer	Agriculture	Over $60,000	Over $1 million	• Contractor in levy program during many months in 2004, but no levy was taken because the name did not match with IRS name for levy. • FY 2004 maximum levy collections estimated at $10,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
43	Support and managerial services	Treasury	Over $90,000	Nearly $400,000	• Business in bankruptcy since late 1990s that was discharged in 2004. • No payments levied in FY 2004. • FY 2004 maximum levy collections estimated at $14,000.
44	Health care services	VA	Over $200,000	Nearly $2 million	• Payroll taxes owed for taxes in late 1990s and early 2000s. • Payments were not levied because the business was in notice status, which is an IRS statutory exclusion. • FY 2004 maximum levy collections estimated at $31,000.
45	Ambulance services	VA and Agriculture	Over $20,000	Over 600,000	• Since the late 1990s, the company had annual revenue exceeding $10 million but repeatedly reported tax losses. • Company under bankruptcy protection since early 2000s. • No payments levied in FY 2004 due to IRS exclusion policy. • FY 2004 maximum levy collections estimated at $3,000.
46	Taxi services	VA	Over $40,000	Over $600,000	• Company in litigation status since the mid-1990s, which prevented any payments from being levied. • An officer assessed trust fund penalties for willfully failing to pay payroll taxes withheld from employees. • Officer placed on an installment agreement in 2004. • FY 2004 maximum levy collections estimated at $6,000.
47	Home health care services	VA	Over $200,000	Nearly $3 million	• No payments levied in FY 2004 due to an installment agreement for which contractor is making payments. • IRS had to construct payroll tax returns for five periods (over 1 year) because the company did not file quarterly payroll tax returns. • FY 2004 maximum levy collections estimated at $31,000.

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Case study	Goods, services, or nature of work	Agencies making payments	Fiscal year 2004 civilian agency payments	Unpaid federal tax amount at 9/30/04	Comments
48	Residential care	Justice	Nearly $770,000	Nearly $9 million	• Multiple withdrawals of cash from late 1990s to 2001 totaling several million dollars. • An officer assessed trust fund penalties for willfully failing to remit payroll taxes. • The agency location code was not in TOP so no levies would have been possible. • FY 2004 maximum levy collections estimated at $115,000.
49	Building maintenance	Social Security Administration	Over $330,000	Over $400,000	• Company under bankruptcy protection in 2004. • Officers assessed trust fund penalties for willfully failing to remit payroll taxes. • No payments levied in FY 2004. • FY 2004 collections under effective levy estimated at nearly $50,000.
50	Special trade contractor	Justice and Treasury	Over $400,000	Over $100,000	• Tax debt dated to the late 1990s. • Penalty assessed on officers being paid. • Business current on installment agreement. • FY 2004 maximum levy collections estimated at $65,000

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

Appendix III

Comments from the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 27, 2005

Mr. Steven J. Sebastian
Director, Financial Management and Assurance
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Sebastian:

We have reviewed your report entitled, "Financial Management: Some Civilian Agency Contractors Abuse the Tax System with Little Consequence" (GAO-05-637) and agree that we must continue to improve and enhance the use of the Federal Payment Levy Program (FPLP) as a tool to deal with contractors who abuse the federal tax system.

We appreciate your acknowledgement of the significant progress we have made in the past year to improve the effectiveness of the FPLP. In March 2004, the Internal Revenue Service (IRS), Financial Management Services (FMS) and the Department of Defense (DOD) established the Federal Contractor Tax Compliance Task Force (FCTC) to recommend and implement actions to ensure federal contractors pay their taxes and that we take appropriate enforcement actions, including levies, to collect unpaid taxes. The collaborative efforts of the federal agencies represented on the FCTC task force have already resulted in tremendous benefits as evidenced by the improved program results. The IRS removed many of the systemic exclusions that had prevented tax debts from being available for levy through the FPLP. Consequently, as of April 2005, $98 billion in tax debts were included in the FPLP, an increase of $28 billion over the prior year. Total FPLP collections in FY 2005 through April exceeded $109 million compared to $50 million during the same period of FY 2004. A similar comparison for collections from federal contractors shows an even more significant increase – $23 million through April 2005 compared to $5.4 million through April 2004. From civilian contractors, the subject of your report, we have collected $12.2 million in FY 2005 compared to $4.7 million in the same period of FY 2004.

We are pleased with the results to date, and we continue to work with FMS and other federal agencies on the FCTC to pursue further enhancements to the FPLP. For example, we already have implemented a data exchange with the DOD that enables issuance of the Collection Due Process (CDP) notice at the time of contract award rather than after a contract payment is made. As a result, IRS will be in a position to levy an increased number of contractor payments without a delay. We plan to expand this process to all federal contractors later this year. As you noted, we are working with Treasury on a legislative proposal to allow a post-levy CDP process on federal

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payments to contractors. If enacted, this change will further improve our ability to levy earlier on an increased number of contractor payments. In addition, we are working to change our business tax collection process to combine the CDP notice with the final notice making more debts ready for levy at the time of inclusion in the Treasury Offset Program (TOP).

In order to increase the number of name and Taxpayer Identification Number (TIN) matches with FMS, in January 2006, the IRS will begin sending FMS up to ten additional business control names for each account to be matched against payment data. We are also developing a consent-based TIN verification system that will require contractors interested in doing business with the federal government to consent to validation of their name and TIN as a condition of registration in the Central Contract Registration (CCR) database. We anticipate implementation of this process later this year.

We agree that the use of purchase cards to pay federal vendors presents a significant challenge. As you noted, the purchase card program yields significant savings and efficiencies for the government-wide procurement system. However, due to the complexity of the purchase card payment process, vendors are paid in a manner that prevents the offset of other debts, including taxes. We will partner with FMS and the other agencies through the FCTC to conduct further analysis of this issue.

On April 15, 2005, we implemented the recently enacted 100 percent levy provision on certain DOD contracts paid through the largest DOD payment system. This provision will be implemented with respect to the remaining DOD vendor payment systems in July 2005. We are also working with Treasury on a technical correction which would allow the 100 percent levy on payments made to all federal vendors, not only vendors of goods and services. We will continue to partner with FMS on full implementation of this provision.

While we have taken significant actions to increase the dollars available for levy, as you acknowledge in your report, a substantial amount of tax debt ($71 billion) is excluded from the levy program for statutory reasons. These excluded debts include those for taxpayers who are in bankruptcy, have an installment agreement or have not yet received their appeal rights prior to levy. The IRS must continue to honor these statutory taxpayer rights as enacted by Congress. Another $99 billion is excluded from the levy program due to IRS policy including, as an example, tax debts of taxpayers who are experiencing a financial hardship. We continuously evaluate these policy exclusions to ensure that they are no broader than necessary.

In response to your recommendation, we are reviewing our case actions on the 50 contractor businesses and individuals identified in your report and will evaluate what additional actions are warranted. We believe the FPLP is an effective automated process for serving tax levies and collecting unpaid taxes. We will continue to pursue further opportunities to improve the FPLP and deal with contractors who abuse the tax system.

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If you have any questions, please contact me or call Brady R. Bennett, Director, Collection, Small Business/Self Employed Division at (202) 283-7660.

Sincerely,

Mark W. Everson

Appendix IV

Comments from the Financial Management Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

May 25, 2005

Mr. Steven J. Sebastian
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Sebastian:

Thank you for the opportunity to comment on the May 2005 draft audit report titled "*FINANCIAL MANAGEMENT: Some Civilian Agency Contractors Abuse the Tax System with Little Consequence* (GAO-05-637)." We acknowledge that with any successful program, there are still opportunities for improvement. Although I agree with many of the recommendations presented in this draft report, I have concerns regarding the following aspects of this report.

1. Management Oversight of the Levy Program

I disagree with the draft report's conclusion that the Financial Management Service (FMS) has ineffectively managed oversight of the levy program. FMS and the Internal Revenue Service (IRS) have very successfully implemented a phased-in approach of this program over the last several years. Collections increased 49% from FY 2002 (first full year of the Levy Program) to FY 2003, and another 27% from FY 2003 to FY 2004. Through seven months of FY 2005, FMS has collected over $115 million in tax debts, more than in any prior full year of this program. Much of this success is attributable to the work of the Federal Contractor Tax Compliance Task Force (FCTC). The FCTC is a joint task force consisting of the IRS, Department of Defense (DOD), Department of Justice, General Services Administration (GSA), Office of Management and Budget, and FMS. As a result of this task force: (1) more debts were loaded into the Treasury Offset Program (TOP) database; (2) more debts were made available earlier by the IRS for collection; and (3) improvements were made in the accuracy of name and taxpayer identification number (TIN) information in the Central Contractor Registration (CCR) database. These and other changes will significantly contribute to the continued rapid growth of the program.

In addition, throughout the report, the Government Accountability Office (GAO) mischaracterizes FMS' role in the levy process. The Federal Payment Levy Program (FPLP) is not exclusively an FMS program. It is a program to collect delinquent taxes, the primary responsibility for which rests with the IRS. FMS has no statutory role in the collection of delinquent tax and has no authority to make determinations regarding outstanding tax obligations or the method of collecting those obligations. For example,

Page 2 – Mr. Sebastian

the draft report charges FMS with failing to levy vendor payments to collect individual tax debt. IRS, which makes all determinations regarding what debts are subject to levy, expressly instructed FMS not to levy vendor payments to collect individual tax debts, and we have complied with its instructions. Accordingly, we have modified our systems to support the requirements of IRS.

I believe that FMS has provided excellent leadership and program management to the debt collection program, both non-tax and tax debt. Virtually every trend line shows strong increases in collections for the past several years. Yet, managing any program is also about making choices and determining priorities. FMS has made such choices in managing our part of the tax levy program. We have allocated resources to the highest management priorities to increase collections, but also to ensure that the proper management controls are in place. Further, FMS has long been an advocate of legislative or procedural changes that would allow agencies to improve their debt collection referrals to us. While FMS has demonstrated leadership, we are also not normally in a position to mandate changes by agencies or to direct agency resources.

2. Withholding Payments

At this time, I am opposed to GAO's recommendation to withhold payments. Instead, we plan to work with Federal Program Agencies (FPAs) on improving compliance before we consider rejecting payments. As the Government's chief disbursing office, FMS ensures that certified payments submitted to FMS are disbursed timely and accurately. Pursuant to 31 U.S.C. 3528, it is certifying officials at the FPAs who are responsible for the information (name, TIN, payment type) on the payment voucher and for ensuring that the payment is legally authorized.

Rather than withholding payments that do not include names, which could unduly interfere with the timely disbursement of federal funds to thousands of contractors who do not owe tax debts, we believe a better approach is to increase our efforts to monitor and ensure agencies' compliance with the requirement to include names, TINs, and payment types on certified vouchers. Within the next week, FMS will be sending a letter to all Chief Financial Officers enlisting their support in this endeavor. It is our view that this approach will most effectively address any underlying barriers to agency compliance. Withholding payments should only be considered as a last resort. We therefore plan to evaluate this approach over the next year and, at the end of that time, determine whether withholding payments is warranted.

3. Implementing 100% Levy for Vendor Payments

I disagree with the draft report's conclusion that we failed to implement 100% levy as authorized in the American Jobs Creation Act of 2004, enacted October 2004. In November 2004 FMS made the programming changes and was fully prepared to implement the 100 percent levy based on its existing vendor payment guidance to the

Page 3 – Mr. Sebastian

agencies. Subsequently, in review of the statute, IRS determined that Treasury could not fully implement this new version of the law without revisions. Where the law could be implemented, FMS, IRS, and DOD have done so, effective April 29, 2005. Since then, DOD reports that on the two files they matched with FMS for 100 percent levy, it collected $432,000 as compared to $100,000 that it would have collected at 15 percent.

4. Government Purchase Card Program

I agree with GAO's concern that the government purchase card program does not facilitate tax levy of payments to contractors. It is my view, however, that the GAO recommendations should be redirected to GSA and IRS. In addition, the FCTC could provide valuable assistance in determining the most efficient and effective means of addressing vendors who have unpaid taxes and are paid via the government purchase card.

The FPLP model does not work for credit cards. When a purchase is made using a purchase card, there is no point in the process where FMS has in its possession property belonging to the vendor. IRS levies FMS to collect from payments disbursed by FMS or an authorized disbursement officer. Credit card payments to vendors are not processed through FMS or an authorized disbursement official. Because FMS does not issue payments to contractors paid with purchase cards, or have information regarding which vendors are receiving purchase card payments, FMS is not in a position to implement the recommendations.

5. Misleading and Confusing Amounts in the Draft Report

Throughout the draft report there is a confusing mix of numbers. At some points the draft report discusses the overall tax gap, at other points the report discusses taxes that might be collectible by tax levy and at other times the report discusses amounts that might be collectible by tax levy from contractors. In addition, GAO provides estimates of the amount that FMS could have potentially collected compared to what was actually collected even though it is clear that the "potential" amount was not sent to us for levy in the first place. For example, on page 26 of the report, GAO states: "We estimate that if there were no legal or administrative provisions that remove some tax debt from the levy program and if all PACER contractor payments were subjected to a 15 percent levy ..., FMS could have collected as much as $350 million in fiscal year 2004." In the next paragraph, GAO goes on to say: "We found that a vast majority of the collection gap is attributable to debts that because of current law and IRS policies, are excluded from TOP." I believe that on one hand suggesting that FMS could have collected $350 million in fiscal year 2004 and then later acknowledging that most of the debts to realize that amount of collections were not sent to FMS for levy because of current law and IRS policies is misleading. There are other similar instances in the report of GAO showing large hypothetical or potential tax levy amounts only to later state that only a small percentage was available to FMS for levy purposes. While I recognize that GAO wants

Page 4 – Mr. Sebastian

to portray the full dimensions of the tax gap and the use of tax levy in narrowing that gap, I believe that indicating that FMS could collect large amounts from tax levy except for certain constraints gives an overall impression that FMS has the authority to remove those constraints even though that is not normally true.

Thank you for the opportunity to comment on this draft GAO report. If you have any questions or wish to discuss these comments in more detail, I can be reached on (202) 874-7000, or you may contact Marty Mills on (202) 874-3810 or Judy Tillman on (202) 874-6780.

Sincerely,

Richard L. Gregg

cc: Donald V. Hammond
Fiscal Assistant Secretary
U.S. Department of the Treasury

Appendix V

Staff Acknowledgments

Acknowledgments

The following individuals made major contributions to this report: Beverly Burke, Ray Bush, Richard Cambosos, William Cordrey, Francine Delvecchio, F. Abe Dymond, Paul Foderaro, Alison Heafitz, Kenneth Hill, Aaron Holling, Jason Kelly, John Kelly, Rich Larsen, Tram Le, Mai Nguyen, Kristen Plungas, Rick Riskie, John Ryan, David Shoemaker, Sid Schwartz, Esther Tepper, Tuyet-Quan Thai, Wayne Turowski, Matt Valenta, Scott Wrightson, and Mark Yoder.

FEDERAL CONTRACTOR TAX COMPLIANCE TASK FORCE REPORT

TO

SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

September 2004

Permanent Subcommittee on Investigations
EXHIBIT #3

OCT 26 2004

The Honorable Norm Coleman
Chairman, Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

We are pleased to forward the enclosed report from the Federal Contractor Tax Compliance Task Force. This multi-agency task force was established to address issues raised by your Subcommittee and outlined in the Government Accountability Office (GAO) report titled, "Some DoD Contractors Abuse the Federal Tax System with Little Consequence" (GAO-04-95, dated February 12, 2004). The task force included representatives from the Department of Defense (DoD), Defense Finance and Accounting Service (DFAS), Internal Revenue Service (IRS), Financial Management Service (FMS), General Services Administration (GSA), Office of Management and Budget (OMB), and Department of Justice (DOJ). The objective of this effort was to increase the number of IRS tax debts and the number of DoD contract payments available for matching through the Treasury Offset Program (TOP). The task force has made recommendations to enhance tax enforcement actions, including the more effective use of the Federal Payment Levy Program (FPLP).

The task force report details a number of recommendations that will significantly improve the effectiveness of the FPLP. For example, the task force recommends a consent-based Taxpayer Identification Number (TIN) validation program that would require vendors wishing to do business with the government to consent to the disclosure of certain tax return information (name and TIN). In addition, the task force recommends an amendment to Section 6330 of the Internal Revenue Code to provide an opportunity for a Collection Due Process hearing to Federal contractors post-levy. Several process improvements have already increased the number of DoD contractor levy payments. As a result, the IRS received 207 levy payments on DoD contractors totaling $2.4 million from January through June 2004, compared to 43 levy payments and $323,000 during the same period last year.

We believe implementation of the recommendations outlined in the GAO report and those proposed by the task force will effectively improve tax enforcement results. Furthermore, the task force has agreed to meet periodically to oversee implementation of their recommendations and to coordinate future actions to improve the tax levy process.

For further information, please feel free to contact Floyd Williams, IRS Legislative Affairs Director, at (202) 622-3720.

Sincerely,

Mark W. Everson
Commissioner of Internal Revenue

Richard L. Gregg
Commissioner, Financial Management Service

Tina W. Jonas
Under Secretary of Defense (Comptroller)

Enclosure

Report to Senate Committee on Governmental Affairs
Permanent Subcommittee on Investigations

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Executive Summary

On February 12, 2004 GAO issued a report entitled "Some DoD Contractors Abuse the Federal Tax System with Little Consequence (GAO-04-95) (the "GAO Report"). The GAO Report, as well as a subsequent hearing before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs (the "PSI Hearing"), determined, among other findings, that improvements could be made to the process for levying payments to Department of Defense (DoD) contractors. The GAO Report also recommended that policy options designed to prohibit contractors that abuse the tax system from doing business with the federal government be considered.

Recognizing that improving tax compliance by federal contractors is a shared problem, the responsible federal agencies established the Federal Contractor Tax Compliance Task Force (the "Task Force") with representatives from the Department of Defense (DoD), Defense Finance and Accounting Service (DFAS), Internal Revenue Service (IRS), Financial Management Service (FMS), General Services Administration (GSA), Office of Management and Budget (OMB), and Department of Justice (DOJ). The Task Force agreed to work together toward a common goal of ensuring that federal contractors pay their taxes and that appropriate enforcement actions, including levies, are taken to collect delinquent tax accounts.

The Task Force identified actions and recommendations to improve the effectiveness of the Federal Payment Levy Program (FPLP). Under the FPLP, federal payments, including payments to contractors, are matched against delinquent tax obligations. If there is a match between a contractor payment and a delinquent tax obligation and all of the legal requirements for making a levy have been met, the payment is levied and applied to the tax obligation. The automated process for matching tax debts and serving tax levies has proven to be a cost-effective means to collect unpaid taxes. The Task Force has identified the following actions to improve the effectiveness of the FPLP:

- Maximizing the number of delinquent tax debts that IRS makes available for matching;
- Maximizing the number of DoD payments available for matching;
- Increasing the frequency of data exchanges between DFAS and FMS;
- Improving the timing of Collection Due Process (CDP) notices that are required to be issued to taxpayers before a levy can be made; and
- Establishing a process for validating Taxpayer Identification Numbers (TINs) of federal contractors.

The Task force also identified actions to prevent federal contract awards to contractors who abuse the tax system. The Task Force has recommended a process to ensure that existing debarment and suspension procedures provided under Federal Acquisition Regulation (FAR) 9.4 are used to prevent the award of contracts to individuals and businesses who abuse the tax system.

Members of the Task Force have learned a great deal about the program complexities faced by each agency and have identified a number of ways to address federal contractor tax compliance, the success of which depends on improved coordination among these agencies. The participating agencies will continue to utilize the Task Force to complete the recommended actions in this report.

Report to Senate Committee on Governmental Affairs
Permanent Subcommittee on Investigations

Federal Contractor Tax Compliance

The GAO Report and the subsequent Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations hearing (the "PSI hearing") addressed concerns regarding Department of Defense (DoD) contractors abusing the tax system. The responsible federal agencies recognized that improving tax compliance by federal contractors is a shared problem, and agreed to work together toward a common goal of ensuring that federal contractors pay their taxes and that appropriate enforcement actions, including levies, are taken to collect delinquent tax accounts.

To address these concerns, the Federal Contractor Tax Compliance Task Force (the "Task Force") was established with representatives from DoD, Defense Finance and Accounting Service (DFAS), Internal Revenue Service (IRS), Department of the Treasury's Financial Management Service (FMS), General Services Administration (GSA), Office of Management and Budget (OMB), and Department of Justice (DOJ).

The objectives of the Task Force were to:

1) Identify and implement short and long term operational changes to improve federal tax compliance of Department of Defense (DoD) contractors, including increasing the number of tax debts and the number of DoD contractor payments available for matching through the Treasury Offset Program.

2) Identify potential changes that would enhance efforts to address federal contractor tax delinquencies, and/or prevent future occurrences of tax abuse by federal contractors.

Background

The Debt Collection Improvement Act (DCIA) of 1996 authorized a centralized program for the offset of federal payments, including vendor payments, to individuals and businesses to collect delinquent non-tax debts owed to the federal government. To implement this authority, FMS created the Treasury Offset Program (TOP). FMS matches payments being disbursed by the federal government against non-tax debts owed to the government. If there is a match between a federal payment and a debt and all of the requirements for offset have been met, the payment is offset to satisfy the debt. In lieu of including tax debts in TOP, the Taxpayer Relief Act of 1997 (TRA 1997) authorized the IRS to continuously levy up to 15 percent of certain federal payments, including vendor payments, to collect delinquent taxes[1]. To implement this authority, the Federal Payment Levy Program (FPLP) was created. The FPLP uses the TOP system to match delinquent tax debts with federal payments disbursed by the government. When a match occurs and all of the requirements for levy have been met, the payment is levied and applied to the tax debt. The DCIA also requires federal agencies to obtain taxpayer identification numbers

[1] "Levy" refers to seizure of property to collect a tax debt. See I.R.C. § 6331(b). In contrast, "offset" or "setoff" refers to the practice of applying payments due another party to debts owed by that party. *See generally* Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995).

from persons, such as contractors, doing business with the government. These statutes provide a valuable tool to collect delinquent tax debts, and provide the authority for the FPLP. The effectiveness of the FPLP depends on maximizing both the number of debts provided by the creditor agencies – in this case, the IRS – and the number of payments for which payor agencies – in this case, the DFAS – provide access. Since the inception of the FPLP in July 2000, IRS has used it to collect $254 million in tax debt. Actions already taken and those recommended by the Task Force will further increase the benefits of the FPLP. With minimal resource expenditures for programming changes, positive results from actions to better utilize the existing automated processes are already being realized. During January through June 2004, the IRS received 207 levy payments on DoD contractors totaling $2.4 million, compared to 43 levy payments and $323 thousand during the same period of 2003. We expect this trend to continue as the Task Force recommendations are fully implemented.

The Task Force identified the following actions to improve tax compliance by federal contractors:

- Maximize the number of delinquent tax debts that IRS makes available for matching;
- Maximize DoD payment information available for matching;
- Increase the effectiveness of the matching and levy processes; and
- Prevent federal contract awards to those who abuse the tax system.

IRS Actions to Maximize Tax Debts Available For Matching

The FPLP provides an automated process for serving tax levies and collecting unpaid taxes through FMS. FMS uses the TOP to match certain types of federal payments against federal tax debt records provided by the IRS. Federal tax debt records include both tax debts for which any payment to be made to a taxpayer can be levied immediately (debts "turned on" for levy) and tax debts for which payments cannot be levied because all of the prerequisites to levy have not been satisfied (e.g., the issuance of a collection due process (CDP) notice). When a match occurs, a portion of these federal payments to be made is applied to outstanding tax liabilities that have been "turned on" for levy.

As GAO observed, IRS determines when cases are eligible to be included in the FPLP and whether to restrict or block cases from entering the FPLP. For example, in the past, IRS excluded most accounts in the Automated Collection System (ACS) process due to resource constraints related to the issuance of required levy notices.

To ensure that IRS maximizes the effectiveness of the FPLP, IRS has taken a number of completed and planned steps to speed the collection of delinquent taxes through FMS. These steps to make additional tax debts available for the FPLP and the projected timetable for completion of the steps are summarized below.

Effective January 2004:

- Eliminated the one-year waiting period for cases awaiting assignment to the Collection Queue (i.e., cases awaiting inclusion in the FPLP);[2] and
- Eliminated the one-year waiting period for low dollar cases in deferred status.

[2] Cases assigned to revenue officers from the Queue after January 2004 were made eligible to enter the FPLP.

As a result of these actions, FMS reports that from January through June 2004, IRS made an additional 3.1 million tax debts totaling $28.9 billion available for levy compared to 680,061 tax debts totaling $5.1 billion added for the same period in the prior year.

Beginning July 2004:

- Eliminate all remaining systemic blocks on collection cases assigned to revenue officers (ROs);[3] and
- Eliminate systemic blocks on additional ACS inventories other than cases in which a taxpayer has been contacted and collection action is pending.

Beginning in January 2005:

- Include the following Criminal Investigation (CI) cases (other than CI cases in active status) in the FPLP:
  - Refund scheme cases, and
  - Cases being monitored for satisfaction as condition of probation.

IRS estimates that the actions planned to be completed in July 2004 and January 2005 will place over $26 billion additional dollars in the FPLP earlier in the collection process, increasing the amount of tax debt available for matching in the FPLP from $68 billion to $94 billion.

[The total tax debts available for levy as of January 2004 and the total tax debts expected to be available for levy after completion of the planned July 2004 and January 2005 actions are summarized below in Charts 1 and 2, respectively.]

[3] Revenue Officers will continue to have authority on a case by case basis to remove an account from the FPLP.

Chart 1 – Tax Debts Available for Levy as of January 2004- $68B

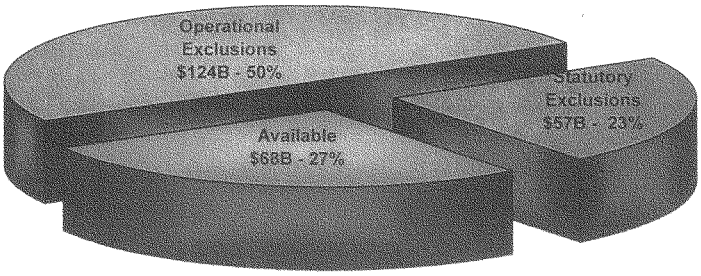
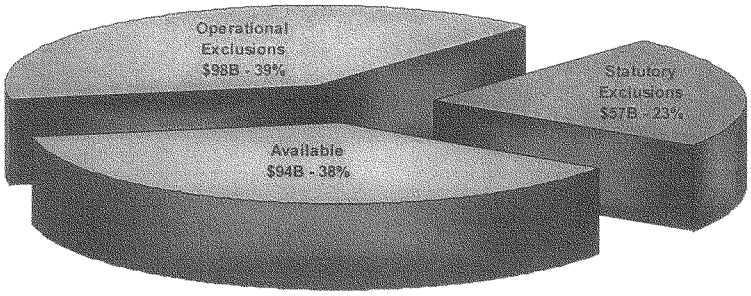
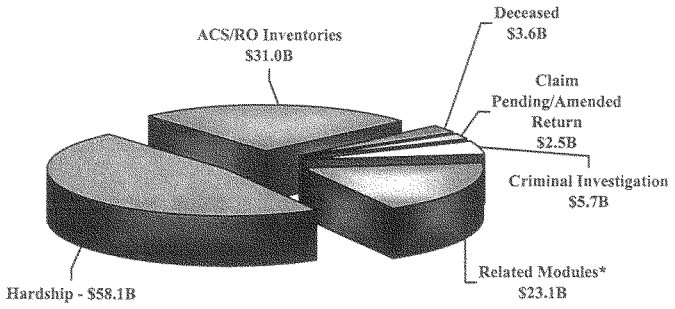


Chart 2 – Tax Debts Available for Levy after Planned Changes - $94B



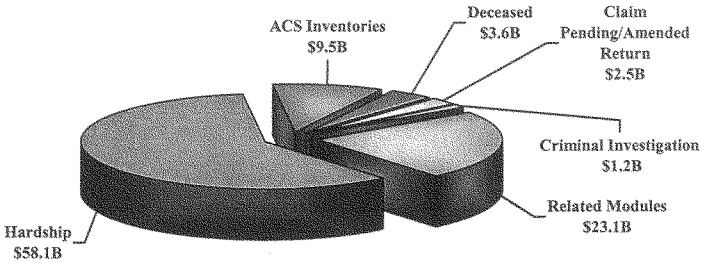
[The total operational exclusions as of January 2004 and the expected total operational exclusions remaining after completion of the planned July 2004 and January 2005 actions are summarized below in Charts 3 and 4, respectively.]

Chart 3 – Operational Exclusions as of January 2004- $124 B



*** Includes $18.6B – on non-hardship currently not collectible cases such as unable to locate and unable to contact.**

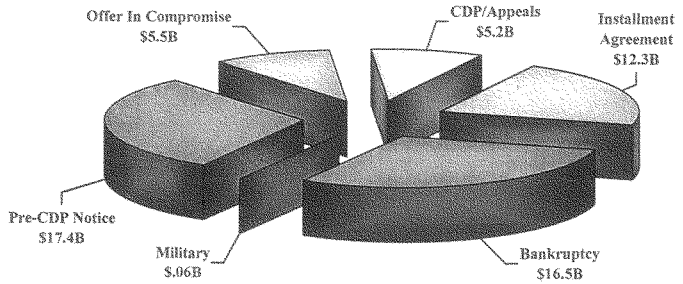
Chart 4 – Operational Exclusions after Planned Changes - $98B



Making these additional tax debts available for the FPLP program increases the likelihood that these debts will be matched with federal payments and satisfied through levy prior to the expiration of the statute of limitations on collection or the cessation of payments to the contractor. In addition, the steps taken accelerate the availability of tax debts available for the FPLP will increase the likelihood that future tax debts of federal contractors and others will be matched and levied.

[In addition to the operational exclusions discussed above, additional tax debts are ineligible to be included in the FPLP because various provisions of the Internal Revenue Code prohibit collection action for certain taxpayers. The following chart summarizes tax debts that are excluded from the FPLP by Internal Revenue Code provision.]

Statutory Exclusions Before/After Planned Changes - $57B



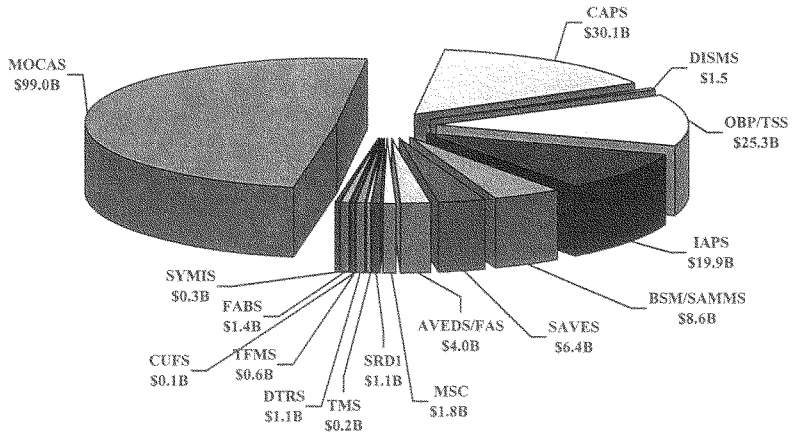
DFAS Actions to Maximize Payment Systems Available for Matching

Under 31 U.S.C. 3321, DoD disburses payments. Under DCIA, all non-Treasury disbursing offices, such as DoD, are required to offset payments to collect non-tax debts included in the FMS database. This is the same database used for the collection of tax debts. This database resides at FMS and consequently DoD cannot directly match its payments with the FMS database as part of the disbursement process. Therefore, DFAS, the primary DoD disbursing agency[4], must provide its available payments to FMS for matching to IRS tax debts and then must provide the results of their collections to FMS to update the database. Both of these steps result in lag time between DoD and FMS. The general process is that DFAS notifies FMS of contract payments it is about to make. If FMS identifies a match between those payments and IRS debt, FMS issues a continuous, 15% levy for DFAS to honor. DFAS honors the levy and then notifies FMS to update its database.

DFAS makes payments using 20 separate systems. DFAS was able to re-program the system from which it makes the largest dollar amount of payments, Mechanization of Contract Administration Services (MOCAS), to extract payment data for FMS and by December 2002, the procedures were in place to match MOCAS payment data to the debts in the TOP. Early in 2004, DFAS began providing a portion of the payments from Computerized Accounts Payable System (CAPS), one of the other remaining systems. Since the February 12, 2004 PSI hearing, DFAS has made available to FMS information from additional payment systems, as reflected in Appendix 1.

[4] DFAS is not the disbursing office for the Army Corps of Engineers.

Estimated Dollars Disbursed by DFAS Systems in FY03



To ensure that DFAS takes full advantage of the FPLP, DoD is taking aggressive action to implement the vast majority of its payment systems by August 2004. Payments from all of its systems will be available to FMS for matching by March 2005.

The payments identified below (regardless of the system used to pay them) are excluded from submission to FMS for matching.

a. Payments assigned to another entity via contractual agreement.

DFAS levies payments due an assignee to offset a debt owed by the assignee. A payment being issued to an assignee cannot be associated with the assignor.

b. Payments made to a vendor on behalf of the Government by a third party, such as by the issuing bank on a government credit card.

DFAS is the payor for payments made to third party payors and makes those payments to the banks available to FMS for levy. In order for the IRS to capture payments from the banks to the individual vendors, levies would have to be served directly on the banks. There is currently no mechanism for IRS to identify such payments on a systematic basis.

c. Payments under classified contracts.

Interim Steps Pending Implementation of Systemic Improvements

The Task Force identified several possible interim remedies for making DoD payments available for levy under the FPLP. However, DoD has had great success in providing its payment

information to FMS. At the time of this report over 85% of the payment dollars are available to FMS. By August 2004, that number will exceed 90%. In addition, DoD anticipates being at 100% before its originally projected date of March 2005. Conversely, the interim remedies identified were manual, cumbersome, and costly. Given DoD's progress in making payments available to FMS and the nature of possible interim remedies, the Task Force focused its attention on permanent solutions.

Opportunities to Improve the Effectiveness of the Matching and Levy Processes

A. Increase Frequency of Data Exchanges

DFAS issues payments six days a week. Historically, DFAS has provided FMS with a payment data file that contains payments scheduled for disbursement up to 30 days in advance on Monday of each week. FMS matches the DFAS files against its database and provides back to DFAS a file of eligible levies. DFAS then researches the levies to determine whether they can be honored.

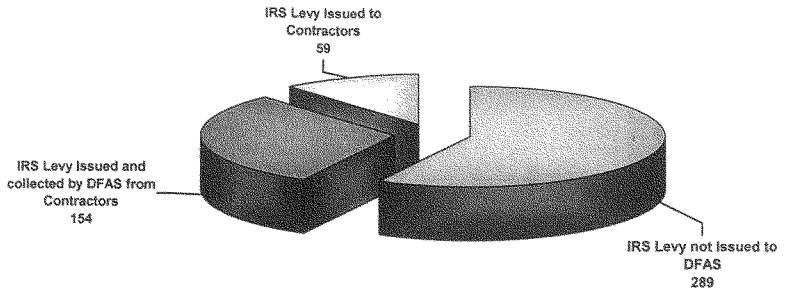
The Task Force focused on situations in which payments are issued before the data exchanges between the agencies can be completed, including for example, situations in which a payment becomes available and is paid between the two data exchanges. To alleviate this problem, DFAS and FMS agreed to increase the frequency of data exchanges from once per week to twice per week, and implemented the change in April 2004.

DFAS will continue to evaluate the possibility of increasing the frequency of data exchanges to three times per week as future automation improvements are completed.

B. Identify Areas of Improvement to the Levy Process

The Task Force gathered data concerning the effectiveness of levies with the following results.

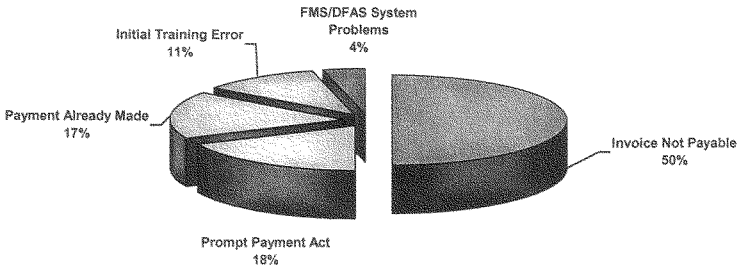
- From December 2002 through May 26, 2004, FMS matched 502 delinquent taxpayers with the payment availability files provided by DFAS.
- For 289 of these matches, no levy was issued to DFAS for various reasons, such as a lack of CDP notice or because IRS had removed the debtor from the FPLP. IRS removes cases from FPLP when the account is fully paid or meets statutory or operational criteria for exclusion.
- The remaining 213 matches resulted in levies being sent to DFAS.
- Of these 213 matches, 154 were levied at least once for a total of $3.5 million.



As depicted in the above chart, IRS did not issue levies to 289 of the contractors. This was due to the need to issue CDP notices or removal of the account from the FPLP based on taxpayer response to the notice.

Of the contractors who were levied, 154 resulted in collections by DFAS. The remaining 59 contractors were not levied for the reasons identified in the chart that follows.

Reasons Levies for 59 Contractors Did not Result in Collections

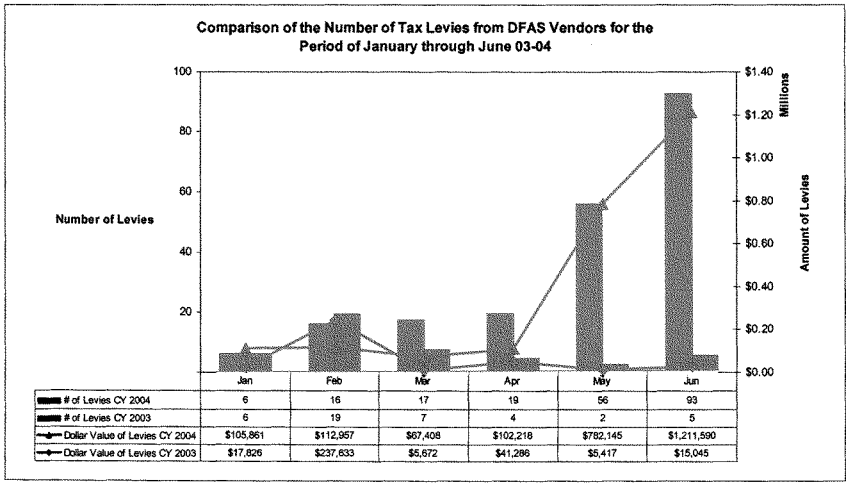


Since the inception of the program in December 2002, DFAS has received 548 individual levy actions with respect to these 59 contractors. Half of these actions did not result in collections due to problems incurred early in the program, including (1) payment information was sent to FMS prematurely (i.e., before the payment was ready to be made); (2) errors were made while employees were learning the processing steps; and (3) there were some initial computer system glitches that were later resolved. These three causes are historical and no longer pose a problem.

Two causes of lack of collections persist and the Task Force will continue to work to identify improvements. First, as discussed above, there is lag time between DoD and FMS processing because DoD does not have access to the FMS database. The Task Force has made

improvements to minimize this lag time. Additional time also is required for the levy to be processed at DFAS and DFAS is working to minimize that lag time. However, there remain some situations in which levies are missed because the payment is issued before the levy is recognized. Second, DFAS did not make collections in some cases due to interest penalties imposed by the Prompt Payment Act (PPA). Often, when DFAS receives a tax levy, honoring it would delay payment resulting in PPA interest. When a portion of a payment to a delinquent taxpayer has been levied, DFAS must stop the payment process, deduct the amount of the levy, and re-initiate the payment at the reduced amount. If the timing causes the payment to exceed the PPA period, interest accrues to the delinquent taxpayer. The Task Force is evaluating a variety of improvements that would yield a more efficient levy process and, therefore, help to avoid the incurrence of PPA penalties.

The following chart shows the increase in both the monthly volume of levies processed and dollars collected thus far in Calendar year 2004 compared to 2003.



	Jan	Feb	Mar	Apr	May	Jun
# of Levies CY 2004	6	16	17	19	56	93
# of Levies CY 2003	6	19	7	4	2	5
Dollar Value of Levies CY 2004	$105,861	$112,957	$67,408	$102,218	$782,145	$1,211,590
Dollar Value of Levies CY 2003	$17,826	$237,633	$5,672	$41,286	$5,417	$15,045

C. Improve Collection Due Process Notice Timing

The IRS must ensure taxpayer rights are protected while proceeding with enforced collection action. IRC § 6330(a) requires that, prior to taking levy action, taxpayers must be notified by the IRS of their CDP rights and allowed a minimum of 30 days to appeal a collection decision to levy. In the interest of cost-effective tax administration, IRS policy requires that the CDP notice be issued only when levy is the next expected action.

Under current procedures, DFAS provides payment information to FMS at the time payments are available. GAO found that IRS missed the opportunity to collect delinquent taxes on cases in which a payment was identified in the FPLP match process, but no CDP notice had been issued. In these cases, IRS procedures require IRS to issue the CDP notice, allow an appropriate amount of time for taxpayer response, and then levy through the FPLP. During this process, contractors continue to receive all payments until the CDP process is completed, which results in the loss of payments potentially available to satisfy delinquent taxes.

GAO recommended accelerating the CDP notice process for all delinquent accounts. The Task Force agreed with GAO's objective of being able to levy the first available payment, but disagrees with the proposed remedy. IRS expressed concern with sending notices to as many as 8 million taxpayers against whom no enforced collection action is contemplated or likely to occur in the absence of an identified levy source. The cost of implementing the recommendation (i.e., creating and mailing millions of notices, answering taxpayer phone calls about the notices, hearing CDP appeals resulting from the notices, etc.) also appeared prohibitive.

As an alternative to the GAO proposal, the agencies participating in the Task Force will conduct an earlier, additional match soon after contract award. At the time a contract is awarded, DoD obligates funds. By matching the DoD obligation file against the FMS database, delinquent taxpayers who have active contracts with DoD can be identified and a CDP notice can be issued promptly. By issuing the CDP notice soon after contract award, IRS will be in a position to levy an increased number of contractor payments without a delay.

The CDP notices can be accelerated using the existing FMS-IRS interfaces. The proposed process requires DoD to provide FMS with a contract obligation file monthly. FMS will match the DoD obligation file against the delinquent account files received from IRS, and pass the matches back to IRS as part of the FPLP monthly matching process. IRS will systemically check the matched accounts to determine if a CDP notice has been sent, and issue the notice if there is no CDP indicator on the file.

By matching the contractor to the IRS delinquencies soon after the contract is awarded, CDP notice requirements should be satisfied on more accounts by the time contractor payments are first made, thereby increasing the range of payments that can be levied. IRS will issue CDP notices for DoD contracts in excess of $25,000 because the DoD contract obligation file only includes those contracts in excess of that amount.

Although the new CDP matching process described above will go a long way toward ensuring that necessary prerequisites to levy have been completed before payments to tax delinquent vendors are made, the process does not address three types of payments that could be levied. First, as noted above, the process will only accelerate the CDP notice for those DoD contracts exceeding $25,000. Second, some contracts are granted, performed, and paid for within a time frame that is shorter than the time required under the new process for conducting a match and issuing a CDP notice. Finally, if a taxpayer appeals the levy decision, any payments to be made

while the case is being resolved will continue to be made even if the proposed levy ultimately is determined to be proper.

Legislative Proposal

To achieve greater coverage of contractor payments, I.R.C. § 6330 could be amended to allow FPLP to operate as originally enacted by Congress in TRA 1997. When Congress authorized the FPLP, IRS could levy a payment immediately upon matching a tax debt with a federal payment. (Other statutory requirements, such as the 30-day notice provision in I.R.C. § 6331(d) that existed when TRA 1997 was enacted, would still apply.) The CDP procedures subsequently enacted in the IRS Restructuring and Reform Act of 1998 (RRA 1998), by providing pre-levy hearing and appeal rights, diminish the effectiveness of the FPLP with respect to those federal contractors who are able to receive payment before their challenge to the proposed levy action can be resolved. Under the CDP procedures, a case must be referred back to the IRS if the taxpayer has not had an opportunity for a CDP hearing. The hearing process can often run for many months or, if the taxpayer appeals an adverse IRS Appeals Office determination to the U.S. Tax Court or a Federal district court, several years. Payments due the contractor for disbursement must be disbursed while the appeal process runs its course.

The Task Force recommends amending section 6330 to allow the IRS to begin levying federal payments through the FPLP before a CDP hearing requested by a federal contractor is conducted. The existing procedures under section 6330(f)(2) provide a working model. Pursuant to section 6330(f)(2), when levy is made on a state to collect federal tax liabilities from a state tax refund, the taxpayer is not entitled to an opportunity for a hearing under I.R.C § 6330 before IRS can make the levy. (The taxpayer is entitled to a post-levy hearing.) Adopting a similar procedure for federal contract payments would allow the FPLP to operate more efficiently and effectively with respect to payments to be made to federal contractors, thus restoring the process as originally instituted by the Congress in 1997. Federal contractors would still be afforded the opportunity to challenge IRS collection actions in a CDP hearing. This proposed amendment would apply only to federal payments to contractors and not to other types of federal payments.

To accomplish the desired change, I.R.C § 6330(f) should be amended to read as follows (additions in italics):

> *(f)* Jeopardy, State Refund Collection, *and Collection from Federal Contract Payments.* If
> (1) the Secretary has made a finding under the last sentence of section 6331(a) that the collection of tax is in jeopardy;~~ or~~
> (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund*; or*
> *(3) the Secretary has approved a levy under section 6331(h) on any contractor payment for goods or services provided to the Federal Government*
>
> This section shall not apply, except that the taxpayer shall be given the opportunity for the hearing described in this section within a reasonable period of time after the levy.

D. Improve TIN Matching through TIN Validation

As GAO[5] concluded, the absence of valid taxpayer identification numbers (TINs) contributes to DoD and IRS failing to collect unpaid Federal taxes from contractors. GAO recommended that DoD and IRS consider a TIN matching program to ensure valid TINs in the Central Contractor Registration (CCR) database that would aid in accurate information reporting and federal tax collection with respect to contractors. Recognizing the statutorily mandated confidentiality of return information (including TINs), GAO recommended that the IRS and the OMB consider a consent-based program under I.R.C. § 6103 to allow the IRS to validate routinely all vendor TINs in the CCR. If a consent-based program was determined to be infeasible due to statutory restrictions on disclosure, the GAO recommended the use of the existing TIN matching program under the back-up withholding provisions of I.R.C. § 3406 to validate the TINs in the CCR. The Task Force recommends that consent-based TIN validation under I.R.C. § 6103 should be instituted, initially under a consent-based program. In addition, the Task Force notes that limits inherent in the consent-based program may ultimately necessitate a legislative change.

Consent-Based TIN Matching Program

Under current law, the name, address and TIN of a taxpayer are items of return information as defined in I.R.C. § 6103(b) (2) (A). I.R.C. § 6103(a) sets out the general rule that returns and return information are confidential, except for disclosure authorized by the Internal Revenue Code. Because I.R.C. § 6103(c) authorizes the disclosure of return information to a taxpayer's designee upon a consent authorizing such disclosure, the Task Force concluded that TIN validation could be accomplished through the registrant's written consent. Under this option, CCR registrants would be required to execute written consents authorizing the disclosure of certain return information (*i.e.*, name and TIN only) as a condition to registration in the CCR and eligibility for a Federal contract.

I.R.C. § 6103(c) and Treasury Regulation § 301.6103(c)-1 enumerate the requirements for a valid consent. These include the requirement that the consent: (1) be in writing; (2) appear on a separate document (or screen) pertaining solely to the consent; (3) contain the taxpayer's identity (name, address, TIN), tax years and items of return information to be disclosed; (4) be signed and dated by the taxpayer; and (5) be received by the IRS within 60 days of signature. Electronic consents are authorized provided they meet these requirements. The Task Force recognizes that the policies underlying the Internal Revenue Code's confidentiality rules should apply to TINs in the CCR. To be consistent with the policies underlying the Code's confidentiality rules, the consent also should specify the purpose for the disclosure of the information into the CCR and the uses that may be made of the information once disclosed.

The Task Force recommends establishing a consent-based, TIN matching program to validate all TINs in the CCR. Although this recommendation does not address TIN matching for vendors that are not required to register in the CCR, the Task Force will continue to explore possible solutions. Because a consent-based program can be established without new legislation, the IRS and DoD will establish a joint team to develop and implement a consent-based TIN matching program.

[5] GAO Report issued December, 2003 entitled "Tax Administration – More Can Be Done to Ensure Federal Agencies File Accurate Information Returns" (GAO-04-74).

The Task Force recognizes that although a consent based program can be established under the existing statutory authority in I.R.C. § 6103(c), Congress, in enacting I.R.C. § 6103, specifically enumerated when disclosures of return information could be made. Accordingly, the use of consent-based programs historically has been limited, and the Task Force appreciates that any consent-based program raises policy issues that must be carefully considered. The Task Force will continue working with the Treasury Department to review these policy issues and to determine whether alternative approaches should be pursued.

Existing TIN Matching Program under I.R.C. § 3406

The Task Force did not agree with GAO's recommendation that DoD utilize the current TIN matching program under I.R.C. § 3406. The universe of eligible participants in the I.R.C. § 3406 TIN matching program, and the uses that can be made of the validated TINs, are much more limited than what is needed to significantly improve collections of unpaid Federal taxes. Because the Task Force believes a consent-based program is feasible under I.R.C. 6103(c), the Task Force concluded that a new TIN matching program separate and apart from the program established under this section should be established, as described above. The proposal for a consent-based, CCR TIN matching program would exist parallel to the current TIN matching program under I.R.C. § 3406 and would not eliminate backup withholding obligations Federal agencies may have as payors. However, Federal agencies using a CCR-validated TIN would greatly reduce instances requiring back-up withholding.

E. Increase Continuous Levy for Certain Federal Payments

Proposed legislation for increasing the amount of a vendor payment that could be levied for the continuous levy program from 15 percent to up to 100 percent was submitted in the President's FY 2005 Budget. This proposal, with some modifications, has been approved by the Senate as part of the Jumpstart Our Business Strength Act (S 1637), and by the House as part of H.R. 4520, the American Jobs Creation Act of 2004. Enactment of this proposal could significantly increase levy collections by allowing a greater proportion of each payment to be used to satisfy delinquent tax liabilities.

Stop Federal Contract Awards to Those Who Abuse the Tax System

The GAO recommended that the Director of OMB pursue policy options, including government-wide debarment and suspension, to prohibit Federal contract awards to contractors that disregard their Federal tax obligations (*e.g.*, failure to remit payroll taxes for several tax periods or default on an installment agreement) and do not contest that the tax is owed. In subsequent testimony, the PSI asked DoD to consider various policy options to stop the award of contracts to contractors who abuse the tax system using the responsibility determination required by FAR 9.1. As a result, the Task Force agreed to evaluate various options to stop the award of contracts to noncompliant taxpayers.

The Federal Government previously attempted to stop the award of contracts to contractors with unsatisfactory records of tax compliance using the contractor responsibility rules provided under FAR 9.1. On December 20, 2000, the Federal Acquisition Regulation (FAR) Council published a rule that required contracting officers to consider prospective contractors' compliance with various laws, including tax laws, when making the responsibility determination required by FAR 9.104. The FAR Council subsequently revoked the rule after considering 4,698 public comments on the rule change.

Although some favored the rule, it was strongly opposed by industry groups such as the Chamber of Commerce and the National Association of Manufacturers, Government agencies including DoD and GSA, and various members of Congress. The public comments expressed the opinion that contracting officers lacked the required expertise to make decisions regarding satisfactory compliance with the laws. The rule required contracting officers to evaluate complex tax, labor, employment, environment, antitrust, and consumer protection laws. Because contracting officers are not trained or experienced in these specialized areas, the FAR Council believed the rule could lead to uninformed, inconsistent, or arbitrary decisions. The FAR Council also believed that the rule failed to maintain a clear distinction between "responsibility determinations" and "de facto debarments," and thus would negate the due process protections afforded by the existing Government debarment and suspension procedures. The Task Force believes that any new attempt to expand the responsibility rules would raise many of the same concerns that led to the withdrawal of the prior rule.

Instead of using the responsibility determinations under FAR 9.1, the Task Force agreed to use the existing debarment and suspension procedures provided under FAR 9.4 to stop the award of contracts to individuals and businesses that abuse the tax system. The Task Force also recommends a standard to be applied to contractors for debarment for reasons related to tax noncompliance.

FAR 9.406-2 entitled "causes for debarment" provides, in relevant part:

> The debarring official may debar-
> (a) A contractor for a conviction of or civil judgment for-
>
> * * *
>
> (3) Commission of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, **tax evasion**, or receiving stolen property;
>
> * * *
>
> ; or
> (5) Commission of any other offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a Government contractor or subcontractor.

Upon a showing of conviction or civil judgment for such an offense, an authorized debarring official, in consultation with other agencies having an interest in the case, proposes debarment and, after giving the contractor an opportunity to respond and considering all of the evidence, makes a final decision as to whether the contractor should be placed on the excluded parties list. See FAR 9.406-3. Similarly, FAR 9.407-2(a) authorizes suspension of contractors upon a finding of "adequate evidence" of the same offenses, such as where an individual has been indicted but not yet convicted or acquitted. See FAR 9.407-2(b).

Although it is not entirely clear, a more aggressive policy of debarring and suspending contractors for tax compliance problems not rising to the level of tax evasion potentially could be authorized under existing regulations. FAR 9.406-2(c) authorizes debarment for "any other cause of so serious or compelling a nature that it affects the present responsibility of the contractor or subcontractor." Other federal agencies with whom the Task Force consulted reported that this "catch all" provision is used to debar individuals for violations of federal statutes in the absence of a conviction or a civil judgment. The debarring agencies undertake fact-finding and afford contractors an opportunity for a formal hearing.

In its response to the GAO Report, OMB stated that setting a standard for removing abusive taxpayers from the procurement system should be a function of the Office of Tax Policy or of Congress. Accordingly, the Task Force members deferred to the IRS on the level of tax noncompliance for which it is appropriate to undertake the debarment of contractors and potential contractors on a systematic basis.

Development of a uniform standard of abuse to the federal tax system by contractors poses several challenges. Defining noncompliance by contractors justifying debarment is inherently a fact-intensive inquiry that depends upon a wide variety of factors, including: (1) the type of taxpayer - sole proprietors, small businesses, large corporations, etc.; (2) the type of tax – income, employment, excise, etc.; (3) the particular compliance obligations – paying tax due, filing returns, withholding and paying over taxes; (4) the particular compliance failures; and (5) the reasons for noncompliance. In addition, the varying backgrounds and resources available to procurement officials who would be required to apply such a standard compound these challenges.

After carefully evaluating the range of options, there appeared to be several reasons against adopting a noncompliance standard that is broader than convictions for tax evasion and other criminal offenses. First, there is no other readily identifiable standard that could be consistently applied by procurement officials in all cases. Short of conviction by a court, there is no level of tax compliance – including the failure to remit payroll taxes or default of an installment agreement – which will in all cases reflect a lack of present responsibility by the contractor. Because tax compliance is a factual inquiry, sorting through all cases of non-compliance by prospective contractors would be extremely resource intensive and burden the procurement system with investigations that may contribute little to the stated goal of efficient contracting. Second, absent public information relating to such convictions, the IRS may not reveal to procurement officials the information necessary to make compliance determinations. The GAO Report appeared to acknowledge this limitation when it stated that any option developed should "fully comply with the statutory restriction on disclosure of taxpayer information." If there is a conviction for tax evasion, however, all this information is in the public record and is available to debarment officials without regard to section 6103. Application of a standard that requires information that is not in the public record would require either the adoption of legislation to allow broad disclosures of tax return information for procurement purposes, or the institution of a practice of requiring all prospective contractors to consent to the disclosure of a wide range of taxpayer information.

For these reasons—and in light of the improvements being made which will increase the likelihood of collecting taxes from delinquent contractors—the IRS agrees to utilize conviction of tax evasion or other offenses showing a lack of business integrity as the standard for undertaking the debarment of contractors as a routine practice. Currently there are no established procedures to inform procurement officials that a contractor or potential contractor has been convicted of tax evasion or of a tax-related offense indicating a lack of business integrity or business honesty. It would be impractical for a procurement executive or contracting officer to search the dockets of all district courts for this information. Moreover, if a search revealed a conviction, obtaining relevant documents from the court would be costly and time-consuming.

The Task Force recommends and the IRS agrees to develop a procedure, as part of the closing of cases following criminal convictions, to determine whether the convicted party is registered in the CCR and, if so, to institute debarment proceedings. If the convicted party is listed in the CCR, the IRS would, through appropriate channels, propose debarment to the Senior Procurement Executive in the Department of the Treasury. Because of the restrictions imposed by I.R.C. § 6103, the referral would include only information drawn from the public record of the judicial tax proceeding (*i.e.*, pleadings, rulings, and court opinions). As part of the normal debarment process, the contractor could provide other information or documents relevant to the final determination, but no confidential return information would be disclosed by the IRS to the procurement executive absent the taxpayer's consent. Assuming adequate tax information became available as part of the public record, a similar system for the suspension of an indicted party pending the outcome of the case also could be explored.

Use of the existing debarment and suspension procedures, including the central listing of contractors ineligible for contract award, would minimize administrative burdens on contracting officials, fully comply with rules regarding the confidentiality of taxpayer information, and provide a standard that could easily be applied by the debarring official.

Summary

The Task Force report provides a number of actions the responsible agencies can implement to strengthen tax compliance within current statutory constraints. The work of the Task Force highlighted that improving federal contractor tax compliance could only be achieved by working together to address the program complexities faced by each agency. The agencies will continue to use the Task Force to improve federal contractor compliance.

Appendix I

DoD Implementation Plan for Providing Payment Information to FMS for DoD Payment Systems					
Entitlement System Abbreviation	Entitlement System	System Owner	Locations	Estimated Implementation Date	Implementation
CAPS-CLIPPER	Computerized Accounts Payable System (Clipper)	DFAS	Europe, Rock Island, St. Louis, Columbus, Lawton, San Antonio, Indianapolis, Japan	All sites by 3/22/04	Complete
CAPS-W	Computerized Accounts Payable System (Windows)	DFAS	Columbus, St. Louis, Rock Island, Rome, Orlando, Indianapolis, Lexington, Norfolk, Lawton, San Antonio, Seaside	All sites by 3/22/04	Complete
IAPS	Integrated Accounts Payable System	DFAS	Dayton, Omaha, Limestone, Orlando, Pacific, San Antonio, Japan, San Bernardino	All sites by 8/30/04	On Track
OBP	One Bill Pay (Previously Called STARS One Bill Pay)	DFAS	Charleston, Norfolk, Pensacola, Oakland, San Diego, Pacific, Japan	All sites by 6/28/04	Complete
DTRS	Defense Transportation Payment System	DFAS	Indianapolis	No later than March 2005	Ahead of Schedule 8/16/04
TSS	Transportation Support System	DFAS	Norfolk	No later than March 2005	Complete
AVEDS	Automated Voucher Examination Disbursing System	DLA	Columbus	4/26/04	Complete
FAS	Fuels Automated System	DLA	Columbus	No later than March 2005	Ahead of Schedule 11/1/04
DISMS	Defense Integrated Subsistence Management System	DLA	Columbus	No later than March 2005	Complete
FABS	Financial Accounting Budget System	DITCO	Pensacola	No later than March 2005	Ahead of Schedule 11/22/04
SAMMS	Standard Automated Material Management System	DLA	Columbus	No later than March 2005	Complete
SAVES	Standard Automated Voucher Examination System	DECA	Columbus	4/05/04	Postponed Until 1/24/05 Pending System Change Request (SCR)
CUFS	College And University Financial System	USUHS	Omaha	No later than March 2005	On Track
SYMIS	Shipyard Management Information System	USN	Norfolk	No later than March 2005	On Track
TMS	Transportation Management System	USMC	MCLB Albany	No later than March 2005	Ahead of Schedule 12/13/04
TFMS-M	Transportation Financial Management System	MTMC	Omaha	No later than March 2005	On Track
BSM	Business Systems Modernization	DLA	Columbus	2/16/04	Complete
SRD-1	Standard Finance System Redesign- Subsystem 1	DFAS	Columbus	4/26/04	Postponed Until 8/12/04 Pending SCR
MSC	Military Sea-lift Command	Navy	Washington, D.C.	No later than March 2005	On Track
MOCAS	Mechanization of Contract Administration Services	DFAS/ DCMA	Columbus	Implemented 12/16/02	Complete

Federal Contractor Tax Compliance Task Force Participants

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United States General Accounting Office
Washington, DC 20548

July 29, 2005

The Honorable Norm Coleman
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security
and Governmental Affairs
United States Senate

Dear Chairman Coleman:

This letter responds to your request for additional information related to the Subcommittee's June 16, 2005, hearing entitled *Civilian Contractors Who Cheat on Their Taxes and What Should Be Done about It.* Enclosed are our responses to the supplemental questions you submitted for the record. Our responses are based largely on information contained in our published reports and testimonies related to Department of Defense and civilian contractors with unpaid taxes and reflect our views based on that information.

If you have any further questions or would like to discuss these responses, please call John V. Kelly, Assistant Director, Forensic Audits and Special Investigations, on (202) 512-6926.

Sincerely yours,

Gregory D. Kutz
Managing Director
Forensic Audits and Special Investigations

Steven J. Sebastian
Director
Financial Management and Assurance

Enclosure-1

Permanent Subcommittee on Investigations
EXHIBIT #4

Responses to Supplemental Questions for the Record Submitted by Senator Norm Coleman, Permanent Subcommittee on Investigations Hearing on *Civilian Contractors Who Cheat on Their Taxes and What Should Be Done about It* June 16, 2005

1. **During the course of your investigation, you determined that hundreds of thousands of federal contractors do not appear to have registered in the Central Contractor Registry. Please explain how you were able to make this determination, including the data you used and the analysis you performed.**

   Answer:
   Ongoing work indicates that during fiscal year 2004, FMS made payments to about 900,000 unique contractors, and that only about 350,000 contractors had registered in the Central Contractor Registry (CCR). Thus, payments were made to hundreds of thousands of federal contractors that were not registered in CCR during fiscal year 2004. However, some contractors may not have been required to register in CCR for a variety of reasons. Data from FMS does not contain information for us to determine why a contractor was not in CCR.

   Federal Acquisition Regulation (see FAR subpart 4.11) requires that, as of October 1, 2003, contractors must be registered in the CCR before award of a contract, basic ordering agreement, or blanket purchase agreement. In addition, the rule requires contracting officers to require contractors whose existing contracts extend beyond December 31, 2003, to register in the CCR database by December 31, 2003. However, Federal Acquisition Circular (FAC) 2001-16 exempts specific contractors from registration. The exemptions include: (1) purchases made using a government commercial purchase card as the purchasing and payment mechanism, (2) contracts with classified information or national security, (3) contracts awarded by deployed contracting officers in the course of military operations, (4) contracts awarded in the conduct of emergency operations, (5) contracts to support unusual and compelling needs, (6) awards made to foreign vendors performing work outside the United States, and (7) micro purchases ($2,500) that do not use the electronic funds transfer method for payment. Some of the civilian contractors we identified as not being registered in CCR could be legitimately excluded because they met one of the exemption criteria, or may have been paid under a contract that was not covered under the effective period of the new requirement. However, payment data we received from FMS did not contain the critical information to allow us to determine why a contractor was not in CCR.

2. **You identified 50 cases of potential criminal abuse drawing these cases from among the 33,000 contractors you identified as owing taxes. Are there more examples of potential criminal abuse among the 33,000 beyond the 50 cases you highlighted in your report? How many more cases of potential criminal abuse exist? How many have been referred for prosecution?**

   Answer: We believe that there are more than 50 potentially criminal or abusive cases in the 33,000 contractors with delinquent tax debt. As stated in our report, we used a nonprobability selection approach to select the 50 case study contractors from the population of about 33,000 contractors that were receiving federal payments during fiscal year 2004, and which owed over $3.3 billion in unpaid federal taxes as of September 30, 2004. The basis for selecting each of the case study contractors was that they all had unpaid taxes totaling more than $100,000 and federal payments totaling more than $10,000. We also evaluated contractors with tax debt on the basis of the number of tax periods owed, the types of taxes owed, the owner's involvement with other companies, and representation across a range of civilian agencies. We characterized as potentially criminal any activity related to the federal tax liability that may be a crime under a specific provision of the Internal Revenue Code. As we have reported, all 48 of the 50 case study contractors that filed business tax returns failed to pay their payroll taxes–amounts that businesses withheld from employees' wages for federal income taxes, Social Security, and Medicare but failed to remit to the Internal Revenue Service (IRS) (as well as the related employer matching contributions for Social Security and Medicare taxes). The willful failure to remit payroll taxes is a criminal felony offense. While we used data mining techniques to focus our selection on 50 cases with egregious tax debts, given the number of contractors with unpaid payroll taxes, we believe that there are a substantial number of additional cases of contractors that receive money from the federal government, but are engaged in potentially criminal or abusive activity.

   Further, as part of our investigations, we found that 3 of the 50 case studies involve owners or officers who had been either convicted or indicted for non-tax-related criminal activities, or were under IRS investigation. We did not find evidence that any of the 50 case studies were referred for prosecution based solely on potential criminal activities related to the tax system.

3. **What are the most common factors among the 97 cases you have thus far identified of federal contractors who abuse the federal tax system? For example, all 97 cases involved federal contractors with tax debt. Based on the frequency of occurrence please provide an analysis showing the number of contractors who had**
   - **failed to file tax returns,**
   - **federal tax liens,**
   - **state tax liens,**
   - **state tax debt,**
   - **trust fund recovery penalties,**
   - **convictions for tax evasion,**
   - **indictments for tax evasion,**
   - **felony convictions by type,**
   - **felony indictments by type, and**
   - **any other factors that are common to the 50 cases.**

   Answer: The most common trait among most of the case study contractors on whom we reported was their failure to pay payroll taxes. These are cases where the contractor withheld money from their employee's salaries, but failed to carry out their fiduciary role and transfer those amounts to the government. As you have already noted, we found that the contractors with abusive activities related to the tax system frequently had federal and state tax liens filed against them. In many cases, IRS had also assessed trust fund recovery penalties against the contractors. Please see table 1 for further information. While there is not a comprehensive source for state tax debt information, data we gathered on state tax liens provide a good indication that the contractors may have abused state tax systems. The data we provide below are based on audit and investigative work we performed.

Table 1. Analysis of the Most Common Factors among the 97 Case Studies

Category	47 Department of Defense (DOD) contractor cases[a]	50 civilian agency contractor cases	All 97 contractor cases
Failed to file tax returns by entity and/or owner (entity only for DOD contractors)[b]	12	6	18
Federal tax liens	34	37	71
State tax liens	26	37	63
Trust fund recovery penalty assessments	18	27	45
Conviction for tax evasion	0	0	0
Indictment for tax evasion	0	0	0
Convictions by type			
Drug and Alcohol related	1	1	2
Grand larceny, embezzlement, election fraud	2	1	3
Property-related, breach of peace	2	1	3
Indictments by type			
Drug- and alcohol-related	1	1	2
Grand larceny, embezzlement, election fraud	2	1	3
Property-related, breach of peace	2	1	3
Assault	1	0	1

Source: GAO analysis of civilian agency, IRS, FMS, public, and other record

[a]Federal lien information were obtained from IRS record of Unpaid Assessments as of September 30, 2004. State tax information was from GAO's analysis of other data sources as of July 2005 for state tax liens filed prior to September 30, 2004.
[b]GAO's review of IRS data indicates that IRS records may not reflect all tax periods for which a contractor was liable and therefore this number may be understated.

4. Is there adequate statutory or regulatory federal contract authority for each federal agency to terminate existing contracts and deny future contracts to federal contractors who abuse the tax system? Please cite the relevant authorities.

Answer:

The basis for terminating existing contracts with federal contractors can be difficult to establish because of the serious ramifications of debarment. The Federal Acquisition Regulation (FAR) governs the federal government's consideration of a contractor's suitability to conduct business with the government. Subpart 9.1 of the FAR requires companies conducting business with the federal government to successfully pass a responsible source determination. Furthermore, subpart 9.4 of the FAR governs the process to suspend and debar contractors from conducting business with the federal government for a variety of reasons. With specific regard to those that abuse the tax system, a contractor may be suspended or debarred for commission of tax evasion. None of the 97 egregious case study contractors that we reported on met the above criteria of being charged with tax evasion. Contractors may also be debarred on other grounds that may relate to abuse of the tax system, such as commission of any serious offense indicating a lack of business ethics integrity or any other cause of so serious or compelling nature as to affect the contractors' present responsibility (see FAR 9.406-2).

A more fundamental issue than the authority to deny tax abusers contracts is the limitation in providing tax information to contracting officers. Specifically, section 6103 of the Internal Revenue Code generally prohibits the disclosure of IRS taxpayer data. Therefore contracting officers do not have ready access to information related to a contractor's unpaid tax debt. Further, there is no ready mechanism available for contracting officers to assess such information even if it was available. While contracting officers have access to public databases containing data on federal tax liens that have been filed against some federal contractors who are delinquent in their taxes, searching those databases is time-consuming. Because contracting officers are not able to quickly and easily identify the population of all contractors who have abused the tax system, they are unlikely to use such information in making contracting decisions, nor does the FAR presently require them to do so.

5. **Federal contractors receive multiple notices from IRS before their payments are levied. How many notices do they receive and how long does this take? Do individuals and companies receive the same number of notices?**

Answer:

After a tax assessment is posted to IRS's records and the tax has not been paid, IRS sends taxpayers a series of balance-due notices prior to beginning the levy. Generally IRS notifies individual taxpayers five times (including the notice of intent to levy) and business taxpayers three times (including the notice of intent to levy). IRS waits about 5 weeks between each notice. The notice of intent to levy is sent when IRS has established that placing a levy is the next collection action intended. The amount of time taken to make this determination varies.

6. **What can IRS do to identify federal contractors who do not file their tax returns and for whom no tax debt is recognized by IRS, even though one may exist?**

Answer:

IRS does not have a specific process targeted at identifying federal contractors who do not file tax returns. To the extent that these contractors are identified, it is through the generic process that IRS uses to identify non filers in the general population. While most individuals and businesses voluntarily comply with the requirement to timely file taxes, many do not. IRS is authorized to assess a tax liability for individuals and businesses who fail to file their tax returns. IRS refers to the program for individual nonfilers as the substitute for return (SFR) program and has designated the program for business non-filers as the 6020(b) program. IRS matches data received from employers, the Social Security Administration, and

other third parties (such as banks and investment companies) with its tax files to identify potential nonfilers. When a potential nonfiler is identified, IRS advises the taxpayer that the return has not been received and requests the taxpayer to file the return (or provide a copy of the return if it was already filed). If the taxpayer does not respond to the delinquency notices, IRS prioritizes the case for investigation to determine if the case is valid. If so, IRS will send out a series of notices informing the taxpayer that IRS is going to assess taxes on the basis of information provided by third parties, such as W-2 salary information. IRS may process a SFR either through its automated systems or manually.

Although IRS has a program in place to identify nonfilers in the general population, IRS does not target federal contractors that do not file taxes. We recognize that in order to manage its collection program, IRS needs flexibility to determine priorities. One option IRS has in identifying federal contractors who do not file their tax returns is to obtain a database of the name and TIN of contractors who receive payments from the federal government, including FMS and DOD. IRS could then analyze the contractor payment data to identify federal contractors that failed to file tax returns.

Another difficulty is that a contractor can receive payments using one Tax Identification Number and file tax returns under another Tax Identification Number. Consequently, the effectiveness of IRS's efforts to ensure that federal contractors submit tax returns could be challenged. One solution to this could be to require contractors who register in the CCR to record in CCR both the TIN used to receive payments and the TIN used in filing tax returns.

7. **From the 50 cases of potential fraud or criminal activity identified in your report, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, please update the chart to include all cases where (1) a federal tax lien has been filed, (2) a state tax lien has been filed, (3) a trust fund recovery penalty for failing to remit payroll taxes has been assessed, or (4) the contractor has failed to file required federal tax returns. In addition, for specific cases please provide additional information regarding the type of IRS or FMS exclusion.**

Answer:

Our report on civilian agency contractors that abuse the federal tax system provided summary data on tax liens and trust fund recovery penalties of 50 case study contractors. As requested, table 2 below provides detailed data on the 50 civilian agency contractors with unpaid taxes related to (1) federal tax liens, (2) state tax liens, (3) trust fund recovery penalties, and (4) whether the case study contractor filed required federal tax returns. As you further requested, we also provided information on why payments to specific case study contractors were not levied for unpaid tax debt.

Table 2. Civilian Agency Contractors with Unpaid Federal Taxes

Case study	Were federal tax liens filed?	Were state tax liens filed?	Were trust fund recovery penalties assessed?	Were required federal tax returns filed?	Requested information on why payments to specific case study contractors were not levied[a]
1	No	Yes	Yes	Yes	
2	Yes	Yes	Yes	Yes	
3	Yes	No	Yes	Yes	
4	Yes	Yes	Yes	Yes	
5	Yes	Yes	Yes	Yes	
6	Yes	Yes	Yes	Yes	
7	No	Yes	Yes	Not all	
8	Yes	Yes	Yes	Yes	
9	Yes	Yes	Yes	Not all	
10	Yes	Yes	Yes	Not all[a]	IRS policy exclusion. • Systemic block[b]. IRS statutory exclusion. • IRS litigation[c].
11	No	Yes	No	Yes	
12	No	Yes	Yes	Yes	
13	Yes	Yes	No	Yes	IRS policy exclusion • Systemic block[b].
14	Yes	No	Yes	Yes	IRS policy exclusion • Systemic block[b]. IRS statutory exclusion • IRS litigation[c].
15	Yes	Yes	No	Yes	FMS exclusion. • Type A; FMS does not levy type A payments.
16	Yes	Yes	No	Yes	
17	Yes	Yes	No	Yes	
18	No	No	No	Yes	FMS exclusion. • Type A payments; FMS does not levy type A payments.
19	Yes	Yes	Yes	Yes	FMS exclusion • CTX
20	Yes	Yes	Yes	Yes	IRS policy exclusion • Systemic block[b]. FMS exclusion. • FMS does not have agency location code in TOP.
21	Yes	Yes	No	Yes	
22	No	No	No	Yes	IRS policy exclusion. • Systemic block[b]. In TOP, but levy indicator not turned on because IRS collection due process not yet completed.
23	Yes	No	Yes	Yes	

Case study	Were federal tax liens filed?	Were state tax liens filed?	Were trust fund recovery penalties assessed?	Were required federal tax returns filed?	Requested information on why payments to specific case study contractors were not levied[a]
24	No	No	No	Not all	IRS policy exclusion. • Systemic block[b]. FMS exclusion. • Type A payments; FMS does not levy type A payments. In TOP, but levy indicator not turned on because IRS collection due process not yet completed (Some other types of payments were levied).
25	Yes	Yes	No	Yes	
26	Yes	Yes	No	Yes	IRS policy exclusion. • Manual block placed on the case by an IRS collections official.
27	No	No	No	Yes	IRS statutory exclusion. • Initial notice status[d].
28	Yes	Yes	Yes	Yes	
29	No	No	No	Yes	
30	No	Yes	No	Yes	IRS statutory exclusion • Taxpayer's accounts were in IRS notice status[d].
31	Yes	Yes	No	Yes	
32	Yes	Yes	Yes	Not all[e]	IRS statutory exclusion • Initial notice status[d]. • Litigation[c]. In TOP, but levy indicator not turned on because IRS collection due process not yet completed.
33	Yes	Yes	No	Yes	IRS policy exclusion • Systemic block[b]. In TOP, but levy indicator not turned on because IRS collection due process not yet completed.
34	Yes	Yes	No	Yes	Installment agreement was current.
35	No	Yes	No	Yes	Not available.
36	Yes	Yes	Yes	Yes	
37	Yes	Yes	Yes	Yes	Taxpayer had a current installment agreement with IRS.
38	Yes	No	Yes	Yes	IRS policy exclusion. • Systemic block[b]. • Manual block plac.ed on the case by an IRS collections official. FMS exclusion. • Type A and CTX payments; FMS does not levy these payments. (Some other types of payments were levied) .

Case study	Were federal tax liens filed?	Were state tax liens filed?	Were trust fund recovery penalties assessed?	Were required federal tax returns filed?	Requested information on why payments to specific case study contractors were not levied[a]
39	Yes	Yes	Yes	Yes	IRS policy exclusion. • Systemic block[b]. In TOP, but levy indicator not turned on because IRS collection due process not yet completed. FMS exclusion. • FMS did not have a control name in the payment record. • Type A payments; FMS does not levy type A payments. (Some other types of payments were levied).
40	Yes	Yes	No	Yes	IRS statutory exclusion. • Installment agreement -but not current. In TOP, but levy indicator not turned on because IRS collection due process not yet completed. (Some other types of payments were levied) .
41	Yes	Yes	Yes	Yes	
42	No	Yes	No	Yes	
43	Yes	No	No	Yes	IRS statutory exclusion. • Litigation[c].
44	No	No	No	Yes	
45	Yes	No	No	Yes	IRS policy exclusion. • Systemic block[b]. In TOP, but levy indicator not turned on because IRS collection due process not yet completed.
46	Yes	Yes	Yes	Yes	
47	Yes	Yes	Yes	Not all	
48	Yes	Yes	Yes	Yes	
49	Yes	No	Yes	Yes	
50	Yes	Yes	Yes	Yes	

Source: GAO's analysis of IRS, FMS, and public records.

[a]One of the officers is a non-filer.
[b]IRS took actions during 2004 to remove most systemic blocks. Prior to those actions, IRS routinely placed a block on various categories of cases, such as blocking all cases in its Automated Collection System and blocking, for a period of a year, cases in the queue awaiting assignment to the field for collection.
[c]The taxpayer had filed some sort of litigation action, such as bankruptcy.
[d]IRS's notice status is the first phase of IRS's collection process during which IRS sends up to 5 separate notices to tax debtors asking them to pay their tax debt.
[e]Data provided are for disbursements made in fiscal year 2004. In a number of cases, payments were excluded from levy due to a number of reasons. For a number of cases, the reasons changed throughout fiscal year 2004.

8. **From the 47 cases of potential fraud or criminal activity identified in your prior report, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, please update the chart from that report and identify all cases where (1) a federal tax lien has been filed, (2) a state tax lien has been filed, (3) a trust fund recovery penalty for failing to remit payroll taxes has been assessed, or (4) the contractor has failed to file required federal tax returns. In addition, where contractors are cited as having a statutory or policy exclusion, please cite the specific type of exclusion.**

Answer:

Our report on DOD contractors who abused the federal tax systems provided data on tax liens and trust fund recovery penalties on 47 case study contractors. Table 3 below provides detailed information on the 47 DOD case studies related to on (1) federal tax liens, (2) state tax liens, (3) trust fund recovery penalty assessments, and (4) whether the case study contractor filed required federal tax returns. We updated the federal and state tax liens, and trust fund penalty assessments information to include information as of September 30, 2004. Further, as you requested, we also provided information the levy status or type of exclusion.

Table 3. DOD Contractors with Unpaid Federal Taxes

Case study	Were federal tax liens filed?[a]	Were state tax liens filed?[b]	Were trust fund recovery penalties assessed?[a]	Were required federal tax returns filed?[c]	Levy status or type of exclusion[d]
1	No	Yes	No	Yes	In levy program.
2	Yes	Yes	Yes	Yes	In levy program.
3	Yes	Yes	Yes	Yes	In levy program.
4	Yes	Yes	No	Yes	In levy program.
5	No	Yes	No	Not All	In levy program.
6	Yes	No	No	Yes	Policy exclusion—criminal investigation.
7	Yes	No	No	Yes	Fully paid.
8	No	Yes	No	Yes	In levy program.
9	Yes	Yes	No	Yes	In levy program.
10	Yes	Yes	Yes	Not All	In levy program.
11	Yes	Yes	No	Yes	Policy exclusion—criminal investigation.
12	Yes	Yes	Yes	Yes	Statutory exclusion-bankruptcy.
13	No	No	No	Yes	In levy program.
14	Yes	No	Yes	Not All	In levy program.
15	Yes	No	Yes	Not all	Statutory exclusion—due process appeal
16	No	No	No	Yes	In levy program.
17	Yes	No	No	Not All	In levy program.
18	Yes	No	No	Yes	Policy exclusion—civil referral suit under Department of Justice.
19	Yes	No	No	Yes	Statutory exclusion—bankruptcy.
20	Yes	No	No	Yes	Policy exclusion—financial hardship.
21	Yes	Yes	Yes	Yes	Fully paid.
22	Yes	No	Yes	Yes	In levy program.
23	No	Yes	No	Yes	In levy program.
24	No	Yes	No	Yes	Statutory exclusion—litigation (defunct).
25	Yes	Yes	Yes	Yes	Statutory exclusion—bankruptcy.
26	Yes	Yes	Yes	Not All	In levy program.
27	Yes	Yes	No	Yes	Statutory exclusion—pending installment agreement.
28	No	No	No	Yes	In levy program.
29	Yes	Yes	Yes	Yes	Statutory exclusion—installment agreement.
30	No	Yes	No	Yes	Fully paid.
31	No	Yes	No	Yes	In levy program.
32	Yes	Yes	Yes	Not All	In levy program.
33	Yes	No	Yes	Yes	Statutory exclusion—bankruptcy.
34	Yes	Yes	Yes	Yes	Statutory exclusion—litigation/bankruptcy.
35	Yes	No	No	Yes	In levy program.

Case study	Were federal tax liens filed?[a]	Were state tax liens filed?[b]	Were trust fund recovery penalties assessed?[a]	Were required federal tax returns filed?[c]	Levy status or type of exclusion[d]
36	No	No	No	Not All	Statutory exclusion—installment agreement.
37	Yes	Yes	Yes	Yes	In levy program.
38	Yes	Yes	No	Yes	Statutory exclusion—offer in compromise (company's 4th).
39	Yes	Yes	No	Yes	In levy program.
40	No	No	No	Yes	In levy program.
41	Yes	No	No	Not All	Policy exclusion—financial hardship.
42	Yes	No	No	Yes	In levy program.
43	Yes	Yes	No	Not All	Statutory exclusion—installment agreement.
44	Yes	Yes	Yes	Yes	Policy exclusion—financial hardship.
45	Yes	No	Yes	Not All	In levy program.
46	Yes	No	Yes	Not All	In levy program.
47	No	No	No	Not All	Statutory exclusion—litigation/bankruptcy

Source: GAO's analysis of IRS, FMS, and public records.

[a]Based on GAO analysis of IRS Masterfile information as of September 30, 2004.
[b]Based on review of Lexis-Nexis data as of July 2005 for liens filed prior to September 30, 2004.
[c]Based on GAO's review of IRS taxpayer information as of May 2003. Taxpayer status may have changed.
[d]IRS provided updated information showing that 25 cases were currently in the levy program, 3 had been fully paid, and the reasons why the other 19 cases were not in the levy program. We did not audit the updated IRS information.

RESPONSES TO QUESTIONS FOR THE RECORD
SUBMITTED BY

SENATOR NORM COLEMAN
for
THE HONORABLE MARK EVERSON
Commissioner, Internal Revenue Service
Department of the Treasury

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
CIVILIAN CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT
June 16, 2005

1. Can IRS notify federal contracting officials about federal contractors who are egregiously violating U.S. tax laws? For example, one federal contractor, who provides security guard services for the Departments of Homeland Security and Veterans Affairs, has not filed all required tax returns since the early 2000s; has been delinquent in paying payroll taxes since the late 1990s, and currently owes over $400,000 to the IRS in unpaid taxes. Moreover, the owner of the company has repeatedly failed to file individual income tax returns and has diverted his employees' payroll taxes to build a personal residence overseas. If IRS cannot notify contract officials at the Departments of Homeland Security and Veterans Affairs about this contractor's noncompliance with federal tax laws, how can this be overcome?

   Information concerning taxpayers' liability or potential liability under the internal revenue laws, including efforts to collect those liabilities, is specifically protected by statute. The confidentiality provisions of section 6103 generally do not allow the IRS to discuss taxpayers' tax information with federal agencies with whom taxpayers have contracts. Thus, the IRS does not routinely share the names and other tax information regarding federal contractors with the Departments of Homeland Security and Veterans Affairs or other federal contract officials.

   One way in which contractors' noncompliance with the tax law is being addressed is through the proposed debarment of contractors from the federal procurement system in appropriate cases. The Federal Acquisition Regulations include conviction for tax evasion -- a matter of public record -- as grounds for debarment from contracting. The IRS has instituted a procedure for identifying such cases and commencing the debarment process (see answer to question 5, below). Federal contract officials must check the Excluded Parties List to verify that a contractor has not been debarred prior to awarding contract.

Permanent Subcommittee on Investigations
EXHIBIT #5

2. Does IRS maintain a nationwide database of federal tax liens? If not, how does IRS track federal tax liens to determine whether they are outstanding or have been satisfied?

   The IRS maintains a nationwide database of notices of federal tax liens called the Automated Lien System (ALS). The system is used to generate Notices and Releases of Federal Tax Liens for filing in state, county, and city offices. The ALS is updated as new lien filings or lien releases are requested by IRS employees. For accounts that are fully paid or otherwise satisfied, ALS generates a certificate of release of lien. The certificate of release of lien is sent to the office where the lien was originally filed for formal release of the lien.

3. One of the problems identified by GAO is that IRS records do not reflect a tax liability for federal contractors who fail to file tax returns. Would IRS be willing to establish a Federal Contractor Nonfiler Program? For example, could nonfiling federal contractors be identified by matching vendor payment data from FMS with tax return filing data from the Individual and Business Master Files? What would the estimated cost be to implement a Federal Contractor Nonfiler Program?

   The Internal Revenue Service is currently considering whether to implement a nonfiler program targeting federal contractors, or whether contract award data might be used to supplement existing processes for identifying nonfilers. The IRS is holding preliminary discussions with the General Services Administration regarding the type and volume of information potentially available to assist in identifying nonfiling federal contractors. The cost to implement a program to target nonfilers in the federal procurement system cannot be estimated until the problem is quantified, a task the Federal Contractor Tax Compliance Task Force intends to undertake.

4. Federal tax liens are public information when filed with a court. What information can the IRS furnish the Administrator of the General Services Administration with regard to federal tax liens that are filed against federal contractors? Federal tax liens generally include the taxpayer's name, address, taxpayer identification number, type of tax, and the amount owed. Are there any impediments to providing this information to the Administrator of the General Services Administration?

   The purpose of a Notice of Federal Tax Lien is to put the public on notice of the IRS' interest in a delinquent taxpayer's property. Although the Internal Revenue Code does not contain an exception to the general confidentiality rule for information that has been made a matter of public record, the IRS has taken the position, based on decisions made by several Federal Circuit Courts of Appeal, that information that has properly been made a matter of public record in judicial tax proceedings and in connection with tax administration (such as the filing of a Notice of Federal Tax Lien), is no longer subject to the confidentiality rules of section 6103, so long as the IRS makes public only information taken from, <u>and attributed to</u>, the public source. While a filed

Notice of Federal Tax Lien is itself a public document, information about that notice that is maintained in IRS files and databases remains subject to the confidentiality rules of section 6103. Therefore, section 6103 prohibits sharing information in these databases with the General Services Administration (GSA).

The ALS system, discussed in response to question 2, above, contains a listing of liens for which notice filings have been requested, but it can often take months for a requested filing to occur and some small percentage of notices may never actually be filed. ALS therefore contains some accounts for which the lien has not yet—and may not ever—be filed. The existence and amount of such liens could not be disclosed to GSA or any other party. The IRS maintains no database containing only liens for which the filing of a Notice of Federal Tax Lien has been confirmed.

5. Federal contractors are required to provide federal contract officials with a statement indicating among other things whether they have been convicted for tax evasion in the last three years. These statements may be used by contracting officials to disqualify a potential federal contractor from consideration for a contract award. Does IRS provide the Administrator of the General Services Administration or other federal officials with contract oversight responsibility with the names and other identifying information for federal contractors who have been convicted of tax evasion? Is there a legal or regulatory impediment to providing such information to federal contract officials?

   Section 6103(a) of the Internal Revenue Code provides that tax return information is confidential except as specifically provided in the Code. This confidentiality applies to information in Service files regarding convictions for tax evasion and would generally prohibit the IRS from sharing such information with procurement officials. Thus, the IRS does not routinely share the names of convicted parties with GSA or other federal contract officials.

   All federal agencies share responsibility for protecting the integrity of the federal procurement system. The IRS has instituted a process of checking the names of those convicted of tax evasion against the Central Contractor Registration (CCR) to determine whether any of the convicted parties are current or prospective federal contractors. In the event a convicted party's name is found in the CCR, the IRS will forward the name along with appropriate documentation to the Senior Procurement Executive for the Department of the Treasury, with a recommendation that the contractor be debarred from the federal procurement system. Because of the confidentiality rules mentioned above, the IRS intends to make referrals for debarment purposes using only public records, such as court pleadings and decisions. To date, no convicted parties have been found listed in the CCR and no debarments have been proposed.

6. How many tax fund recovery penalties did IRS assess in fiscal year 2004? How many of these penalties were assessed against federal contractors? How many of the tax fund recovery penalties also have a federal tax lien?

   In fiscal year 2004, the IRS assessed 104,585 trust fund recovery penalties under Code section 6672. When notice and demand for payment of these penalties was sent, a statutory tax lien arose under Code section 6321. In order to put the public on notice of these liens, the IRS filed 27,507 Notices of Federal Tax lien on these accounts. Our system does not enable us to determine how many of these accounts involved federal contractors.

7. Last year the Government Accountability Office referred 47 cases of potential fraud or criminal activity to IRS. How many of these cases have been presented for prosecution? How many were accepted?
   - **All of the 47 cases cited in the report were reviewed for potential criminal prosecution.**
   - **Twelve cases were selected for further development because indications of fraud were present and sent to Criminal Investigation's Indianapolis Lead Development Center (LDC) for further evaluation.**
   - **After further development, the Indianapolis LDC concluded that five of the twelve cases lacked sufficient criminal potential (these cases were referred for potential civil action). Seven cases were numbered as primary investigations and sent to the appropriate Criminal Investigation Field Office for investigation.**
   - **Of the seven cases sent to the field offices, five are currently actively being investigated; one has been closed and one is still in the primary investigative stage. To date no prosecution recommendations have been made.**
   - **All cases not initially selected by Criminal Investigation or closed by Criminal Investigation for lack of criminal potential, were turned over to the other IRS operating divisions for civil disposition.**

8. One particularly egregious case involved a contractor who owed $10 million in unpaid taxes, turned his business over to relatives, who were also tax delinquent, and fled to the Caribbean. The United States has an extradition treaty that covers the jurisdiction to which this individual fled. Has any action been taken to indict this individual or to seek his extradition to face criminal charges?

   The IRS does not comment on specific matters that may be the subject of an open criminal investigation. In general, however, the Service makes every effort to ensure extradition proceedings are vigorously pursued when criminals flee the United States to avoid criminal prosecution.

9. According to the GAO report, IRS waits 10 weeks after sending a federal contractor a collection due notice before levying the contractor's payments. Is there any valid reason not to decrease that time period?

The ten-week waiting period between the time IRS receives a weekly match from FMS and the time IRS issues a levy to FMS accounts for operational mailing and processing time and statutory due process requirements. Currently, the IRS must first send the taxpayer a Collection Due Process notice following a match, and then wait at least 30 days before any levy action can occur.

The process of matching contract awards against tax debts is already reducing the time frame in many cases. Legislation allowing levy to proceed first and then granting post-levy CDP rights, similar to the post-lien CDP rights currently in place, would further help accelerate the levy process. The Task Force intends to explore other options to simplify this process as it relates to federal vendors.

10. With limited exceptions, the Federal Acquisition Regulations require all federal contractors to register in the Central Contractor Registry. Generally, contractors who claim they have no U.S. tax liability are exempt. However, there is currently no process in place to verify that a claimed exemption is valid. Is IRS able to determine the validity of a claimed exemption? Is IRS the most appropriate federal agency to make this determination? What would the estimated cost be to implement a verification program?

    CCR registrants are informed that they must provide a TIN unless they are located outside the United States and pay no employees within the United States. The data edit rule in CCR is that if the registering party has a physical address inside the United States, a TIN (or SSN for sole proprietors) is a required data element. If the registering party has a physical address outside the United States, it is an optional data field. That is basically all that can be done currently in CCR, because there is no way for CCR to verify the lack of U.S. employees at the time of registration.

    The IRS does not have the means to systematically verify the U.S. tax status of a foreign vendor. The cost to implement a verification program cannot be estimated at this time.

11. GAO has identified 97 cases of potential fraud or criminal activity in two separate reports: Financial Management Some DOD Contractors Abuse the Federal Tax System with Little Consequence, GAO-04-95, February 2004 and Financial Management Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence, GAO-05-637, June 2005. How would IRS legally characterize and define these cases? For example, would IRS be of the opinion that these cases represent examples of criminal tax evasion? In the opinion of IRS, would any of the 97 GAO cases be an exception to IRS' definition of criminal tax evasion? If yes, please identify the specific cases designated for identity purposes as DOD 1-47 and Civilian 1-50. Please define the most common characteristics of these cases that support your opinion of their characterization.

The Service concurs with the Government Accountability Office's (GAO) conclusion that abuse of the tax system by some civilian contractors is a serious problem that demands attention. Although the disclosure provisions of IRC Section 6103 prohibit the Service from commenting publicly on particular cases, and the IRS does not comment on specific matters that may be the subject of open criminal investigations, the following factors should be taken into consideration in evaluating the 97 cases of "fraud or potential criminal activity" cited in the GAO reports. The Service has a variety of criminal and civil sanctions available to address non-compliance which are applied based on the facts and circumstances of each case. The statements made concerning individual cases cited in the report are allegations only. Only after a thorough investigation has been conducted can it be determined if prosecution recommendation is warranted.

Many of the cases cited in the reports involve:

- **De minimis tax liabilities.**
- **Tax liabilities that have been full paid or where the taxpayer has entered into an installment agreement or other payment arrangement and is making substantial payments to reduce the tax liability.**
- **Taxpayers in bankruptcy or out of business.**
- **Undercapitalized businesses or businesses unable to perform the contract.**

These factors (and others) mitigate against the use of criminal sanctions because it would be difficult for the government to sustain a criminal prosecution. Such cases are better handled civilly. While criminal sanctions may be appropriate in more egregious cases, the appropriateness of any criminal investigation or prosecution must be determined on a case by case basis.

12. Potential federal contractors are required to disclose whether they have been convicted in the last three years for tax evasion. This information can be considered as part of the contract award process and may result in denying a federal contract to a potential contractor. How many federal contractors were convicted for tax evasion in fiscal year 2004? Were the names of these contractors reported to the Administrator of the General Services Administration or to any other federal authority? Is there any impediment to reporting the names of federal contractors who are indicted for or convicted of tax evasion to the Administrator of the General Services Administration? If there are impediments, how can they be overcome?

    The process of checking convicted parties against the Central Contractor Registration, discussed in response to question 5, began in April 2005. The IRS is not aware of any federal contractors convicted of tax evasion in fiscal year 2004.

As was also discussed in response to question 5, section 6103(a) of the Internal Revenue Code generally prohibits the IRS from sharing tax return information with procurement officials. The IRS does not believe that this prohibition will be an impediment to proposing debarment of contractors convicted of tax evasion, as the fact of their conviction is a matter of public record. Under the process currently employed by the IRS to determine whether convicted parties are federal contractors and to propose debarment in appropriate cases, the IRS will share with procurement officials only information obtained from documents already in the public record of the tax proceedings.

13. The Federal Contractor Tax Compliance Task Force's report of September 2004 stated that IRS would free additional tax debt for the Federal Payment Levy Program using a three phased approach:

- Phase I - In January 2004, IRS "eliminated the one-year waiting period for cases awaiting assignment to the Collection Queue...and eliminated the one-year waiting period for low dollar cases in deferred status. As a result of these actions, FMS reports that from January through June 2004, IRS made an additional 3.1 million tax debts totaling $28.9 billion available for levy."

- Phase II - Beginning in July 2004, IRS planned to "eliminate all remaining systemic blocks on collection cases assigned to revenue officers and eliminate systemic blocks on additional ACS inventories other than cases in which a taxpayer has been contacted and collection action is pending."

- Phase III - Beginning in January 2005, IRS planned to "include the following Criminal Investigation cases...in the FPLP" – refund scheme cases and cases being monitored for satisfaction as a condition of probation.

"IRS estimates that the actions planned to be completed in July 2004 and January 2005 will place over $26 billion additional dollars in the FPLP earlier in the collection process, increasing the amount of tax debt available for matching in the FPLP from $68 billion to $94 billion."

Please provide the amount of tax debt for each phase that was made available for collection. What was the total amount of tax debt that was referred to FMS for inclusion in the FPLP? What amount of this debt was "turned on" for collection?

Phase I (deferred and queue cases), completed in January 2004, added approximately 1.7 million accounts for $13.1 billion. Phase II (ACS and Field cases), that began June 2004 and completed December 2004, added approximately 1.5 million accounts for an additional $15 billion. As a result of these first two phases, IRS made an additional 3.2 million tax debts totaling $28.1 billion available for levy.

For Phase I and II, we cannot provide how many of these particular accounts, that were added based on the changes, have been "turned on" for levy since the

changes. We would only be able to provide the number of total levies on all accounts since January 2004, and that would include accounts that were at FMS prior to these changes.

Phase III (CID cases), completed January 2005, and through June 2005, IRS added approximately 16,000 accounts for $444 million. Of that volume, 3,400 accounts are open for levy.

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RESPONSES TO QUESTIONS FOR THE RECORD
SUBMITTED BY

SENATOR DANIEL K. AKAKA
for
THE HONORABLE MARK EVERSON
Commissioner, Internal Revenue Service
Department of the Treasury

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
CIVILIAN CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT
June 16, 2005

1. The Internal Revenue Service sends four separate due process notices to taxpayers before a tax debt is sent to the TOP database for potential levy. After the debt is received by FMS, taxpayers are sent an additional notice once a payment is identified.

   In your opinion, how can this notification process be simplified while at the same time ensuring that taxpayers receive due process?

   The ten-week waiting period between the time IRS receives a weekly match from FMS and the time IRS issues a levy to FMS accounts for operational mailing and processing time and statutory due process requirements. Currently, the IRS must first send the taxpayer a Collection Due Process notice following a match, and then wait at least 30 days before any levy action can occur.

   The process of matching contract awards against tax debts is already reducing the time frame in many cases. Legislation allowing levy to proceed first and then granting post-levy CDP rights, similar to the post-lien CDP rights currently in place, would further help accelerate the levy process. The Task Force intends to explore other options to simplify this process as it relates to federal vendors.

2. You testified that last year the IRS referred more than 3,000 cases to the Department of Justice (DOJ) for possible criminal prosecution.

   How many of these cases were accepted for prosecution by DOJ, and how many were declined? Also, what trends have you seen in criminal tax prosecutions since September 11, 2001?

   For fiscal year 2004, Criminal Investigation (CI) recommended prosecution on 3,037 investigations. During the same time, 47 investigations were declined by

the Department of Justice (Tax Division). An additional 211 investigations were declined by the local U.S. Attorneys Office.

With respect to trends in criminal tax prosecutions, in recent years CI has been focusing its investigative efforts on criminal tax investigations with an emphasis on legal source income cases. The number of prosecution recommendations for FY 2004 represent a four year high.

3. After our previous hearing on Defense Department contractors, the IRS took certain actions to increase the amount of tax debt sent to TOP. However, GAO is reporting that huge amounts of tax debt are still being excluded from the levy program.

   What are you doing to further increase the percentage of tax debt sent to TOP?

   The task force will explore and determine what additional accounts, that have been operationally excluded, should be included into the FPLP in order to further increase the percentage of accounts going to FMS. This includes accounts that are not normally levied due to a particular condition on the account, i.e. decedent or claims accounts.

4. GAO has recommended that federal payment levies be the first collection action IRS takes. What have you done to ensure that this is taking place?

   The IRS must ensure taxpayer rights are protected while proceeding with enforced collection action. Code section 6330(a) requires that, prior to taking levy action, taxpayers be notified of their CDP rights and allowed time to appeal a collection decision to levy. IRS policy requires that the CDP notice be issued only when levy is the next expected action. Although the Government Accountability Office (GAO) recommended accelerating the CDP notice process for all delinquent accounts, IRS is concerned with sending notices to millions of taxpayers against whom no enforced collection action is contemplated. Additionally, the cost of implementing the recommendation (i.e., creating and mailing the notices, answering taxpayer phone calls about the notices, hearing CDP appeals, etc.) is prohibitive.

   We are considering systemic changes to merge the CDP notice with the second notice to business taxpayers. This will accelerate the collection process for all BMF cases by as much as 30 days.

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RESPONSES TO QUESTIONS FOR THE RECORD
SUBMITTED BY

SENATOR NORM COLEMAN
for
RICHARD L. GREGG
Commissioner, Financial Management Service
Department of the Treasury

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON

CIVILIAN CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

June 16, 2005

Question #1:

- *What does FMS propose to do about tax delinquent federal contractors who are receiving payments through Fedwire?*

FMS is in the process of drafting a Treasury Financial Manual (TFM) bulletin entitled "Guidelines for Submitting Payment Requests to Enable Contractor/Vendor Payments to be Offset or Levied". This supplements the payment records formats that provide specific direction as to the required information to be contained in each field of the certified payment file. The bulletin, which will be distributed by the end of FY 2005 to all agencies for which FMS issues payments, will provide instructions to federal agencies on payment mechanisms to use in submitting contractor/vendor payments to FMS for disbursement. It will encourage agencies to utilize Automated Clearing House (ACH) as a payment mechanism (which is offset/levy ready) and dissuade them from using Fedwire unless the payment must be made the same business day as the payment request.

- *Will FMS identify these contractors, bar paying them through Fedwire, and pay them only through a disbursement method that is reviewed by the Treasury Offset Program? When will FMS be able to assure this Subcommittee that no tax delinquent contractors are being paid through Fedwire?*

FMS is taking a two-pronged approach to address this. First, we are looking at the feasibility and cost effectiveness of offset/levy for Fedwire payments. The study will be completed in Summer 2006. If a good business case for bringing Fedwire payments into the Treasury Offset Program can be made based on the results of the study, an implementation plan will be developed.

Second, in addition to the guidance contained in the TFM bulletin, we are working to educate federal agencies about using other offset-ready disbursement mechanisms, specifically the ACH payment system. We will monitor the payments submitted to Fedwire

Permanent Subcommittee on Investigations
EXHIBIT #6

and notify the agencies when they make inappropriate use of the Fedwire system and direct them towards offset/levy ready payment systems.

Question #2:

- *What does FMS propose to do about tax delinquent federal contactors who are receiving Type A payments that are not subject to levy?*

We anticipate beginning offsetting Type A payments later this year. By September 30, 2006, all eligible vendor Type A payments will be made available to levy.

- *Will FMS identify these contractors, bar the use of Type A payments to them, and pay them only through a disbursement method that is reviewed by the Treasury Offset Program? When will FMS be able to assure this subcommittee that no tax delinquent contractors are being paid using Type A payments?*

The next payment stream scheduled to become part of the offset/levy program is Type A payments – both vendor and miscellaneous. Once the accounting and partial payment functions for these specific payments are successfully tested, we will begin testing with payment agencies. We anticipate beginning offsetting Type A payments later this year. By September 30, 2006, all eligible vendor Type A payments will be made available to levy.

Question #3:

- *What does FMS propose to do about tax delinquent federal contractors receiving payments through the Automated Clearing House-Corporate Trade Exchange (ACH-CTX) that are not subject to levy?*

As mentioned earlier, FMS is in the process of drafting a TFM bulletin entitled "Guidelines for Submitting Payment Requests to Enable Contractor/Vendor Payments to be Offset or Levied". The bulletin will provide instructions to federal agencies on payment mechanisms to use in submitting contractor/vendor payments to FMS for disbursement and to guide them toward disbursement systems that can currently be offset.

- *Will FMS identify these contractors, bar use of ACH-CTX payments to them, and pay them only through a disbursement method that is reviewed by the Treasury Offset Program? When will FMS be able to assure this Subcommittee that no tax delinquent contractors are being paid using ACH-CTX payments?*

FMS is taking a two-pronged approach to address this. First, we are looking at the feasibility and cost effectiveness of offset/levy for ACH-CTX payments. The study will be completed in Summer 2006. If a good business case for bringing ACH-CTX payments into the Treasury Offset Program can be made based on the results of the study, an implementation plan will be developed.

Second, in addition to the guidance contained in the TFM bulletin, we are working to educate federal agencies about using other offset-ready disbursement mechanisms, specifically the ACH payment system. We will monitor the payments submitted to ACH-

CTX and notify the agencies when they make inappropriate use of this system and direct them towards offset/levy ready payment systems.

Question #4:

- *What specific steps will FMS take to implement the taxpayer identification number (TIN) requirement of the Debt Collection Improvement Act?*

FMS relies on the certifying agencies submitting the payment file for the accuracy and the completeness of data. We do agree that the importance of providing accurate and complete data such as name and TIN needs to be a top priority. We are sending a monthly letter to each CFO providing a "report card" on how well they are providing complete payment format information. With the letters to the CFOs, an education campaign focused directly to our customer agencies and our work with the Federal Contractor Tax Compliance Task Force (Task Force) and Federal Credit Council, we expect significant improvement by the agencies in the submission of correct TINs in their payment files.

- *Will FMS publish supplementary regulations to require TINs on all payment documentation?*

FMS is in the process of drafting a TFM bulletin entitled "Guidelines for Submitting Payment Requests to Enable Contractor/Vendor Payments to be Offset or Levied". This supplements the payment records formats that provide specific direction as to the required information to be contained in each field of the certified payment file. The bulletin will provide instructions to federal agencies on payment mechanisms to use in submitting contractor/vendor payments to FMS for disbursement. It also reiterates the need for a proper TIN to facilitate offset and levy. The TFM will cite the existing requirements of 31 U.S.C 3325 (d) and Treasury instructions for payment certification, as well as the Federal Acquisition Regulations (FAR) subsection 4.902, which requires contractors/vendors to furnish their TIN and for agencies to submit the TIN in the payment requests.

- *If federal departments and agencies have not addressed the TIN problem in the last seven years without regulations, what reason(s) does FMS have to believe that, absent regulatory requirements, agencies will resolve the TIN problem?*

In May, 2005, we began sending monthly letters to CFOs providing a "report card" on how well they are providing complete payment format information. The aggregate compliance rate for vendor payments containing valid TINs for the month of May 2005 was 89%. We are conducting an educational campaign and continuing work with the Task Force and Federal Credit Council. We would like to have time to assess any improvement being made by the Federal Paying Agencies in providing complete payment format information as a result of these initiatives. If we find that sufficient progress is not being made we will develop other remedies.

- *If not regulations, what motivation will FMS provide agencies to ensure that federal agencies include TINs on their payment documentation?*

We will monitor the results of this education effort over the next year and if we find that sufficient progress is not being made we will develop other remedies. Furthermore, in our most recent letter to the CFOs we highlighted the importance of this issue by informing them that complete and valid certified payment requests were a subject of a review by GAO and at the June 16 Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations hearing on the Tax Levy program.

Question #5:

- *What specific steps will FMS take to ensure that payee names are on all payment documentation?*

FMS must rely on the agency certifying the payment file for the accuracy and the completeness of data. We do agree that the importance of providing accurate and complete data such as name and TINs needs to be a top priority. The TFM bulletin will provide instructions to federal agencies on payment mechanisms to use in submitting contractor/vendor payments to FMS for disbursement, including the Treasury policy regarding name requirements. This supplements the payment records formats that provide specific direction as to the required information to be contained in each field of the certified payment file. In addition, our most recent letter to the CFOs informed them that complete and valid certified payment requests were a subject of a review by GAO and at the June 16 Tax Levy hearing.

- *What steps will FMS take to ensure that the payee names match the name controls provided by the Internal Revenue Service?*

The TOP system is capable of accepting up to 99 alias names per debtor. Starting in January 2006, IRS will provide up to 10 additional name controls per debtor, resulting in improved matching. In addition, letters to the CFOs, the education campaign and with our work with the Task Force and Federal Credit Council, we expect improvement in the number of payee names matched against the name control names provided by the IRS.

- *Will FMS publish supplementary regulations to require payee names on all payment documentation?*

FMS is in the process of drafting a TFM bulletin to promulgate Guidelines for Submitting Payment Requests to Enable Contractor/Vendor Payments to be Offset or Levied. This supplements the payment records formats that provide specific direction as to the required information to be contained in each field of the certified payment file. The bulletin will provide instructions to Federal agencies on payment mechanisms to use in submitting contractor/vendor payments to FMS for disbursement, including the Treasury policy regarding name requirements. It should be noted that there are instances on an ACH file where a name legitimately is not provided. FMS has no way of knowing whether the absence of a TIN or a name in an ACH file is because the payment is being made to an

entity or informant whose name and TIN the agency should not reveal for security purposes.

- *If not, please explain what motivation FMS will provide to federal departments and agencies to provide payee names?*

We will monitor the results of this education effort over the next year. If we find that sufficient progress is not being made we will develop another remedy. Furthermore, in our most recent letter to the CFOs, we informed them that complete and valid certified payment requests were a subject of a review by GAO and at the June 16 Tax Levy hearing.

Question #6:
Some of the presumptions FMS has built into its programming software are completely biased against the Treasury Offset Program. For example, if the payment type field is blank the computer is told to bypass the levy program or if the Agency Location Code does not match that the payment should bypass the Treasury Offset Program. Will FMS rewrite the software instructions to direct that payment documentation without payment types or Agency Location Codes will pass through TOP?

FMS has already implemented a monitoring process to ensure that all eligible Agency Location Codes are included in TOP. FMS is providing guidance to all Federal agencies to ensure that contractor/vendor payments are coded accurately and correctly in terms of the payment type (vendor, miscellaneous, etc.). Agencies are required to submit ACH files with records containing payment type indicators. FMS edits ACH payment files for the payment type indicator, and the compliance rate is currently 100%. Check payment records are being monitored to keep compliance rates high. Monthly letters are sent to the CFOs reiterating the requirement that their payment files be complete and accurate, which includes the payment type indicator. The second quarter FY 2005 payment type indicator compliance rate for checks is 100% for both transaction volume and dollars.

Question #7:
Will FMS work with the General Services Administration and IRS to establish a method to ensure that tax delinquent contractors are not paid with purchase cards?

As a member of the Federal Contractor Tax Compliance Task Force, FMS is working with the General Services Administration (GSA), the Office of Management and Budget, IRS, Defense Finance and Accounting Service, and other Federal Agencies to explore all options for including the collection of both tax and non-tax debt in conjunction with the purchase card program. We will continue to participate in the Task Force and provide expertise on our debt collection systems, strategies, priorities, and enhancements that will increase collections through whatever authorized means possible. We have already met with Visa to ascertain the number of contractors participating in the purchase card program that owe delinquent non-tax or tax debt. We are also meeting with GSA and MasterCard to research similar information.

Question #8:
Will FMS assist the IRS in establishing a Federal Contractor Non-Filer Program by providing the names and TINs of all vendor payments?

We will work with the IRS to determine the feasibility of such a program.

Question #9:
According to GAO, the Central Contractor Registry (CCR) is not complete. According to FMS disbursement data, there were 650,000 federal contractors to whom disbursements were made and only 375,000 contractors are registered in CCR. As you know, registration in the CCR is required with limited exceptions. How can FMS help to ensure that contractors are registered in CCR as required? Does FMS have access to the CCR? What is FMS' view with regard to making registry in the CCR a condition precedent to payment for those contractors who are required to be registered?

While FMS has no involvement in the development or operation of the CCR, FMS has been working with the Task Force to explore ways that information in the CCR can be used to improve the Federal Payment Levy Program. As a result of one Task Force initiative, FMS receives CCR information on a monthly basis and matches that data with information provided to us from the IRS to assist IRS in accelerating the due process required for levy. FMS would support efforts by contracting agencies to ensure that contractors who are required to register in the CCR be properly registered before a contract is awarded or, if there are cases where that is not feasible, before a payment is certified for disbursement.

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RESPONSES TO QUESTIONS FOR THE RECORD
SUBMITTED BY

SENATOR DANIEL AKAKA
for
RICHARD L. GREGG
Commissioner, Financial Management Service
Department of the Treasury

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON

CIVILIAN CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

June 16, 2005

Question #1

Financial Management Service (FMS) is the government's money manager, not simply the nation's bookkeeper. That means that FMS has the authority, and should exercise leadership, in the area of federal disbursements and collections. Certain payments, such as government purchase cards, are not even processed through the Treasury Offset Program and therefore have no chance of being collected. Federal procurements paid for by purchase cards account for $10 billion a year. Commissioner Everson testified that he would be willing to "partner" with GSA and FMS on this issue. You testified, on the other hand, that it was not an FMS problem and GSA should take the lead. That is not the kind of leadership we expect of FMS.

Will you pledge that FMS will take a more prominent role on this issue and seek ways to bring purchase card payments within the debt collection system?

As a member of the Federal Contractor Tax Compliance Task Force (Task Force), FMS is working with the General Services Administration (GSA), the Office of Management and Budget (OMB), the Internal Revenue Service (IRS), the Defense Finance and Accounting Service (DFAS), and other Federal agencies to explore all options for collecting both tax and non-tax debt in conjunction with the purchase card program. We will continue to participate in the Task Force, providing input on our debt collection systems, strategies, priorities, and enhancements that will increase collections through whatever authorized means possible. We have already met with Visa to ascertain the number of contractors participating in the purchase card program that owe non-tax or tax delinquent debt. We are also meeting with GSA and MasterCard to research similar information.

Question #2
In your testimony, you said you "don't disagree" with GAO's statement that its review team contacted a number of states, all of which said they were unaware of the levy program and were interested in pursuing reciprocal agreements with FMS.

Will you pledge to take the lead to ensure that states are made aware of the levy program, and will you work to enter into reciprocal agreements with these states?

FMS is committed to ensuring that States are aware of the opportunity to enter into reciprocal agreements with FMS and, toward that end, we have met with the Federation of State Tax Administrators and have scheduled a meeting with the National Association of State Auditors, Comptrollers and Treasurers. FMS will work with States to assist them in taking a close look at the costs involved in such an arrangement, in relation to the potential return, to determine whether or not reciprocal agreements would be of benefit. We note, however, that the DCIA authority with respect to the collection of State debt through reciprocal agreements does not extend to the levy program. FMS has no legal authority, and therefore no plans, to pursue the collection of federal tax debt via reciprocal agreements with States.

Question #3
Federal law requires that each federal agency obtain a Taxpayer Identification Number (TIN) from every person doing business with the agency. GAO found that Treasury Offset Program collections could be improved by simply requiring a TIN before making a contractor payment because without a TIN, a match is impossible. In your testimony, you respond to this recommendation by saying FMS should not be in a position of "picking and choosing" which payments to disburse. I disagree. There is certain minimum information required for every payment, and a TIN should be required. I understand that you have begun providing monthly reports to agency Chief Financial Officer's on TIN compliance. I do not believe this provides enough incentive for agencies to ensure that TINs are provided.

If FMS made a no TIN - no money rule, how difficult would it be to block payments that have a blank TIN, or payments with an obviously erroneous TIN such as all zeros or all 9s?

While everyone agrees that contractors should repay debts owed to the government, we believe that it is an overly broad approach to reject all payments to vendors without TINs. We would prefer to use a more finely-honed approach in dealing with TIN compliance. We must rely on the agency certifying the payment file for the accuracy and the completeness of data. To focus management attention on this issue, we are sending a monthly letter to each Chief Financial Officer (CFO) providing them a "report card" of their TIN compliance as well as reminding them of the requirements in providing complete and accurate payment format information. With letters to the CFOs, an educational campaign and with the Task

Force and Federal Credit Council, we expect overall TIN compliance to significantly improve.

It must be recognized that TIN compliance will never be at 100%. As a result, it is necessary to balance the mission-critical agency program needs for timely and accurate payment disbursement with important collection functions such as Tax Levy and the Treasury Offset Program. Maximizing tax levies by rejecting payments without TINs would delay U.S. Government payments and might jeopardize an agency mission.

Many foreign vendors will not have a TIN. FMS has no way of knowing from the payment file whether the vendor is foreign or domestic and whether, if it is a foreign vendor it is required to have a TIN. We rely on the Federal Program Agency (certifying agency) for such information. The same is true of security-related payments. FMS has no way of knowing whether the absence of a TIN or a name in an ACH file is because the payment is being made to an entity or informant whose name and TIN the agency should not reveal.

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