

**PAYROLL TAX ABUSE: BUSINESSES OWE BILLIONS  
AND WHAT NEEDS TO BE DONE ABOUT IT**

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**HEARING**

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON  
HOMELAND SECURITY AND  
GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE

OF THE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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JULY 29, 2008  
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**PAYROLL TAX ABUSE: BUSINESSES OWE  
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**TUESDAY, JULY 29, 2008**

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 9:05 a.m., in Room SD-342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin, Coleman, and McCaskill.

Staff Present: Elise J. Bean, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; Julie Davis, Counsel to Senator Levin; Audrey Ellerbee, Congressional Fellow to Senator Levin; Mark L. Greenblatt, Chief Counsel and Staff Director to the Minority; Jay Jennings, Senior Investigator to the Minority; Erica Flint, Staff Assistant to the Minority; Sheldon Shoemaker (Sen. McCaskill); John Kim, Law Clerk; and Mark Leduc (Sen. Collins).

**OPENING STATEMENT OF SENATOR LEVIN**

Senator LEVIN. Good morning, everybody.

Today, over 1.6 million businesses owe more than \$58 billion to Uncle Sam for unpaid Federal payroll taxes that have accumulated over the last 10 years. Over half of this debt is now uncollectible. That is the conclusion of a Government Accountability Office (GAO) study requested by this Subcommittee on the problem of unpaid payroll taxes.

Today's Subcommittee hearing will examine what is behind this staggering number and what can be done about it. Of the many tax schemes this Subcommittee has investigated over the years, the blatant cheating on the payroll tax is particularly galling because delinquent businesses are stashing away not only the payroll taxes that they owe Uncle Sam, but also stealing funds withheld from employee paychecks. Employers are required to withhold from their employees' salaries amounts for individual Federal income taxes and for Social Security and Medicare taxes. These businesses have a fiduciary responsibility to hold the funds they withhold from employees "in trust" for the government. The employer must also match the amounts withheld for Social Security and Medicare. The willful failure to remit any of these types of payroll taxes is a felony. The fact that this problem is so widespread is a disgrace.

Ten years ago, in 1998, the GAO conducted another study on payroll taxes and found that unpaid payroll taxes then totaled \$49 billion. In the 10 years since, the number of businesses with unpaid payroll taxes declined from 1.8 million to 1.6 million, but the size of the tax debt got nearly \$10 billion worse, not better. Part of the reason appears to be ineffective IRS payroll collection efforts, despite the fact that IRS has continued to deem collection of payroll taxes “one of its highest priorities.” The GAO report identifies a host of problems with those efforts, and here are just three of them.

The first is the fact that many payroll tax cheats have been allowed to repeatedly violate the law for years at a time, accumulating massive payroll tax debts that cannot ultimately be collected.

GAO’s report discloses that 70 percent of all unpaid payroll taxes are owed by businesses that have failed to remit payroll taxes for more than 1 year. This means the business has at least four violations since payroll taxes are supposed to be remitted quarterly. Over 25 percent have failed to remit their taxes for more than 3 years. Nine percent have payroll violations stretching back 5 to 10 years. In addition, thousands of businesses are involved. GAO reports that the number of firms with more than 5 years of payroll tax debt has nearly tripled, from 5,000 in 1998 to 14,000 in 2007. And those with more than 10 years of payroll tax debt went from 68 in 1998, to 490 businesses in 2007. That is a 500-percent increase.

One case study highlighted in GAO’s report involves a business with payroll violations dating back to 1994. As of July 2007, that business had accumulated unpaid payroll taxes totaling almost \$1 million.

And IRS data shows that as unpaid payroll taxes get older, the likelihood of collecting the amounts owed declines dramatically. The result, according to the GAO, is that 52 percent of existing payroll tax debt is now uncollectible.

But that is not all. Tax delinquent businesses allowed to operate for years with impunity gain an unfair advantage over honest competitors. By shirking their taxes, these businesses incur lower operating costs and may drive out honest firms. In one case study in the GAO report, a business used \$2.5 million that should have gone for payroll taxes to subsidize its underbidding of contracts.

Next, how is it that payroll tax cheats are able to continue operating with impunity for years at a time? That gets us to the second major problem: The IRS’ failure to make effective use of available enforcement tools.

Current law provides the IRS with several powerful collection tools, but often the IRS has failed to make effective use of them. As the GAO points out, “Having a reticence to use enforcement tools may, over time, actually diminish voluntary compliance and collections.” In other words, when honest taxpayers see tax cheats getting away with blatant misconduct, it not only undermines confidence in the tax system as a whole, it could encourage cheating.

The IRS has two primary enforcement tools to stop payroll tax cheats: Filing liens against the business and filing personal claims against the business’ officers or owners. The GAO found that tax liens were not filed against businesses with unpaid payroll taxes in

over 30 percent of all payroll tax cases assigned to the field for collection effort. That is nearly one-third of the payroll cases being “worked on” by a revenue officer, or 140,000 delinquent businesses.

GAO also found that the IRS often failed to assess penalties against the individual officers and owners of the business charged with collecting payroll taxes. Current law states that these individuals can be held personally liable for the portions of the payroll tax withheld from an employee if they willfully failed to collect or pay the tax. GAO describes multiple cases of business owners with payroll tax debt using business funds to pay for their own lavish lifestyles.

To collect the missing money from individual business officers or owners, the IRS can file a trust fund recovery penalty (TFRP). GAO determined that it took the IRS an average of 40 weeks to determine whether a TFRP should be assessed and then an additional 40 weeks to actually assess it. Now, that adds up to nearly 2 years, or over a year and a half, to start collection on a TFRP.

In addition, a 2005 study by the Treasury Inspector General for Tax Administration revealed that 43 percent of people who received a TFRP never made a payment on it, and that the IRS only collected 8 percent of the amount for which the TFRPs were issued. In one example reported by the GAO, the IRS assessed a business owner with a TFRP, but failed to file an accompanying tax lien. Therefore, the owner was able to sell a vacation home in Florida, and the IRS missed the opportunity to collect any of the unpaid taxes from the proceeds of the sale.

Still another problem is the IRS’ practice of assigning a new revenue officer to assess a TFRP in cases where another revenue officer has already initiated enforcement action against a business with unpaid taxes. GAO found that in 75 percent of the cases it reviewed, the TFRP was either not assigned or was assigned to a different revenue officer than the one already taking action against the business for unpaid taxes. Doubling up revenue officers on a single business makes little sense when there are too few revenue officers to go around.

In addition to finding that the IRS made ineffective use of tax liens and TFRPs in many payroll cases, GAO determined that the IRS failed to take timely enforcement action in half of the cases in which tax debtors missed specific deadlines. That means one out of two tax cheats missed payments they were required to make with no immediate consequences. Now, that shocking statistic sure has to change.

Finally, the Subcommittee has discovered that the majority of businesses with unpaid payroll taxes do not get immediate enforcement attention. Instead, following a 15-week notification process, many cases are assigned to a so-called queue where they languish until a revenue officer is assigned to them. Right now, of the \$28 billion in unpaid payroll taxes still deemed collectible, about \$9 billion is sitting in the queue awaiting assignment to a revenue officer. That so many cases sit unproductively before any enforcement action is taken is inexcusable.

Now, here are three actions that could be taken to strengthen enforcement action against payroll tax cheats.

First, the IRS should develop an expedited process for filing liens and assessing TFRPs against businesses with unpaid payroll taxes. These tax liens and TFRPs should be automatically imposed after a business has missed a specified number of quarterly payroll tax payments, unless a revenue officer provides written justification why those actions should not be taken. Also, the business tax case and the TFRP assessment should, when possible, be treated as a single, unified, and coordinated collection effort assigned to a single revenue officer, instead of the current practice, which most often has TFRP collections assigned to a different revenue officer, if they get assigned at all.

Second, Congress should enact S. 1124—the Levin-Coleman Tax Lien Simplification Act, to streamline the tax lien system. Right now, tax liens have to be filed on paper in 4,000 locations across the country, each with its own forms and filing requirements. The process is wasteful, burdensome, and inefficient. Our bill would require the Treasury to establish an electronic tax lien registry at the Federal level, which would not only make filing liens easier and more transparent, but would also, according to the IRS' own estimates, save \$570 million over 10 years from improved efficiencies alone.

Third, the IRS should develop payroll tax collection performance measures. It is baffling that, with respect to this “high-priority” issue, the IRS currently does not have a single performance measure to assess its progress in combating payroll tax cheats. When we asked IRS how long the average payroll tax case is open, we were told they do not track this data. Moreover, neither IRS managers nor revenue officers are currently evaluated on their efforts to collect payroll taxes or prevent the accumulation of payroll tax debt. These types of agency-level and personnel performance measures should be developed on an urgent basis.

Finally, it is ridiculous that one of this Administration's top tax enforcement efforts has been to go after the small-dollar claims under the Earned Income Tax Credit Program, the EITC Program, which is a refundable tax credit available to workers with low incomes. We should be using our limited number of revenue agents to catch the biggest fish—including payroll tax cheats who are misusing billions of dollars of employee and taxpayer money to benefit themselves.

I commend Senator Coleman for initiating the Subcommittee's request for the GAO study on this important problem, I commend his staff, and I now turn to him for his opening remarks.

#### **OPENING STATEMENT OF SENATOR COLEMAN**

Senator COLEMAN. Thank you, Mr. Chairman, and let me, if I may, return the compliment. I was reflecting on where we are with this hearing and the work that we did together on sham tax schemes, I think “Flips” and “Blips,” and looking at literally billions of dollars that were not being put into the Federal Treasury, and we focused on those. And you, Mr. Chairman, and your staff have been a champion of targeting the offshore tax havens, cleaning those up. I have joined you with full force and vigor, and it has been a tremendous effort. We focused on Federal contractors, and they are being paid Federal dollars at the same time that they owe

tax dollars. It was actually during the course of that investigation that we noticed a commonality of payroll taxes not being forwarded to IRS. These are cases in which we were actually paying Federal dollars to folks who owed tax dollars.

I think we have reached a point now with payroll taxes where this is the mother of all tax gaps, \$58 billion. And clearly it needs to be addressed. Payroll taxes are an essential part of our tax system. As the Chairman has indicated—and GAO will go through it—employers withhold taxes from their employees' paychecks and are required to forward that money to the IRS. These funds include income taxes, as well as other taxes that go directly to fund Social Security and Medicare. The employers handle these in trust for their employees and, clearly, that trust is being violated, and in many cases has been violated for years. The loss ultimately is to all taxpayers.

According to the GAO study, more than 1.6 million of those businesses are breaching that trust and are simply keeping their employees' taxes. The amount over the past 10 years that those businesses have failed to pay is a whopping \$58 billion of their employees' payroll taxes.

But, again, I think it is important to stress that they are not just breaching their employees' trust; they are shortchanging all honest American taxpayers by forcing more of the weight on the sagging shoulders of hard-working Americans. This is not a theoretical exercise. As a direct result of these unpaid payroll taxes, the government must transfer up to \$4 billion in taxes from the general fund to pay for Medicare and Social Security. The IRS estimates that, over the past 10 years, \$44 billion has been transferred from general tax revenues to Social Security and Medicare.

These are difficult times, as stressful as certainly any in my 32 years of public service as I have seen. And so when we look at the challenge of the times that the average taxpayer is facing and we have these deadbeats and billions of taxpayer dollars being used to cover the shortfalls, clearly something must be done.

If you look at the cases, it is enough at times to make your blood boil—cases in which business owners have failed to pay payroll taxes, while purchasing luxury cars, planes, mansions, properties in tropical islands and other far-flung countries. In several case studies, the owners made massive withdrawals from business accounts, pocketing \$20,000, \$50,000, and even hundreds of thousands of dollars in cash. It is clear that tax cheats are living the high life at the expense of hard-working American taxpayers.

The GAO report identifies case after case in which the businesses owe millions upon millions in payroll taxes. Even worse, these tax cheats appear to be stringing the IRS along, refusing to submit their taxes for 8, 9, and even 10 years. And after 10 years, because of the statute of limitations the case falls over the edge and we lose any ability to proceed. Some play a shell game to avoid paying taxes, moving money between multiple entities, shifting assets to family members, and even claiming bankruptcy to avoid obligations.

So let's step back and put this in perspective: Our tax gap, which is the difference between the taxes that are owed and the amount that is actually paid, approaches \$300 billion. And this, by the way,

is just taxes that we know of. It does not include underreported taxes. It does not include unreported income. And so it is actually understating the nature of the problem. Unpaid payroll taxes are the single largest business component of that gap, making up more than 20 percent of the tax gap itself. And to make matters worse, the GAO will indicate that the problem is growing and growing. Over the past few years, the amount of unpaid payroll taxes has increased just under 20 percent.

While the problem is expanding, our ability to address the problem is shrinking. The IRS' backlog of payroll tax cases dwarfs the number of cases actually being pursued. As cases languish in the backlog and the statute of limitations expires, billions of dollars in unpaid payroll taxes are written off every year. I believe more than \$4 billion in unpaid tax debt will be completely written off this year. By 2012, the write-off of unpaid tax debt is expected to reach \$5 billion each year, and within a couple of years, the write-offs of taxes that simply cannot be collected will grow another 20 percent to \$6 billion. So what is clear is that we have a problem and we have to fix it.

Is it a \$58 billion problem? Is it a \$28 billion problem if half of the \$58 billion is uncollectible? Is it uncollectible because we did not move quickly enough? Whether it is \$28 billion or \$58 billion, even for government this is real money. This is big money.

How do we move forward? The report identifies a number of concerns with the IRS' current collection procedures and offers numerous recommendations to improve its enforcement regime. If we are going to make any inroads in collecting unpaid payroll taxes, we have to consider substantial changes to IRS' collection policies and procedures.

A specific concern here is that when we are dealing with scoff-laws and egregious cases, the IRS may have overemphasized getting taxpayers to comply with the law voluntarily. Getting voluntary compliance is a desirable goal. I want to stress that. We understand that. And it would appear to be the right strategy in most circumstances.

But GAO cites examples in which the tax cheats are simply stringing the IRS along for years and years, even though they show no inclination to comply voluntarily. The voluntary measures are not increasing compliance in these egregious cases. The time for talk in these cases, in the egregious cases, beyond-the-pale cases, the time for talk and voluntary compliance has passed, and it is time for action.

The report is chock full of case studies in which the IRS revenue officers appear to treat the worst of the worst with kid gloves. Perhaps we should reconsider the broad discretion given to those revenue officers when dealing with the worst tax cheats and encourage the use of more stringent enforcement tools for these extreme cases.

Mr. Chairman, I would note that I would add my voice and associate myself with your comments in terms of some of the specific recommendations that should be adopted.

As a former prosecutor, I know the threat of prosecution and aggressive enforcement are powerful deterrents. I call upon the IRS

to ratchet up its efforts to recover these billions in back taxes and hold these tax cheats accountable.

The good news is that there is hope. The States have been developing creative and effective mechanisms for collecting taxes, such as identifying tax cheats on the Internet. The State of Minnesota is one of those States that publishes the names of tax cheats, and these are not folks who are working out the problem, these are not folks who are in bankruptcy. So you can identify the specific class of folks who deserve to have their name out there, and as a result, it serves as a deterrent. In addition, the IRS has also acknowledged the problem and has indicated a positive attitude and a willingness to take necessary steps to address the issue.

If the issue is more legislation, we need to know what that is. If the issue is a change in process, then the IRS has to do that. The bottom line is that the problem is real and has to be addressed, and hopefully this hearing will be a step in that direction.

Mr. Chairman, I look forward to exploring these issues with you and our witnesses today.

Senator LEVIN. Thank you very much, Senator Coleman.

Let me now welcome our witnesses for today's hearing: Steve Sebastian, the Director of the Financial Management and Assurance Unit at the Government Accountability Office; and Linda Stiff, the Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. We appreciate very much both of you being with us today. You have appeared before this Subcommittee in the past. We welcome you back.

I think you will remember that, pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. So at this time, I would ask you to please stand and raise your right hand. Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. SEBASTIAN. I do.

Ms. STIFF. I do.

Senator LEVIN. We will be using our usual timing system today so that about a minute before your time is up—a minute before the red light will come on, you will see the light change from green to yellow, which then gives you an opportunity to conclude your remarks, and your written testimony, for which we are grateful, will be printed in the record in its entirety. And we ask that you limit your oral testimony to no more than 5 minutes.

Mr. Sebastian, we will have you go first, followed by Ms. Stiff, and then we will turn to questions. Mr. Sebastian.

**TESTIMONY OF STEVE J. SEBASTIAN,<sup>1</sup> DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. SEBASTIAN. Mr. Chairman and Senator Coleman, thank you for the opportunity to discuss the results of our review of unpaid

<sup>1</sup>The prepared statement of Mr. Sebastian appears in the Appendix on page 27.

payroll taxes. Our report,<sup>1</sup> which is being released today, was prepared at the request of this Subcommittee and the Senate Committee on Finance in response to previous work we have done on Federal contractors with tax debt. The bottom line of my testimony this morning is that unpaid payroll taxes are substantial and represent a significant enforcement challenge for the IRS.

Before I begin, it is important to remember that payroll taxes are comprised of individual income tax withholdings and employee withholdings for Social Security and Medicare, as well as the employer's matching amounts. As the posterboard illustrates, employers withhold amounts from employees' paychecks, hold them in trust for the Federal Government, and periodically are required to remit them and the matching amounts.

My testimony this morning will discuss two main aspects from our review: First, the significance of unpaid payroll taxes and, second, issues impacting IRS' ability to collect payroll taxes owed and to prevent the further accumulation of such taxes.

First, our study found that, as of September 30, 2007, 1.6 million businesses owed over \$58 billion in unpaid payroll taxes, including penalties and interest. As such, payroll taxes comprise over half of IRS' inventory of delinquent business taxes. Much of this debt is owed by repeat offenders. In fact, the number of more egregious offenders has grown significantly since our last review in 1998.

As the posterboard illustrates, the number of businesses with over 5 years of unpaid payroll taxes has increased nearly three-fold, and the number with over 10 years of unpaid payroll taxes has increased five-fold. Equally disturbing is that over 9,000 individuals were responsible for not paying the payroll taxes at multiple businesses, over a dozen for some.

Second, our study found that while payroll taxes are considered a high priority, IRS does not always utilize its existing collection tools to collect the payroll taxes owed and to prevent the further accumulation of such taxes.

IRS has a powerful tool to hold business owners and officers personally responsible for the non-payment of payroll taxes: The trust fund recovery penalty (TFRP). However, IRS is not always assessing the TFRPs timely, and once assessed, the IRS is not always moving to take aggressive action against these TFRPs. Further, the TFRP is treated as a separate collection effort from the business case when, in essence, it is essentially the same tax debt.

Liens are another powerful tool in IRS' enforcement arsenal. However, IRS does not always file liens to protect the government's interest, and when it does, it does not always do so timely. Ironically, because of certain IRS policies, lower-priority cases may actually have tax liens filed while higher-priority cases, such as payroll taxes, may not. Eighty percent of payroll tax cases in IRS' queue awaiting assignment did not have a tax lien filed.

Driving these issues is IRS' emphasis on gaining voluntary compliance. While this approach is consistent with IRS' mission statement and is appropriate for the vast majority of generally compliant taxpayers, such an approach for egregious payroll tax offenders

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<sup>1</sup>The GAO report entitled "Tax Compliance, Businesses Owe Billions in Federal Payroll Taxes," July 2008, GAO-08-617, submitted by Mr. Sabastian appears in the Appendix on page 59.

appears to do little to collect what is already owed and to prevent businesses from further accumulating payroll tax debt.

There is a point at which efforts to continue to work with the business to gain voluntary compliance may need to cease and more aggressive enforcement efforts commence. State collection officials we spoke with seemed to have recognized this. After a certain point, they changed their focus to one of stopping the bleeding.

In summary, businesses that withhold money from their employees' paychecks and fail to remit these monies to the Federal Government are breaching their fiduciary responsibility to the government and to their employees. Additionally, such businesses have a competitive advantage over those businesses that comply with the tax laws.

There is a lot at stake. As the posterboard illustrates, the \$58 billion in unpaid payroll taxes currently on the books will expire over the next several years. To the extent IRS' efforts are unsuccessful in collecting such taxes prior to their expiration, and in preventing the further accumulation of such taxes, the compliant taxpayer is left to pick up the tab.

We believe implementation of the recommendations contained in our report will assist IRS in strengthening enforcement and improving the collection of payroll taxes.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions you or Senator Coleman may have at this time.

Senator LEVIN. Thank you so much, Mr. Sebastian. Ms. Stiff.

**TESTIMONY OF LINDA STIFF,<sup>1</sup> DEPUTY COMMISSIONER FOR SERVICES AND ENVIRONMENT, INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY**

Ms. STIFF. Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee, thank you for the opportunity to testify today on the status of IRS efforts to collect Federal employment taxes. I appreciate the contribution this Subcommittee has made over the last 4 years with its investigations of Federal contractors who are delinquent and of efforts by unscrupulous promoters and taxpayers to avoid taxation in the United States. The IRS has found the opportunity to work with you and your staffs very valuable in each instance.

We look forward to working with you to improve our efforts in the collection of Federal employment taxes. While we have made great progress over the last 5 years, as the GAO report released this morning demonstrates, we can and we must do better.

Employment taxes represent the largest portion of total tax dollars collected by the IRS. In fiscal year 2007, of the \$2.7 trillion that came in through taxes, \$1.7 trillion was payroll taxes. Accordingly, the collection of delinquent employment taxes is a critical priority for us at the Service.

In 1998, Congress passed the IRS Restructuring and Reform Act, which provided a sweeping realignment of the IRS workforce, particularly in the area of collection. In addition, it significantly raised the bar on taxpayer rights. As we at the IRS sought to respond to

<sup>1</sup>The prepared statement of Ms. Stiff appears in the Appendix on page 133.

these sweeping changes, our enforcement presence suffered. There was uncertainty over when and how certain enforcement tools should be applied; and as a result, over the next 4 years, there was an erosion in the use of those tools, including liens.

The findings in the GAO report reflect the lingering results of this drop-off. As the GAO reported, more than 60 percent of the unpaid payroll taxes are owed for periods 2002 and prior. By 2003, the IRS had managed to reset the workforce, and we are beginning to restore the balance between services and enforcement. We once again began utilizing our full arsenal of enforcement tools, including liens, without sacrificing the gains we had made in improving taxpayer rights.

For example, in fiscal year 2002, we resolved just over 3 million delinquent accounts. By last year, that number had grown to over 58 percent, with more than 5.2 million delinquent accounts being resolved. This gain occurred despite the fact that we have been operating with a relatively flat budget and while ensuring the protection of taxpayer rights.

Part of our success in this turnaround can be credited to research. Since 2003, 19 research projects have been conducted to help improve IRS employment tax efforts. These projects have focused on selecting the right cases, routing those cases to the IRS staff with the right skills, and enhancing our ability to choose the right enforcement tools to resolve cases as efficiently as possible.

Further complicating our collection efforts is the overall environment in which many businesses operate. It is important to note that the Small Business Administration has found that more than a third of all small businesses do not survive 2 years. Sixty percent do not survive 6 years. Unpaid payroll taxes reflect this reality. Of the \$58 billion in total reported unpaid employment taxes reported by GAO, 34 percent of that is attributable to firms in bankruptcy or out of business.

I also want to note that historically the IRS succeeds in collecting 99.8 percent of all employment taxes owed. Over the last 10 years, that means more than \$11 trillion in payroll taxes was collected. Clearly, when you are dealing with net numbers this size, even a decimal point represents a significant amount.

I want to report to you that, after reviewing the findings in the GAO report, I have charged a service-wide task force on collections to refocus its efforts to concentrate solely on the more effective use of enforcement tools in employment tax cases.

To support that effort, we are launching a series of research studies to determine—and I think they go right on point to the recommendations that the two of you have made for us today—to look at the effective use of the Trust Fund recovery penalty; earlier consideration of the filing of liens; greater use of automated collection tools throughout the collection process; and to determine if there is a “point of no return” where we need to take a different position with the taxpayers we are dealing with.

The task force met last week and has begun an aggressive plan for completing its review of these areas. We think these efforts will result in continued improvements.

Mr. Chairman, Senator Coleman, let me assure you that the collection of employment taxes is a core mission of the IRS and that,

like you, we believe leaving \$58 billion on the table is unacceptable. I pledge to you today that we can and we will do better. I look forward to working with you and other Members of the Subcommittee as we move forward.

Thank you, and I will be happy to respond to any questions.

Senator LEVIN. Thank you very much, Ms. Stiff.

Why don't we start with about an 8-minute round, whoever is keeping track of this.

I was intrigued by the report that talked about 15 weeks of notices when there is a failure to remit the payroll tax. Is that the traditional period of notices that go out to businesses?

Ms. STIFF. Actually, it is a little bit more complex than the way you have described it. Taxpayers receive a notice—I think you were talking about the application of the trust fund recovery penalty notice?

Senator LEVIN. No, just the business—I guess you call it the business case.

Ms. STIFF. OK. On a business case, taxpayers are entitled to receive two notices with an attempt to collect, and let me add that 80 percent of taxpayers actually self-correct through that notice stream. And each of those notices offer up to about 45 days, so you quickly accrue into a period of weeks to let taxpayers resolve that debt. And it works because 80 percent of them participate.

Senator LEVIN. So then it is two 45-day periods, so that is about 12 to 13 weeks.

Ms. STIFF. Right.

Senator LEVIN. So at the end of the 13 weeks, about 20 percent typically have not responded; 80 percent have responded. That is worth doing, obviously. Then why not an automatic lien for the 20 percent?

Ms. STIFF. There are a couple of instances where our practices provide for, if taxpayers get to that point in the process and there is a dispute over whether or not the liability is correct or whether the amount of the liability is in question—

Senator LEVIN. Putting those aside.

Ms. STIFF. OK. Taxpayers are entitled to due process. In other instances, there is another exception where taxpayers are actually in the process of securing financing to pay off the debt.

Senator LEVIN. OK. What does that leave left?

Ms. STIFF. I don't know what the number is that is left—

Senator LEVIN. Well, 10 or 15 percent, would you guess?

Ms. STIFF. Let me bottom-line it. I agree with you that in those instances, once we have exhausted those two exceptions, we should be looking to apply the lien.

Senator LEVIN. And how many weeks would you estimate it takes to exhaust those two exceptions? A month? Two months?

Ms. STIFF. Depending on the—

Senator LEVIN. What should your target be? You have got to have targets here? What is your target?

Ms. STIFF. I don't know that I could give you a number of days, but certainly I would expect that once we have made contact with the taxpayer, we make a request for financial information to help us make the assessment. We provide taxpayers an opportunity to get that information, provide it back. We work with them. In some

instances, 30 days might be adequate. In other instances, taxpayers with complex financial information may need 90 days. But I think the important thing is at the point where we have determined that they are no longer acting in good faith with us, that is the point when we need to be applying that lien. And that is sooner than we are doing it today in many instances.

Senator LEVIN. All right. So at the point when you have made that determination, which you should begin to make that determination, would you agree immediately after those two 45-day periods are over? Is it 30 days or 45?

Ms. STIFF. They get the notice process, and then we contact them and start soliciting their financial information. Once we have ascertained that either the information they have leads us to believe that filing the lien is correct.

Senator LEVIN. OK.

Ms. STIFF. We should do it.

Senator LEVIN. And, on the average, should that take 2 months more? Does that sound about right on the average? Give me some number.

Ms. STIFF. Sir, I don't have a number.

Senator LEVIN. A range. How about 30 to 90 days?

Ms. STIFF. I will say that I would like to think that in 30 to 90 days that taxpayers would have had an opportunity to provide the information to us that they need to.

Senator LEVIN. All right. And then you agree that the lien should automatically be filed.

Ms. STIFF. I don't know that I can say in every instance because it will be fact and circumstance driven. But as a general rule, I would expect that we would take the action at that time.

Senator LEVIN. And when you file a lien, do you have to have a precise number of dollars on that lien?

Ms. STIFF. Yes.

Senator LEVIN. There has to be a precise number of dollars on—

Ms. STIFF. No. I think the lien is on the property, and it is for the amount that is owed the government.

Senator LEVIN. But it has to be for a specific amount? It cannot be for a range here?

Ms. STIFF. It is a specific amount on the lien.

Senator LEVIN. All right. GAO has found that tax liens were not filed at any point against these businesses with unpaid payroll taxes in over 30 percent of all payroll tax cases assigned to the field for collection effort. And we have introduced a bill called the Tax Lien Simplification Act, S. 1124, which would create a centralized electronic registry that would be more efficient, less burdensome. And according to estimates provided by the IRS itself, taxpayers would save about \$570 million over 10 years just from the simplification, the efficiency of an electronic system instead of what you do now.

Do you believe that the creation of that electronic system would help raise the percentage of cases in which liens are filed? Ms. Stiff, do you want to start?

Ms. STIFF. Sure. I don't know that the creation of the system itself will increase the number of liens, but I think it certainly will enable and facilitate our ability to do it.

Senator LEVIN. Mr. Sebastian.

Mr. SEBASTIAN. I believe it expedites the process and could result in an increase in the number of lien filings. Also very important, it may address an issue, a longstanding issue GAO has on the back end of the process. When taxpayers have actually resolved their tax debt, it may lead to more timely release of those tax liens. So it really serves two purposes.

Senator LEVIN. Now, is the Treasury aware that the IRS has estimated that our tax lien bill would save the taxpayers \$570 million just due to lower administrative costs, Commissioner Stiff? Are they aware of the fact that you have made that estimate?

Ms. STIFF. I don't know that they are, and I have to say that I actually have not seen all those numbers myself. I believe those numbers were estimates that were done sometime back when this was a gleam in someone's eye. But I do believe that there is definitely cost savings to be had and would want an opportunity to update those.

Senator LEVIN. Well, would you make the Treasury aware?

Ms. STIFF. Yes, sir.

Senator LEVIN. And would you let us know what you tell them in terms of your estimate?

Ms. STIFF. Yes, sir.

Senator LEVIN. The IRS has told the Subcommittee also that if the tax lien bill were enacted, it would free up a couple hundred persons from the Tax Lien Division to do other tax collection work. Are you familiar with that estimate that the IRS has given our Subcommittee?

Ms. STIFF. No, sir, I have not seen that myself. But we do have a group of people that are dedicated to this full-time, and I have no doubt that with the implementation of new technology, those numbers might be less than they are today.

Senator LEVIN. Has the IRS taken a position on our bill?

Ms. STIFF. As you know, the IRS does not take a position on policy or on legislation. That is the role of the Treasury.

Senator LEVIN. Do you ever make a recommendation to the Treasury about policy?

Ms. STIFF. Let me say this, that we appreciate the work of your staff on putting forward this proposal. We find it thoughtful, and we actually would like the opportunity to flesh it out a little bit more with you and the staff, because there are a number of administrability issues, one being that it would require appropriated funds for funding. Second, it is going to take time to build. Three, there are a number of issues of State law, State rights, State revenue streams, I think security, identity theft protection issues. And so we welcome the opportunity to talk through with your folks how to address those administrability issues.

Senator LEVIN. OK. And, Mr. Sebastian, have you looked at our bill?

Mr. SEBASTIAN. We have read through the bill, and I cannot give you a comprehensive analysis, but on the surface, it appears to resolve several issues. As I just indicated, I think it would streamline

the lien process of assigning liens. It might also help deal with some problems IRS has experienced over the years on the back end, and that is releasing tax liens.

Senator LEVIN. One of you—I think, Ms. Stiff, you talked about using electronic capability a lot more than you use now in terms of using your lien process, which is obviously not used to its fullest extent and it is complicated. You have got thousands of different jurisdictions that you have got to figure out. So this is a way of using an electronic capability that is not now being used, and I would hope that you could let us know within 30 days, if you would, what suggested changes you would make in the language to address any problems that you see?

Ms. STIFF. OK. We will work with the Department to do that.

Senator LEVIN. Thank you. Senator Coleman.

Senator COLEMAN. Thank you, Mr. Chairman.

Mr. Sebastian, if I can ask that question about the scope of the problem, we are talking about \$58 billion, I think I noted in my opening statement. That is based on reported income. We have a \$300 billion tax gap based on reported income. Do we have any estimates on the size of the actual tax gap?

Mr. SEBASTIAN. You mean amounts not currently on—

Senator COLEMAN. Yes, is there any way to figure out what we are really—what the Treasury is really losing here?

Mr. SEBASTIAN. Well, the IRS has estimated, based on a study done several years ago, that the gross tax gap is about \$345 billion, and when all is said and done, their enforcement efforts collect about, I think, \$55 billion of that, which leaves a net of maybe \$290 billion.

In looking at some of the detail behind that study, we have identified a minimum of about \$15 billion annually attributed to payroll taxes, and I am not including self-employed here because the number would grow to maybe \$54 billion. But just with respect to payroll taxes, employee withholding, about \$15 billion annually that is included in that estimate.

Now, some portion of that may ultimately be identified by the IRS through its various enforcement programs, including matching return information with W-2s, etc., and some small portion of that may ultimately be collected. But roughly \$15 billion is what the IRS would estimate annually in payroll taxes associated with the tax gap.

I would also add that in looking at some of the data on IRS' inventory over the years, it looks as though they add roughly \$5 to \$5.5 billion in new unpaid payroll taxes to the inventory of delinquent tax debt each year.

Senator COLEMAN. Let me step back. If we did nothing, if we made no changes, what would happen to the outstanding payroll tax debt?

Mr. SEBASTIAN. My concern is that it would ultimately grow and, to some extent, be offset by amounts that hit their statutory expiration date and are written off. So 9 years ago, we were looking at a balance of \$49 billion. Now we are looking at a balance of \$58 billion, roughly \$5.5 billion being added into the inventory annually, and roughly \$4 billion and growing at \$5 billion and even \$6 billion being written off over the next several years.

Senator COLEMAN. Are we also seeing larger amounts that have to be transferred from the general revenue fund into the Social Security and Medicare funds because of the failure to pay these taxes?

Mr. SEBASTIAN. To the extent that the balance grows, yes, you would see more in the way of transfers from the general fund to subsidize the Social Security and Medicare trust funds.

Senator COLEMAN. Let me turn to you, Ms. Stiff. And, by the way, first, I appreciate the good relationship we have had with the IRS on so many of these matters, and I appreciate your candor, both in discussing the historical perspective and some of the concerns where the IRS did step back from enforcement. We understand that. And the concern is that as we look at these egregious cases, is there a line that needs to be drawn?

Let me first go back to the filing of a lien. The report indicated that \$9 billion, I believe, was in the queue—in other words, there is \$9 billion in debt that is kind of lined up awaiting action. Now, those cases that are assigned to revenue agents, are those past the point where we have sent a notice and it has been determined that there is some debt out there? Where does that fit in with Chairman Levin's—he talked about the timeline of notice, and then you indicated that some of those cases have perhaps some specific concerns that would have us not move forward. When something is assigned, what is the determination point you assign something over to an agent?

Ms. STIFF. Well, I think you have hit the nail on the head. These cases that are sitting there in the queue, in all candor, I would say are the cases, as GAO reported, that I think we have got to in the coming weeks identify actions. We can get those assessed and liens filed whether or not they end up in the hands of a RO. So that we can protect the government's interest during whatever period they are there. We are going to be back with some steps that we are talking through right now as to how to address those cases in the queue that both you and the Chairman have brought up here today.

Senator COLEMAN. I appreciate that. That is what struck me, that \$9 billion in the queue, obviously these are cases in which folks are not making payments, they are going to be assigned to an agent. You have a backlog, and there are other issues that we have to address in terms of funding enforcement, and this Subcommittee has been very supportive of that. But I appreciate the candor, it would appear that the first thing you want to do is protect the government's interest. That is what the lien does. And when you do that, then you have time to do some other things. So I appreciate the focus on that.

I am not sure if this is for Mr. Sebastian or Ms. Stiff. Can I go back to other cases? One of the things we looked at was the Financial Management Service, the levying process. It appears—and this goes back to some earlier reports that have been done, I think perhaps in 1999, there were cases in which the government paid over \$211 million annually to folks who owed \$2 billion in outstanding trust fund recovery penalties. In other words, we have folks who are identified as having trust fund recovery penalties, but at the same time, they are getting Federal payments along the way. Have

we looked at that recently? Is that still a possibility to use the levying process with the FMS to ensure that we are getting a return from folks who have trust fund penalty obligations?

Mr. SEBASTIAN. We did not look at that as part of this study. In previous work that we have done for this Subcommittee, looking at contractors with tax debt, we have looked into that whole issue of how much of IRS tax debt actually gets into the levy program and is turned on and is then subject to levy of Federal payments.

I have some conflicting information, quite frankly, on whether or not individuals that have been assessed a trust fund recovery penalty are or are not included. But what I will point out is a significant number of businesses do not have associated trust fund recoveries. So to the extent that the IRS has not assessed responsible businesses and officers, those accounts would not be subject to levy in the first place.

Senator COLEMAN. So we start off first with, I think, the need to look at moving on a more accelerated basis with the lien process, to at least protect the government's interest, and then the next focus would be at what point can we move more aggressively on the trust fund recovery process. And then if you do that, there is another step to look at, and that is to say are there, in fact, payments being made to these folks that we could then use for the levy process.

So, Ms. Stiff, I appreciate your forward-looking approach here to say you have a task force, you have identified some of the concerns the Chairman and I have raised. For me, it becomes pretty logical: Protect the government's interest and move more effectively to be in a position to levy. We have not even talked about some of the stronger actions you could take such as the injunctive process. There are some very strong actions here that I would think in the most egregious cases may be warranted. The report indicates that those are very rarely used. Very rarely did you take the toughest steps. And we are dealing with folks who may be involved in criminal activity, 10 years of simply ignoring their tax responsibilities, records of using these funds for personal gain, personal use. So I would hope you would take another look at that.

Perhaps this is too big a question to respond in the time I have, but is there a possibility of drawing a bright line about when getting voluntary compliance ceases and more aggressive action is needed—or is this something that requires discretion plus how do we get to that point where we move from voluntary to more aggressive, more forceful, more dictated, more mandated action on the part of the IRS?

Ms. STIFF. I don't think that over our history that we have arrived at a bright-light test that applies in each and every instance. But one of the things I commit to you is that is an area that the task force is going to look at, because even if you cannot have a broad, sweeping rule that applies to everything, it would seem that we can begin testing application of some rules and see where they work and what the outcome is for both the taxpayers and the government, and then where it works, apply it more broadly. So we are going to be doing some work in that area.

Senator COLEMAN. Mr. Chairman, could I ask just Mr. Sebastian to respond?

Senator LEVIN. Sure.

Senator COLEMAN. Mr. Sebastian, would you respond to that, please?

Mr. SEBASTIAN. I would tend to agree with what I just heard. Right now, it would be hard to tell what is the fine line. Clearly, when we get to 40, 50 quarters of outstanding tax debt, these cases have gone on much too long. Whether the magic number is 10, 15, 20 quarters, I don't know. I think that is information that the IRS could actually look at through some detailed analysis and then set up what may be the rule with exceptions that should apply in certain cases.

Senator COLEMAN. Thank you, Mr. Sebastian.

Senator LEVIN. Thank you. Senator McCaskill.

#### **OPENING STATEMENT OF SENATOR MCCASKILL**

Senator MCCASKILL. Thank you, Mr. Chairman.

I am going to follow up a little bit on Senator Coleman's line of questioning. We have had a Treasury Inspector General for Tax Administration study from 8 years ago, another study in 2005 that basically says that voluntary compliance is not working. We are here today because voluntary compliance is not working. This problem is not getting better. It is getting worse.

I understand a little bit about deterrence. There are crimes you can deter, and there are crimes you cannot deter. There are many crimes that, even if you do the toughest prosecutions imaginable, people are still going to go and commit those crimes. I think sometimes politicians like to think deterrence works in every instance if you have tough criminal penalties.

But I will tell you where deterrence does work. It works in the business community. When businesspeople see other businesspeople on the courthouse steps on the evening news, it works. And I would like Mr. Sebastian and Ms. Stiff to discuss the failure of any meaningful criminal prosecution. If someone has gotten notice after notice after notice and they continue to engage in this behavior for years, the reason they are doing it is they know nothing is going to happen to them. And I don't know why we need a task force, honestly. I mean, if you have gotten notice and you have not paid your payroll taxes and you have gotten notices every quarter for 2 or 3 years, we need a task force to tell us that we need to put people in jail for that? They are purposely not paying what they owe. It is so unfair to people who pay taxes.

Mr. Sebastian, what did your report specifically say about the likelihood of criminal prosecution in any of these cases?

Mr. SEBASTIAN. We did not do a detailed review of that looking at past cases. I do know that the IRS has prosecuted payroll tax cases, and the Deputy Commissioner could probably elaborate on that. I can tell you that in discussions that we have had with revenue officers—and this really mirrors what we found in 1998 when we did the earlier study. The IRS and, in particular, the Criminal Investigation Division and the Department of Justice are somewhat reluctant to pursue prosecution for employment tax offenses. They cite the process is very labor intensive, laborious. There is a tremendous amount of burden on the part of the IRS to actually pro-

vide the Department of Justice with the information they need to successfully prosecute a case.

Again, these are discussions that we had with revenue officers, but it has served as a deterrent to moving forward, taking more aggressive enforcement action in a number of cases.

Senator MCCASKILL. Could you address that in terms of the likelihood of criminal prosecution for repeat offenders who have been noticed and noticed and noticed and obviously voluntary is not in their dictionary?

Ms. STIFF. Well, first—and I know that the three of you are familiar with that—the bar for criminal prosecution is certainly a higher bar than what we have in the civil arena. And many of the cases outlined in this report actually would be very difficult for the Department of Justice to prosecute successfully because many of these taxpayers are not out—they are part in, part out. They come in, they make good-faith efforts for a couple of years, and then it recurs again. And so there are a number of difficulties, I believe, for the Justice Department in trying to prosecute that.

Having said that, in the last 4 years our criminal investigations in the employment tax arena have increased by 55 percent. We made a conscious effort in 2003, after the drawdown of enforcement that occurred after RRA 1998 to work with the Justice Department and to work with our criminal investigators and our fraud specialists to reinvigorate that program and the referrals. And I think I outlined in my testimony several strong examples of where we have been effective and successful in actually getting criminal prosecutions and having offenders actually serve time.

Senator MCCASKILL. And how many criminal prosecutions occurred last year for failure to pay payroll taxes in the whole country?

Ms. STIFF. I do not have the number right off the top of my head. I want to say roughly 200.

Senator MCCASKILL. So we are talking about an average of four cases per State?

Ms. STIFF. It probably was not that, but yes.

Senator MCCASKILL. And how many offenders do you think we have in the country right now?

Ms. STIFF. I do not have that number. I know that the GAO report says that we have 1.6 million businesses known to us that we are talking about here today.

Senator MCCASKILL. Well, I think the standard in the criminal law here is “knowingly,” and having a great deal of experience bringing criminal cases in my life, you have to convince 12 people beyond a reasonable doubt that somebody did not pay the money knowingly. And, trust me, there are going to be taxpayers on that jury. They are going to be offended because they are paying their taxes every year. A lot of small businesspeople at their own—they are cutting their take of the business in order to comply with the law.

I just have a hard time—I run into this all the time, where people say, well, what you have to do to bring a criminal case at Justice, or maybe what we have to do is ask some questions at the Justice Department as to what they are requiring in order to bring a criminal case. But if somebody walked into my office when I was

a prosecutor and said, "Here is a stack of letters that this businessman signed for or businesswoman signed for, quarter after quarter after quarter—I am assuming a lot of these are return receipt requested, correct? These notifications?"

Ms. STIFF. I actually do not know the answer to that. I would have to check.

Senator MCCASKILL. I am assuming bad news from the IRS is usually return receipt requested. Usually that green card is something that comes with it. And you have a pile of those in front of a jury and say how many times this employer has been notified to pay their payroll taxes and they failed to do it again? That is knowingly. It is not complicated. It is not hard.

I just think that we need to really stay focused on criminal prosecution for repeat offenders. And I think you would see a miraculous turnaround in this country. I think they all know out there that when it comes to the end of the month and they cannot pay anything, the one that they can get away with is not paying the IRS. And I think that is why they do it. I do not think it is that complicated.

This task force that you are referring to, how long do you think the task force is going to take to come up with recommendations?

Ms. STIFF. Well, I suspect that within 90 days we will have a suite of recommendations. I suspect that sooner than that we will begin doing some of the more obvious and easier things to do.

But on the criminal investigation side, I mean, we do not disagree. We believe we need to have a strong criminal investigation presence where the circumstances warrant that.

Senator MCCASKILL. Well, I think repeat offenders, that is the circumstance. And I think the bright line is just deciding if you do it for longer than 2 years, you are up. And you know what is going to happen? These people are not going to take a chance at rolling the dice in front of a jury. They are going to pay for probation. That is what happens in the criminal justice system all the time with white-collar crime. They pay for probation. But that is better than them not paying.

I think that the efficacy of taking a much more aggressive approach on criminal prosecution is going to make a real difference in this area. And I guess, Mr. Sebastian, my frustration is: How many times has there been a report issued about this subject? And how many times has something actually happened meaningful to change things?

Mr. SEBASTIAN. I can only say I have been involved in multiple reports over the last 10 years looking at payroll taxes, either as the subject or peripherally. And you are absolutely right. We continue to see the same thing. We continue to see multiple offenders flagrantly violating the tax laws.

Senator MCCASKILL. I guess we can go back here another 10 years, another five or six reports, or we can get busy and try to put some people in jail. And I think it will work, Mr. Chairman. Thank you.

Senator LEVIN. Thank you. We have focused also—in addition to what Senator McCaskill has talked about in terms of criminal enforcement—we have also talked about a lien system which is functional, which is easily worked, and how much money would be

saved by doing that. And we would ask you if you would take a look—and I had the staff give you copies of this analysis.

This analysis was prepared by the IRS at our request. We asked the IRS to take a look at an electronic system for lien filing. If you look at the right, the bottom at the right over the 10-year period, the cost of the current system is \$679 million, and the cost of doing this electronically would be \$107 million. That is where our figure comes from. Are you familiar with that, Ms. Stiff?

Ms. STIFF. I cannot say that I have seen this before.

Senator LEVIN. I am kind of surprised.

Ms. STIFF. I have no doubt that my staff and folks worked on this, and I do not challenge that, but I have not personally had a chance to review this.

Senator LEVIN. Well, I hope you will take a look at this.

Ms. STIFF. I certainly will.

Senator LEVIN. Now, there was a chart that the staff put up, increases in number of businesses with multiple payroll tax debts. I am wondering if somebody could put that chart up again.<sup>1</sup>

The number of businesses with unpaid payroll taxes has declined although the number of payroll taxes owing has increased. The decrease in the number of businesses is down from 1.8 to 1.6 million—that is not on the chart. That is the number we have received. I guess the GAO can confirm that.

Mr. SEBASTIAN. That is correct.

Senator LEVIN. And yet we see on this chart that there is a vast increase in the number of businesses with over 5 years of debt, and even a bigger percentage increase in the number of businesses with over 10 years of debt. That is a striking chart to me.<sup>1</sup>

What is the explanation for that? Why don't we go after the ones that have the longest owing debt?

Ms. STIFF. Well, I think that collection experts, private sector and public sector, maintain that the earlier you get to the debt, the greater the likelihood of recovering the amounts owed.

Senator LEVIN. Sure.

Ms. STIFF. Or a higher percent of it.

Senator LEVIN. I can understand that. What I am intrigued by is the percentage has gone up. The numbers have gone up. Do you see what I am saying?

Ms. STIFF. Yes, sir. And I do not know that I can nail the numbers, but basically, as I said in my oral statement, we had a period from 1998 to 2002 where the number of delinquent accounts that we touched decreased significantly.

Senator LEVIN. All right. Does the GAO have the numbers for 2002 to 2007? Do you happen to have those numbers handy?

Mr. SEBASTIAN. In terms of?

Senator LEVIN. If we looked at just 2002, what the numbers were that had over 5 years of debt, instead of 1998?

Mr. SEBASTIAN. No, I do not. It is a snapshot of a certain point in time.

Senator LEVIN. Would you just for the record give us a different snapshot to take care of the point that Ms. Stiff is making?

<sup>1</sup>The chart referred to appears as an attachment to the GAO Statement in the Appendix on page 56.

Mr. SEBASTIAN. We will do what we can, but the reason that I hesitate on that is because, as accounts hit their statutory expiration date and fall off, they are no longer in the inventory. So to be able to construct this analysis, I would need to know what the inventory was comprised of in 2002, 2003, and 2004. We may not be able to get that information. We will do what we can.

Senator LEVIN. Fine. But you do know what it was in 1998.

Mr. SEBASTIAN. Yes, and that was based on the fact we had done this analysis and reported out in 1998.

Senator LEVIN. Got you. If it is not too much trouble, if you could get that for us, it would be helpful.

Now, Senator Coleman read from the top of page 32 of the GAO report, and I want to pursue that: "Our analysis found that for the \$9 billion of payroll tax cases in the queue awaiting assignment as of September 30, 2007, over 80 percent of the cases did not have a lien filed." And I am trying to understand why it should not be automatic at that point. Why should not a lien be automatically filed if somebody is in the queue awaiting assignment?

Ms. STIFF. Well, I think that was the question that I answered earlier, that we actually—I agree that queue is a weakness in the system and that will be one of the first areas that we are looking at, is to see what analysis can be done there and which cases the lien filing would be appropriate.

Senator LEVIN. Automatically. If you are assigned and you are waiting in a queue, why would that not automatically result in a lien? That is my question.

Ms. STIFF. Well, automatically, I guess it may be semantics here. We do not have an automatic lien-filing system, so someone has got to—

Senator LEVIN. Why should it not be automatic?

Ms. STIFF. You mean the decision to apply the lien.

Senator LEVIN. Yes. If someone is in a queue for enforcement, they have ignored all your notices.

Ms. STIFF. I am agreeing with you.

Senator LEVIN. All right. I want to just get back to the taxes owing issue. The taxes that we are talking about in terms of criminal enforcement are taxes which were withheld from the employee. Is that correct? Those are the ones that are put in trust.

Ms. STIFF. Yes.

Senator LEVIN. So that when we are talking criminal enforcement, it is for failure to send to the government the tax money of the employee that was withheld from the employee's pay. Is that correct?

Ms. STIFF. Yes.

Senator LEVIN. It is not a felony for failing to pay your own taxes. It is a felony for withholding taxes from an employee and then not sending those to the government.

Ms. STIFF. Yes, sir.

Senator LEVIN. OK, because I think there could be some confusion. We do not throw people in jail in this country for failing to pay their taxes. It is only if there is fraud, if there is misrepresentation, or if there is a specified crime such as not sending to the government trust fund monies which do not belong to you. It is someone else's money that is being stolen or cheated here. I get a

little nervous here when I hear about not paying your taxes resulting in criminal enforcement. And I think I am right on this. I hope I am.

Ms. STIFF. Well, it is further compounded by the fact that in all too many cases, these individuals have little or nothing that the government can recover at that time.

Senator LEVIN. I understand that.

Ms. STIFF. They have exhausted all their finances.

Senator LEVIN. Yes, but I am just talking about criminal law enforcement here. I want to have the record—if I am correct, which I hope I am.

I would like to talk about this earned income tax credit (EITC). This Administration has put a great deal of emphasis on going after the poorer folks who are somehow or other not entitled to an earned income tax credit, which allegedly they have taken, and comparing that to the big fish who get away with not paying other people's taxes which they have withheld and put in trust, and some of the other abuses that this Subcommittee has seen.

How many IRS personnel are involved in the EITC delinquency program, do you know?

Ms. STIFF. I do not have the number off the top of my head.

Senator LEVIN. Do you know how that would compare to the number of personnel who are in the—

Ms. STIFF. In collection, we probably have between 8,000 and 10,000 individuals working here, and I am guesstimating off the top of my head—I will get you a better number—a couple thousand working on the EITC.

Senator LEVIN. The EITC, would you get us those numbers?

Ms. STIFF. Sure thing.

Senator LEVIN. Thanks. Senator Coleman.

Senator COLEMAN. Thank you, Mr. Chairman. I want to just follow up on the trust fund recovery program, the idea that criminal charges were being focused on monies that you were supposed to forward, held in trust, and the issue I talked about earlier, monies from the general fund coming in at the end of the year, that is for the trust fund recovery program, right? In other words, we have got to take general fund money to pay for what employers do not send in. Is that correct, Mr. Sebastian?

Mr. SEBASTIAN. That is correct. What they withhold from employees' paychecks and do not remit to the Federal Government.

Senator COLEMAN. And when we are talking about levy programs and liens, we are talking about going after the TFRP funds? What about the monies that you are owed? Any levies apply to that? Do the liens apply to that, or we are just dealing with trust fund recovery money?

Ms. STIFF. No, levies and liens apply to individual income taxes as well when there is a delinquency and we believe it is appropriate.

Senator COLEMAN. I talked before about whether we would be referring any cases to the FMS for levying. Do you know if any of the cases in the queue, that \$9 billion, is there any referral to FMS for levying possibilities with those dollars?

Ms. STIFF. All of these cases are in the FMS levy program, so if there is a match, the levy will be applied against them.

Senator COLEMAN. Let me just ask one question—because Senator McCaskill was talking about deterrence. One of the ways in which the State has found what they believe to be an effective deterrence is publishing the names of individuals who have these obligations or repeat scofflaws—again, not cases in which they are contesting, not cases in which there is a bankruptcy, etc., but those cases which establish that you have a problem here and there has been no response. Why doesn't the IRS do that?

Ms. STIFF. Any number of reasons. First of all, probably a matter of policy and a matter of practice, and the fact that the lien-filing process—I forget which one of you described earlier—is very localized and very decentralized across all States. And I do not know that we even have a master database.

Senator COLEMAN. Would it be something that the IRS would look at, this idea of publishing names? Is that something that is within the realm of possibility? And if so, is it something that you need legislative authority to do?

Ms. STIFF. I think we need legislation, absolutely, because we would probably be barred from sharing that under the current statutes.

Senator COLEMAN. I would like you to get back to the Subcommittee with something very specific, in fact, if there is legislative authority that is needed, and also—

Ms. STIFF. I am confident it requires legislation.

Senator COLEMAN. The other area where the States have been apparently more effective is in being able to track down dollars that have been shifted between financial institutions. Oftentimes, we see in these cases somebody emptying out one account and then creating another one, and it is kind of a difficult trail to follow. At least in the States they apparently have been able to cut that.

Mr. Sebastian, did you track that at all? And are there specific things that we could be doing to be as effective on the Federal level?

Mr. SEBASTIAN. Well, in fact, it is one of our recommendations that the IRS take a look at what some of the States are doing. I think we looked at maybe five States, five or six States that actually are working to better perfect their levying process, either through legislation or agreements with financial institutions, so you are not spending a tremendous amount of resources trying to find the bank account of a particular individual and then levying. That process has already been established through agreements with financial institutions.

Senator COLEMAN. And, Ms. Stiff, has this been a problem for IRS—do you have these agreements with financial institutions? Is this something that the agency looks to do in order to more effectively trace where some of the dollars are?

Ms. STIFF. We are going to be looking at everything we are doing and see what opportunities there are to improve. Let me just say—and at the risk of sounding a little bit defensive, when we characterize what the States are doing or what we are doing, I just feel compelled to remind that we succeed in collecting 99.8 percent of all employment taxes owed; over the last 10 years, IRS collected more than \$11 trillion in payroll taxes. And so it is not as if our processes are not robust and rigorous in terms of getting employ-

ment tax collections. I think that both the GAO and the Subcommittee have just highlighted on where the weaknesses are and where there is the most opportunity.

Senator COLEMAN. And we are not arguing about that, but as you indicated in your testimony, when you are talking about trillions, a decimal point is a big number.

Ms. STIFF. It is a lot.

Senator COLEMAN. And if the States are doing something that is seemingly more effective, my question is simply: Is it something that the IRS can do? Is it something you have considered? And if the problem is legislative authority, we would like to know. In other words, if it is something that makes sense—

Ms. STIFF. OK.

Senator COLEMAN [continuing]. I need to know whether you need more authority to do that or whether you simply refuse to do it or whether it is something you would like to do but you can do administratively. Again, does it make sense? Is it another tool in your arsenal? And then if it is not, you have to get back to us and say, Senator, we need legislative authority. If you legislate it, we are prepared to do it.

Ms. STIFF. Absolutely. We will do a review of the best practices, look at what we are doing versus what is being done, and come back to you where we need assistance.

Senator COLEMAN. And I appreciate that. Mr. Sebastian.

Mr. SEBASTIAN. Yes, Senator Coleman, I just wanted to mention, when Ms. Stiff talks about the \$1.7, \$1.9 trillion, it is important to remember that the vast majority of taxpayers are compliant. So those monies, much of those monies are actually coming in almost on autopilot. These are compliant taxpayers. They understand. They make their timely tax deposits, file their returns, etc.

I think the bigger measure would be for those that initially are not paying their taxes when due, how much is IRS collecting on those through the notice process, through its enforcement actions, and compare that against some of the issues that we have identified in our study.

Senator COLEMAN. I think that is fair, and, again, I think what makes this so outrageous and so irritating is that the average taxpayer is doing what they should be doing.

Mr. SEBASTIAN. Absolutely.

Senator COLEMAN. And as a result, certainly the burden then is back to us to say, OK, for those scofflaws and tax cheats, we are going to be very aggressive to ensure that they live up to the obligations because it is an affront to the average taxpayer when they do not.

Thank you, Mr. Chairman.

Senator LEVIN. I just have a couple more questions. Going back to the lien issue again, in terms of the question of if the lien is automatic, how could some businesses then be able to pay their back taxes or stay in business to pay back taxes. If you made it automatic after a certain period of time, then it could be removed, obviously, if the business carries their burden of persuading one of your employees that removal of the lien will lead to greater collection than maintaining the lien. But at least it would create some pressure on that company to pay their back taxes.

Ms. STIFF. I do not disagree with that.

Senator LEVIN. All right. Now, do you have performance measures for employees in the collection area as to how well they are doing that goes into their employment record?

Ms. STIFF. OK. After RRA 1998, we were statutorily prohibited from the use of many of what you would consider common-sense kinds of collection measures in terms of how many dollars you collect, how many cases you close. But we use a variety of other types of measures, proxy measures to how long it takes them to do their cases, are they following up timely. And I think you certainly saw in some of these examples that was not happening as well.

But the issue of measures in the collection arena is, frankly, very dicey in light of the statutory prohibitions and a risk of—I mean, in an area where managers particularly out in the field with revenue officers working for them, there is an abundance of caution and a high degree of angst.

Senator LEVIN. Is there a clear direction as to what can be done and what cannot be done?

Ms. STIFF. Yes, sir. Every year we go out and we do an annual reorientation, a retraining of managers and of ROs about what can be done. But the kinds of things that you talked about earlier are probably going to fall under the statutory prohibition.

Senator LEVIN. But in terms of what can be done, clarity as to that, there is a clear instruction to your managers as to what performance criteria, can be used?

Ms. STIFF. Yes, sir.

Senator LEVIN. All right. Any other questions?

Senator COLEMAN. I have nothing further, Mr. Chairman.

Senator LEVIN. We appreciate again your testimony. It has been very helpful.

Ms. STIFF. Thank you.

Mr. SEBASTIAN. Thank you.

Senator COLEMAN. Thank you.

Senator LEVIN. The hearing is adjourned.

[Whereupon, at 10:25 a.m., the Subcommittee was adjourned.]



# A P P E N D I X

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**GAO**

United States Government Accountability Office

Testimony  
Before the Permanent Subcommittee on  
Investigations, Committee on Homeland  
Security and Government Affairs, U.S.  
Senate

For Release on Delivery  
Expected at 9:30 a.m. EDT  
Tuesday, July 29, 2008

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## TAX COMPLIANCE

### Businesses Owe Billions in Federal Payroll Taxes

Statement of Steven J. Sebastian, Director  
Financial Management and Assurance



GAO-08-1034T

July 29, 2008

TAX COMPLIANCE

Businesses Owe Billions in Federal Payroll Taxes



Highlights of GAO-08-1034T, a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

GAO previously reported that federal contractors abuse the tax system with little consequence. While performing those audits, GAO noted that much of the tax abuse involved contractors not remitting to the government payroll taxes that were withheld from salaries. As a result, GAO was asked to review the Internal Revenue Service's (IRS) processes and procedures to prevent and collect unpaid payroll taxes and determine (1) the magnitude of unpaid federal payroll tax debt, (2) the factors affecting IRS's ability to enforce compliance or pursue collections, and (3) whether some businesses with unpaid payroll taxes are engaged in abusive or potentially criminal activities with regard to the federal tax system. To address these objectives, GAO analyzed IRS's tax database, performed case study analyses of payroll tax offenders, and interviewed collection officials from IRS and several states.

What GAO Recommends

In our report (GAO-08-617) being released today, GAO makes six recommendations to IRS to address issues identified in this report, including development of (1) processes and performance measures to monitor collection actions against egregious payroll tax offenders and (2) procedures to timely file tax liens and assess penalties to hold responsible business owners and officers personally liable for not remitting withheld payroll taxes. IRS agreed to all six of our recommendations.

To view the full product, including the scope and methodology, click on GAO-08-1034T. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

What GAO Found

IRS records show that, as of September 30, 2007, over 1.6 million businesses owed over \$58 billion in unpaid federal payroll taxes, including interest and penalties. Some of these businesses took advantage of the existing tax enforcement and administration system to avoid fulfilling or paying federal tax obligations—thus abusing the federal tax system. Over a quarter of payroll taxes are owed by businesses with more than 3 years (12 tax quarters) of unpaid payroll taxes. Some of these business owners repeatedly accumulated tax debt from multiple businesses. For example, IRS found over 1,500 individuals to be responsible for non-payment of payroll taxes at three or more businesses, and 18 were responsible for not remitting payroll taxes for a dozen different businesses.

Although IRS has powerful tools at its disposal to prevent the further accumulation of unpaid payroll taxes and to collect the taxes that are owed, IRS's current approach does not provide for their full, effective use. IRS's overall approach to collection focuses primarily on gaining voluntary compliance—even for egregious payroll tax offenders—a practice that can result in minimal or no actual collections for these offenders. Additionally, IRS has not always promptly filed liens against businesses to protect the government's interests and has not always taken timely action to hold responsible parties personally liable for unpaid payroll taxes.

GAO selected 50 businesses with payroll tax debt as case studies and found extensive evidence of abuse and potential criminal activity in relation to the federal tax system. The business owners or officers in our case studies diverted payroll tax funds for their own benefit or to help fund business operations.

Examples of Tax-Related Abusive and Potentially Criminal Activity

Business	Unpaid payroll taxes	Activity
Construction	Almost \$2.5 million over 12 years	Potential illegal check kiting and money laundering
Health care	Almost \$2.5 million over 7 years	Officers took large cash withdrawals prior to filing bankruptcy multiple times
Dentist	Over \$500,000 over 10 years	Owner owed over \$500,000 in personal taxes, put property in spouse's name, and sold property to children for less than market value

Sources: GAO analysis of IRS, public, and other records.

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Mr. Chairmen and Members of the Subcommittee:

Thank you for the opportunity to discuss unpaid federal payroll taxes. Our related report, released today and developed at the request of this subcommittee and the Senate Committee on Finance, describes issues we identified in the collection and prevention of unpaid payroll taxes. It builds on a large body of work over the last several years that identified tens of thousands of federal contractors with unpaid taxes, most often unpaid payroll taxes, who abused the federal tax system.<sup>1</sup> This testimony also builds on your concern regarding the almost \$300 billion annual tax gap.

One of the elements of this tax gap is unpaid payroll taxes. Payroll taxes are amounts employers withhold from employee's wages for federal income taxes, Social Security, and Medicare, as well as the employer's mandatory matching contributions for Social Security and Medicare taxes. When businesses do not remit payroll taxes, they are using employees' money to fund business operations or the personal lifestyle of the businesses' owners/officers, and causing shortfalls in funding for Social Security and Hospital Insurance. If left to accumulate unpaid payroll taxes, businesses can gain an unfair business advantage over their tax-paying competitors at the expense of the government. The Internal Revenue Service (IRS) acknowledges that unpaid payroll taxes are a major compliance problem. The willful failure to remit payroll taxes is a felony under federal law.<sup>2</sup>

Today's testimony focuses on (1) the magnitude and composition of unpaid payroll taxes, (2) factors affecting IRS's ability to enforce

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<sup>1</sup>GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-96 (Washington, D.C.: Feb. 12, 2004); GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-414T (Washington, D.C.: Feb. 12, 2004); 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); GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax Systems with Little Consequence*, GAO-05-683T (Washington, D.C.: June 16, 2005); GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006); GAO, *Medicare: Thousands of Medicare Part B Providers Abuse the Federal Tax System*, GAO-07-587T (Washington, D.C.: Mar. 20, 2007); GAO, *Tax Compliance: Thousands of Federal Contractors Abuse the Federal Tax System*, GAO-07-742T (Washington, D.C.: Apr. 19, 2007); and GAO, *Medicaid: Thousands of Medicaid Providers Abuse the Federal Tax System*, GAO-08-239T (Washington, D.C.: Nov. 14, 2007).

<sup>2</sup>26 U.S.C. § 7202.

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compliance or pursue collection of unpaid payroll taxes, and (3) businesses with unpaid payroll taxes that are engaged in abusive<sup>3</sup> or potentially criminal activities with regard to the federal tax system.

To determine the magnitude and composition of unpaid payroll taxes and to identify owners or officers who repeatedly abused the federal tax system by not remitting withheld payroll taxes, we analyzed IRS's database of unpaid taxes as of September 30, 2007. We also performed a macro-analysis of IRS's overall inventory of unpaid tax debts. To determine IRS's procedures to prevent the accumulation of unpaid payroll taxes and to collect such taxes, we reviewed IRS's policies as laid out in its Internal Revenue Manual and discussed those policies and procedures with cognizant IRS officials and revenue officers. We reviewed a sample of 76 businesses whose owners IRS found personally liable for the failure to remit payroll taxes withheld from employees' paychecks and whom IRS assessed a Trust Fund Recovery Penalty (TFRP)<sup>4</sup> to identify the timeliness of IRS's collection actions.<sup>5</sup> We also interviewed tax officials from several states concerning collection tools and techniques they used. Finally, to determine whether businesses with unpaid payroll taxes were engaged in abusive or potentially criminal activities involving the federal tax system, we reviewed documentation on IRS's collection actions and discussed the appropriateness of those actions or the absence of actions with IRS

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<sup>3</sup>We considered activity to be abusive when a business'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.

<sup>4</sup>Under section 6672 of the Internal Revenue Code, individuals who are determined by IRS to be responsible for collecting, accounting for, and paying over payroll taxes who willfully fail to collect or pay these taxes can be assessed a TFRP. This penalty, typically assessed against owners or officers of a corporation, such as a president or treasurer, is assessed for the amount of taxes the business withheld from its employees' salaries but did not remit to the federal government, the so-called trust fund portion of payroll taxes. The business itself is still liable for the entire amount of the unpaid payroll taxes, but IRS can seek collection from the responsible owner/officers for the trust fund portion of the unpaid taxes when they are assessed this penalty.

<sup>5</sup>The sample was originally selected as part of our audit of IRS's financial statements; see GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements*, GAO-08-166 (Washington, D.C.: Nov. 9, 2007). The primary purpose of the sample was to determine whether IRS was properly recording payments to all related parties. However, we also performed other tests of IRS's controls using this same sample. Although we identified issues related to IRS's assignment of cases among revenue officers and the timeliness of certain collection actions based upon that sample, we are unable to project these results because the sampling unit used for the financial statement audit was payments rather than accounts.

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revenue officers for 50 businesses selected as case studies. We performed a more in-depth review of 12 of those cases and presented the results in table 3.

The work supporting the report on which this testimony was based was performed from April 2007 through May 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Summary

Our analysis of IRS's records showed that, as of September 30, 2007, over 1.6 million businesses owed over \$58 billion in unpaid payroll taxes, including interest and penalties. As such, payroll taxes comprise over 20 percent of IRS's \$282 billion inventory of outstanding taxes, penalties, and interest owed by businesses and individuals at September 30, 2007, and over 50 percent of the total amount owed by businesses in IRS's inventory. Our analysis showed that 70 percent of all unpaid payroll taxes are owed by businesses with more than a year (4 tax quarters) of unpaid federal payroll taxes. In addition, over a quarter of payroll taxes are owed by businesses that have tax debt for more than 3 years (12 quarters). Because unpaid payroll taxes include amounts owed for Social Security and Hospital Insurance (Medicare Part A) taxes,<sup>6</sup> the federal government may have to transfer higher amounts from the General Fund to the Social Security and Hospital Insurance trust funds to make up for the amounts businesses fail to remit. IRS estimated that for the tax debt it had in its inventory of unpaid assessments as of November 1, 2007, the General Fund had transferred \$44 billion to the trust funds over what IRS collected because employers failing to remit withheld taxes on employee wages.

IRS has a number of powerful tools at its disposal to prevent the accumulation of unpaid taxes and to collect the taxes that are owed. However, IRS acknowledges that its traditional collection methods do not always bring taxpayers into compliance and that there is a major compliance problem with the large number of businesses that repeatedly

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<sup>6</sup> These amounts are collected pursuant to the Federal Insurance Contributions Act, 26 U.S.C. ch. 21.

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do not remit payroll taxes. In reviewing IRS's collection actions for these egregious payroll tax offenders, we identified several issues that limit the effectiveness of IRS's current approach, including:

- IRS's overall approach to collection focuses primarily on gaining voluntary compliance, which can allow egregious payroll tax offenders to continue to accumulate payroll tax debt for years that may never be collected.
- IRS is not timely filing tax liens against the property of payroll tax debtors to protect the government's interest. For over a third of all businesses with unpaid payroll taxes assigned to the field for collection efforts, IRS had not filed a lien and over 80 percent of payroll cases in the queue awaiting assignment to a revenue officer did not have a lien filed.
- IRS is not timely assessing penalties to individuals responsible for not remitting business's payroll tax debts. In a sample of 76 TFRP assessments, it took IRS over 40 weeks on average to decide to pursue collection against responsible owners/officers and an additional 40 weeks to assess the TFRP. Delays in assessing a TFRP can result in lost opportunities to collect unpaid payroll tax debts from the owners/officers while allowing them to continue to use the business to fund a personal lifestyle through the non-remittance of payroll taxes.
- IRS does not place as high a priority on collection efforts against the responsible owners/officers as it does the related business and treats the TFRP as a separate collection effort unrelated to the business.
- IRS actions do not always prevent egregious payroll tax offenders from accumulating additional unpaid payroll tax debt.
- IRS does not have performance measures to establish goals related to the collection and prevention of unpaid payroll taxes and to track its actual performance against these goals.

Further, some states have additional tools that help prevent the further accumulation of unpaid payroll taxes. These include:

- Publishing tax debtor names: An increasing number of states—currently around 19 and the District of Columbia—now publish the names of tax debtors on Web sites as a means of both collecting unpaid taxes and stopping the further accumulation of these taxes.

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- Identifying levy sources: Several states have initiated legislation or entered into agreements with financial institutions to match account information against tax debts, allowing states to more easily identify levy sources to aid in the collection of unpaid taxes.

Our analysis and data mining of IRS tax records indicated that some businesses were involved in abusive or potentially criminal activity related to the tax system. Some of these business owners repeatedly accumulated tax debt from multiple businesses. For example, IRS found over 1,500 individuals responsible for non-payment of payroll taxes at three or more businesses. Our analysis of 50 case study businesses showed some owners/officers abuse the tax system, willfully diverting amounts withheld from their employees' salaries to fund their business operations or their own personal lifestyle. For example, the owner of one of our case study businesses owed almost \$2.5 million, was under reporting personal income, and was involved in possible check kiting and money laundering. Another had accumulated \$2.5 million in unpaid payroll taxes and made large cash withdrawals prior to filing bankruptcy multiple times. A third had accumulated \$500,000 in unpaid payroll taxes over a 10-year period as well as another \$500,000 in personal taxes. The owner had put property in a spouse's name and sold property to children for less than market value to avoid IRS collection action.

Our companion report, released today, contains six recommendations to IRS to address issues identified in the report, including (1) developing a process and performance measures to monitor collection actions taken by revenue officers against egregious payroll tax offenders and (2) developing procedures to more timely file liens against egregious businesses and assess penalties to hold responsible parties personally liable for not remitting withheld payroll taxes. In commenting on a draft of the report, IRS agreed to our recommendations.

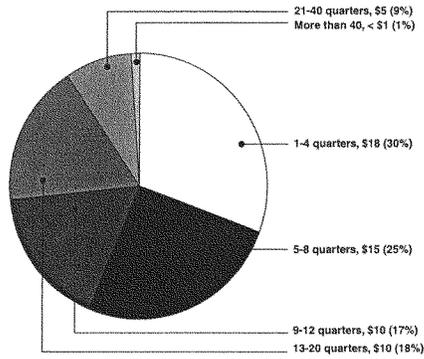
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## Magnitude and Composition of Unpaid Federal Payroll Taxes

While the majority of businesses pay the taxes withheld from employees' salaries as well as the employer's matching amounts, a significant number of businesses do not. Our review of IRS tax records showed that over 1.6 million businesses owed over \$58 billion in unpaid payroll taxes to the federal government as of September 30, 2007, and over 100,000 businesses currently owe for more than 2 years (8 quarters) of payroll taxes. This total includes amounts earned by employees that were withheld from their salaries to satisfy their tax obligations, as well as the employer's matching amounts, but which the business diverted for other purposes. Many of these businesses repeatedly failed to remit amounts withheld from

employees' salaries. For example, 70 percent of all unpaid payroll taxes are owed by businesses with more than a year (4 tax quarters) of unpaid payroll taxes, and over a quarter of unpaid payroll taxes are owed by businesses that have tax debt for more than 3 years (12 tax quarters). Figure 1 shows the total dollar amount of payroll tax debt summarized by the number of unpaid payroll tax quarters outstanding.

**Figure 1: Summary of Payroll Tax Debt Categorized by Number of Tax Quarters Outstanding (dollars in billions)**



Source: GAO analysis of IRS data as of September 30, 2007.

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Using IRS's database of unpaid taxes, we were able to identify many of the industry types associated with businesses owing payroll taxes.<sup>7</sup> The top industries with unpaid payroll tax debt included construction (\$8.6 billion), professional services (\$4.4 billion), and healthcare (\$4 billion).

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**Unpaid Payroll Taxes  
Result in the General Fund  
Subsidizing Social Security  
and Hospital Insurance  
Trust Funds**

When businesses fail to remit taxes withheld from employees' salaries, the payroll tax receipts are less than the payroll taxes due, and the Social Security and Hospital Insurance Trust Funds have fewer financial resources available to cover current and future benefit payments. However, the trust funds are funded based on wage estimates and not actual payroll tax collections. Therefore, the General Fund transfers to the trust funds amounts that should be collected but are not necessarily collected, resulting in the General Fund subsidizing the trust funds for amounts IRS is unable to collect in payroll taxes from employers. As of November 1, 2007, IRS estimated that the amount of unpaid taxes and interest attributable to Social Security and Hospital Insurance taxes in IRS's \$282 billion unpaid assessments balance was approximately \$44 billion. This estimate represents a snapshot of the amount that needed to be provided to the Social Security and Hospital Insurance Trust Funds based on the outstanding payroll tax debt on IRS's books at the time. It does not include an estimate for tax debts that have been written off of IRS's tax records in previous years because of the expiration of the statutory collection period.<sup>8</sup> Recent IRS data indicate that the cumulative shortfall increases by an additional \$2 billion to \$4 billion annually because of uncollected payroll taxes.<sup>9</sup>

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**Collection Status of  
Payroll Tax Debt**

Although IRS has taken a number of steps to improve collections by prioritizing cases with better potential for collectibility, the collection of payroll taxes remains a significant problem for IRS. From 1998, when we

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<sup>7</sup>We analyzed IRS's database of unpaid taxes and the information on the North American Industry Classification (NAIC) system codes in that database. The NAIC system is used by federal statistical agencies in classifying business establishments. Using those codes, we were able to identify the industry type for about 70 percent of the payroll tax debt.

<sup>8</sup>26 U.S.C. § 6502. IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the assessment. The 10-year period can be extended or suspended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period in connection with an installment agreement, bankruptcy litigation, and court appeals.

<sup>9</sup>Because of the statutory limitation, this amount represents an estimate of the subsidy provided over an approximately 10-year period.

performed our last in-depth review of payroll taxes,<sup>10</sup> to September 2007, we found that while the number of businesses with payroll tax debt decreased from 1.8 million to 1.6 million, the balance of outstanding payroll taxes in IRS's inventory of tax debt increased from about \$49 billion to \$58 billion. Our analysis of the unpaid payroll tax inventory shows that the number of businesses with more than 20 quarters of tax debt (5 years of unpaid payroll tax debt) more than doubled between 1998 and 2007. The number of businesses that had not paid payroll taxes for over 40 quarters (10 years or more) increased almost 500 percent, from 86 businesses to 490 businesses. These figures are shown in table 1.

**Table 1: Changes in Payroll Tax Debt, 1998 to 2007**

	As of September 30, 1998	As of September 30, 2007	Percentage Increase
Businesses with over 20 quarters of payroll tax debt	5,367	14,681	174
Businesses with over 40 quarters of payroll tax debt	86	490	470

Source: GAO analysis of IRS data as of September 30, 2007.

Of the \$58 billion in unpaid payroll taxes as of September 30, 2007, IRS categorized about \$4 billion (7 percent) as going through IRS's initial notification process. Because IRS has made the collection of payroll taxes one of its highest priorities, once a case completes the notification process, it is generally sent to IRS's field collections staff for face-to-face collection action. However, IRS does not have sufficient resources to immediately begin collection actions against all of its high-priority cases. As a result, IRS holds a large number of cases in a queue awaiting assignment to a revenue officer in the field. About \$7 billion (12 percent) of the unpaid payroll tax amount was being worked on by IRS revenue officers for collection, and about \$9 billion (16 percent) was in a queue awaiting assignment for collection action. Most of the unpaid payroll tax inventory—\$30 billion (52 percent)—was classified as currently uncollectible by IRS. IRS classifies tax debt cases as currently not collectible for several reasons, including (1) the business owing the taxes is defunct,<sup>11</sup> (2) the business is insolvent after bankruptcy, or (3) the

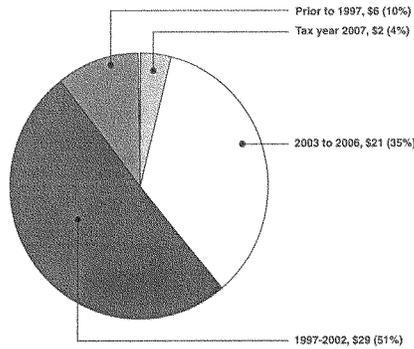
<sup>10</sup>GAO, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AIMD/GGD-99-211 (Washington, D.C., August 2, 1999).

<sup>11</sup>IRS defines a defunct business as one that is inactive and with no leviable assets.

business is experiencing financial hardship. Of those unpaid payroll tax cases IRS has classified as currently not collectible, almost 70 percent were as a result of a business being defunct.

Much of the unpaid payroll tax debt has been outstanding for several years. As reflected in figure 2, our analysis of IRS records shows that over 60 percent of the unpaid payroll taxes was owed for tax periods from 2002 and prior years.<sup>12</sup>

**Figure 2: Summary of Payroll Tax Debt by Tax Year (dollars in billions)**



Source: GAO analysis of IRS data as of September 30, 2007.

Prompt collection action 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.<sup>13</sup> Further, the continued accrual of interest and penalties on the outstanding federal taxes can, over time, eclipse the

<sup>12</sup>The tax period may not always correspond to the age of the tax debt. For example, tax debt may be fairly new even if it is for an earlier tax period when a taxpayer files a tax form years after the due date or when IRS assesses additional taxes for an earlier tax period.

<sup>13</sup>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).

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original tax obligation. Additionally, as discussed previously, IRS is statutorily limited in the length of time it has to collect unpaid taxes—generally 10 years from the date the tax debt is assessed.<sup>14</sup> Once that statutory period expires, IRS can no longer attempt to collect the tax. IRS records indicate that over \$4 billion of unpaid payroll taxes will expire in each of the next several years because of the expiration of their statutory collection period.<sup>15</sup>

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### IRS's Collection Approach Does Not Always Prevent the Accumulation of Unpaid Payroll Taxes

Our audit of payroll tax cases identified several issues that adversely affect IRS's ability to prevent the accumulation of unpaid payroll taxes and to collect these taxes. Foremost is that IRS's approach focuses on getting businesses—even those with dozens of quarters of payroll tax debt—to voluntarily comply. We found that IRS often either did not use certain collection tools, such as liens or TFRPs, or did not use them timely, and that IRS's approach does not treat the business's unpaid payroll taxes and responsible party's penalty assessments as a single collection effort. Additionally, although unpaid payroll taxes is one of its top collection priorities, IRS did not have performance measures to evaluate the collection of unpaid payroll taxes or the related TFRP assessments. Finally, we found some state revenue agencies are using tools to collect or prevent the further accumulation of unpaid taxes that IRS is either legally precluded from using or that it has not yet developed.

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### IRS's Approach Focuses on Voluntary Compliance, Even for Egregious Payroll Tax Offenders

We have previously reported that IRS subordinates the use of some of its collection tools in order to seek voluntary compliance and that IRS's repeated attempts to gain voluntary compliance often results in minimal or no actual collections.<sup>16</sup> Our audit of businesses with payroll tax debt and our analysis of businesses with multiple quarters of unpaid payroll taxes again found revenue officers continuing to work with a business to gain voluntary compliance while the business continued to accumulate unpaid

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<sup>14</sup>26 U.S.C. § 6502.

<sup>15</sup>A certain percentage of unpaid payroll taxes that will expire include taxes due on accounts that have been investigated and determined to be uncollectible. Specifically, the unpaid payroll taxes of an out-of-business and defunct corporation will be reported as currently not collectible and allowed to expire as prescribed by law. IRS may use a TFRP to collect from the responsible individuals.

<sup>16</sup>GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (Washington, D.C.: Feb. 12, 2004).

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payroll taxes. For example, our analysis of IRS's inventory of unpaid payroll taxes found that over 14,000 businesses owed payroll taxes for 20 or more quarters—5 years or more.

Failing to take more aggressive collection actions against businesses that repeatedly fail to remit payroll taxes has a broader impact than on just a single business. If left to accumulate unpaid payroll taxes, businesses can gain an unfair business advantage over their competitors at the expense of the government. As we have found previously,<sup>17</sup> in at least one of our case study businesses, IRS determined that the non-compliant business obtained contracts through its ability to undercut competitors in part because the business's reduced costs associated with its non-payment of payroll taxes. Similarly, in another case the revenue officer noted that the business was underbidding on contracts and was using unpaid payroll taxes to offset the business's losses.

Failure to take prompt actions to prevent the further accumulation of unpaid payroll taxes can also have a detrimental impact on the business and the associated owners/officers. As we have reported in the past, non-compliant businesses can accumulate substantial unpaid taxes as well as associated interest and penalties.<sup>18</sup> Over time, these unpaid balances may compound beyond the business's ability to pay—ultimately placing the business and responsible officers in greater financial jeopardy.

IRS is legally precluded from taking collection actions during certain periods, such as when a tax debtor is involved in bankruptcy proceedings. During those periods, even though IRS may not be able to take collection actions, tax debtors may continue to accumulate additional tax debt. However, IRS's focus on voluntary compliance has negatively affected IRS's collection efforts for years. Our current findings on IRS's focus on voluntary compliance are similar to those of a study performed by the Treasury Inspector General for Tax Administration (TIGTA) 8 years ago. In that study, TIGTA found that revenue officers were focused on IRS's customer service goals and therefore were reluctant to take enforcement

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<sup>17</sup>GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006).

<sup>18</sup>GAO, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 1992).

actions.<sup>19</sup> In another study performed 3 years ago, TIGTA reported that IRS allowed tax debtors to continue to delay taking action on their tax debt by failing to take aggressive collection actions.<sup>20</sup> TIGTA found that IRS did not take timely follow-up action in half of the cases for which tax debtors missed specific deadlines.

One official from a state taxing authority told us that the state benefited from IRS's approach because it allowed the state to collect its unpaid taxes from business tax debtors before IRS. In one of our case study businesses, although IRS successfully levied some financial assets, a mortgage holder and state and local officials seized the business's assets to satisfy the business's debts. IRS has recently strengthened its procedures to include some specific steps for dealing with businesses that repeatedly fail to remit payroll taxes and to stress the importance of preventing the further accumulation of such payroll taxes.

#### IRS Does Not Always File Tax Liens Timely

We found that for payroll tax debt, one of IRS's highest collection priorities, IRS does not always file tax liens to protect the government's interest in property, and when IRS does so, it does not always do so timely. Our analysis of IRS's inventory of unpaid payroll taxes as of September 30, 2007, found that IRS had not filed liens on over one-third of all businesses with payroll tax debt cases assigned to the field for collection efforts—over 140,000 businesses. IRS guidance states that filing a lien is extremely important to protect the interests of the federal government, creditors, and taxpayers in general, and that the failure to file and properly record a federal tax lien may jeopardize the federal government's priority right against other creditors.<sup>21</sup> A 2005 IRS study of TFRP cases found that cases where a lien had been filed had more average payments—about a third more—than where a lien had not been filed.<sup>22</sup>

<sup>19</sup>Treasury Inspector General for Tax Administration, *Improvements Are Needed In Resolving In-Business Trust Fund Delinquencies to Prevent Tax Liabilities from Pyramiding*, 2000-30-111 (Washington, D.C.: Aug. 2000).

<sup>20</sup>Treasury Inspector General for Tax Administration, *The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities*, 2005-30-142 (Washington D.C.: Sept. 21, 2005).

<sup>21</sup>The Internal Revenue Service noted that there are a number of factors that serve to delay the filing of a lien, including cases being placed in the queue for extended periods of time.

<sup>22</sup>Internal Revenue Service Small Business /Self Employed (SB/SE) internal research report, *Research Report on the Collectibility of Trust Fund Recovery Penalty (TFRP) Assessments*, 03.01.001.05 (Denver project, Aug. 31, 2005).

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Failure to file a lien can have a negative impact on tax collections. For example, IRS assessed the business owner in one of our case studies a TFRP to hold the owner personally liable for the withheld payroll taxes owed by the business. However, IRS did not assign the assessment to a revenue officer for collection and thus did not file a lien on the owner's property. Because there was no lien filed, the owner was able to sell a vacation home in Florida, and IRS did not collect any of the unpaid taxes from the proceeds of the sale.

As in the case above, IRS's case assignment policy can delay the filing of liens for payroll tax cases. Because payroll tax cases are one of IRS's top collection priorities, once the notification process is complete, IRS routes these cases to revenue officers for face-to-face collection action instead of being routed to the Automated Collection System (ACS)<sup>23</sup> for telephone contact. However, IRS generally places cases in a queue of cases awaiting assignment until a revenue officer is available to work the cases. Cases can be in the queue for extended periods of time awaiting assignment to a revenue officer. For the period that a case is in the queue, revenue officers are not assigned to file liens and take other collection actions.<sup>24</sup> Our analysis found that for all payroll tax cases in the queue awaiting assignment as of September 30, 2007, over 80 percent did not have a lien filed. As a result, lower priority tax cases that go through the ACS process may have liens filed faster than the higher priority payroll tax cases.

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**IRS Does Not Always  
Assess Trust Fund  
Recovery Penalties Timely**

IRS has a powerful tool to hold responsible owners and officers personally liable for unpaid payroll taxes through assessing a TFRP. However, we found that IRS often takes a long time to determine whether to hold the owners/officers of businesses personally liable and, once the decision is made, to actually assess penalties against them for the taxes. In reviewing a sample of TFRP assessments selected as part of our audit of IRS's fiscal year 2007 financial statements, we found that from the time the tax debt was assessed against the business, IRS took over 2 years, on average, to

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<sup>23</sup>The ACS is a telephone contact system through which telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

<sup>24</sup>Cases may move in and out of the queue several times, so some cases may have liens filed even though the business or owner/officer case is currently in the queue.

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assess a TFRP against the business owners/officers.<sup>25</sup> We found that revenue officers, once assigned to a payroll tax case, took an average of over 40 weeks to decide whether to pursue a TFRP against business owners/officers and an additional 40 weeks on average to formally assess the TFRP.<sup>26</sup> For 5 of the 76 sampled cases, we found that IRS took over 4 years to assess the TFRP. We did not attempt to identify how frequently IRS assesses a TFRP against responsible owners/officers. However, in TIGTA's 2005 report on its review of IRS's collection field function, it noted that revenue officers did not begin the TFRP process in over a quarter of the cases it reviewed.<sup>27</sup>

The timely assessment of TFRPs is an important tool in IRS's ability to prevent the continued accumulation of unpaid payroll taxes and to collect these taxes. Once a TFRP is assessed, IRS can take action against both the owners/officers and the business to collect the withheld taxes. For egregious cases, such as some of those in our case studies, taking strong collection actions against the owners' personal assets may be the best way to either get the business to become tax compliant or to convince the owners to close the non-compliant business, thus preventing the further accumulation of unpaid taxes. Failure to timely assess a TFRP can result in businesses continuing to accumulate unpaid payroll taxes and lost opportunities to collect these taxes from the owners/officers of the businesses. For example, one business we reviewed had tax debt from 2000, but IRS did not assess a TFRP against the business's owner until the end of 2004. In the meantime, the owner was drawing an annual salary of about \$300,000 and had sold property valued at over \$800,000. Within 1

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<sup>25</sup>Taxpayers have 60 days from the date of proposed assessment to make an appeal of the TFRP assessment. According to IRS, during the period July 10, 2007, through July 11, 2008, approximately 6 percent of individual TFRP recommendations were sent to Appeals. IRS stated that, on average, its process took 236 days to resolve the appeal. IRS's lengthy appeals process also contributes to long delays in making some TFRP assessments.

<sup>26</sup>The results of this sample, while statistically selected, are not projectible to the universe because the sample was not specifically designed to assess the timeliness of collection actions.

<sup>27</sup>TIGTA's sample included 166 businesses for which a TFRP interview was applicable. TIGTA 2005-90-142.

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month of IRS's assessing the TFRP, the owner closed the business, which by then had accumulated about \$3 million in unpaid taxes.<sup>28</sup>

In September 2007, IRS implemented new requirements to address the timeliness of TFRP assessments. Under the new policy, IRS is now requiring revenue officers to make the determination on whether to pursue a TFRP within 120 days of the case's being assigned and to complete the assessment within 120 days of the determination. However, the revised policy maintains a provision that allows the revenue officer to delay the TFRP determination. Additionally, the policy does not include a requirement for IRS to monitor the new standards for assessing TFRPs.

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**IRS's Approach for  
Businesses and  
Responsible Parties Is  
Inconsistent**

IRS assigns a higher priority to collection efforts against the business with unpaid payroll taxes than against the business's responsible owners/officers. Further, it treats the TFRP assessments as a separate collection effort unrelated to the business tax debt, even though the business payroll tax liabilities and the TFRP assessments are essentially the same tax debt. As a result, once the revenue officer assigned to the business payroll tax case decides to pursue a TFRP against the responsible owners/officers, the TFRP case does not automatically remain with this revenue officer. Accordingly, IRS often does not assign the TFRP assessment to a revenue officer for collection, and when it does, it may not assign it to the same revenue officer who is responsible for collecting unpaid taxes from the business. In reviewing the sample of TFRP assessments selected as part of our audit of IRS's fiscal year 2007 financial statements, we found that half of the TFRP assessments had not been assigned to a revenue officer by the time of our audit.<sup>29</sup> Of those that had been assigned, over half of the TFRP assessments had not been assigned to the same revenue officer who was working the related business case.

Assigning the collection efforts against the business and the TFRP assessments to different revenue officers can result in the responsible

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<sup>28</sup>This example was originally reported in our prior report on GSA contractors, GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006). For this report, we performed additional analysis of the business.

<sup>29</sup>The sample consisted of 76 TFRP payments in 2007. We were able to obtain sufficient data to perform our analysis for 60 percent of the cases in the sample (45 of the 76 cases). We were unable to project these results because the sampling units used for the financial statement audit were payments rather than accounts.

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owners/officers being able to continue to use the business to fund a personal lifestyle while not remitting payroll taxes. For example, in one of our case studies the owner was assessed a TFRP, but continued to draw a six-figure income while not remitting amounts withheld from the salaries of the business's employees. For egregious cases, taking strong collection actions against the owner's personal assets may be a more effective means of either getting the business to be compliant or convincing the owner to close the non-compliant business to prevent the further accumulation of unpaid payroll taxes.

IRS collection officials stated that attempting to assign the same revenue officer both the TFRP assessments and the business payroll tax case for collection would overload the revenue officers with work and result in fewer high-priority payroll tax cases being worked. This view, however, stems from separating the collection efforts of the business and the individual and not considering the business's unpaid payroll taxes and the TFRP assessment as a single case. In essence, the TFRP assessment is the same tax debt as the business's payroll tax debt; the assessment is merely another means through which IRS can attempt to collect the monies withheld from a business's employees for income, Social Security, and Hospital Insurance taxes that were not remitted to the government.<sup>30</sup> This view that the payroll tax debt and the TFRP assessment are essentially the same tax debt is reinforced by IRS's practice of crediting all related parties' accounts whenever a collection is made against either assessment.

Prior studies have found that IRS's practice of assigning TFRP assessments a lower priority than business cases has not been very successful for collecting the unpaid taxes. In its own 2005 study of TFRP cases, IRS reported that it had assessed over \$11.9 billion in TFRP assessments (including interest) between 1996 and 2004, yet had collected only 8 percent of those assessments.

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<sup>30</sup>Under the law, TFRP assessments, while equal to the total amount of the employee's withheld portion of the unpaid payroll taxes, constitute a separate liability from the payroll taxes. However, it is IRS's policy to collect only the amount of the unpaid payroll tax debt, whether from the business, in the form of a TFRP, or a combination of both.

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**IRS's Approach Does Not Prevent Egregious Accumulation of Unpaid Payroll Taxes**

IRS policies have not resulted in effective steps being taken against egregious businesses to prevent the further accumulation of unpaid payroll taxes. Our audit found thousands of businesses that had accumulated more than a dozen tax quarters of unpaid payroll tax debt. IRS policies state that revenue officers must stop businesses from accumulating payroll tax debt and instructs revenue officers to use all appropriate remedies to bring the tax debtor into compliance and to immediately stop any further accumulation of unpaid taxes. IRS policies further state that if routine case actions have not stopped the continued accumulation of unpaid payroll taxes, revenue officers should consider seizing the business's assets or pursuing a TFRP against the responsible parties. However, IRS successfully pursued fewer than 700 seizure actions in fiscal year 2007. We were unable to determine how many of those seizure actions were taken against payroll tax debtors. Regarding TFRPs, as discussed previously, IRS does not always assess the TFRPs timely, and IRS does not prioritize the TFRP assessment against the owner as highly as it does the unpaid payroll taxes of the business. This can result in little collection action being taken against the parties responsible for the failure to remit the withheld payroll taxes.

When a business repeatedly fails to comply after attempts to collect, IRS policies state that the business should be considered an egregious offender and IRS should take aggressive collection actions, including threats of legal action that can culminate in court-ordered injunctions for the business to stop accumulating unpaid payroll taxes or face closure. However, IRS obtained less than 10 injunctions in fiscal year 2007 to stop businesses from accumulating additional payroll taxes. Revenue officers we spoke to believe the injunctive relief process to be too cumbersome to use effectively in its present form.<sup>31</sup> One revenue officer stated that because of the difficulty in carrying out the administrative and judicial process to close a business through injunctive relief, he had not attempted to take such action in over a decade. IRS is taking some action to attempt to address this issue by piloting a Streamline Injunctive Relief Team to identify cases and develop procedures to quickly move a case from administrative procedures to judicial actions. These procedures will be used for the most egregious taxpayers when the revenue officer can establish that additional administrative procedures would be futile.

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<sup>31</sup>IRS's policies place a high standard for seeking an injunction against a business. The policies state that the revenue officer must be able to show irreparable harm and that IRS has no adequate remedy at law other than the injunction.

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Similar to IRS, all of the state tax collection officials we contacted told us that their revenue department's primary goal was to prevent businesses from continuing to flaunt tax laws and to stop them from accumulating additional tax debt. These officials said that after a business had been given a period of time to comply with its current tax obligations and begin paying past taxes, state tax collection officials changed their focus to one of "stopping the bleeding." As such, some have made the policy decision to seek to close non-compliant businesses. To the extent IRS is not taking effective steps to deal with egregious payroll tax offenders that repeatedly fail to comply with the tax laws, businesses may continue to withhold taxes from employees' salaries but divert the funds for other purposes.

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#### IRS's Approach Does Not Measure Effectiveness

Although IRS has made the collection of unpaid payroll taxes one of its top priorities, IRS has not established goals or measures to assess its progress in collecting or preventing the accumulation of payroll tax debt. Performance measurement and monitoring, however, support resource allocation and other policy decisions to improve an agency's operations and the effectiveness of its approach. Performance monitoring can also help an agency by measuring the level of activity (process), the number of actions taken (outputs), or the results of the actions taken (outcomes).

Although IRS does have a broad array of operational management information available to it, we did not identify any specific performance measures associated with payroll taxes or TFRP assessments. While IRS has caseload and other workload reports for local managers (to measure process and outputs), these localized reports are not rolled up to a national level to allow IRS managers to monitor the effectiveness or efficiency of its collection and enforcement efforts. These operational reports do contain information about unpaid payroll and TFRP case assignments, but they are used primarily to monitor workload issues, not program effectiveness. For example, IRS has developed some reports that identify "over-aged" cases (those that have not been resolved within a certain length of time) and that identify businesses that continue to accrue additional payroll tax debt, but these reports are designed for workload management.

To report on its outcomes or the effectiveness of its operations, IRS reports on overall collection statistics and presents that information in the Management Discussion and Analysis section of its annual financial

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statement and in its IRS Data Book.<sup>32</sup> However, IRS does not specifically address unpaid payroll taxes as a part of this reporting. IRS officials stated that they do not have specific lower-level performance measures that target collection actions or collection results for unpaid payroll taxes or TFRP assessments. Such performance measures could be useful to serve as an early warning system to management or as a vehicle for improving IRS's approach or actions.

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#### IRS's Approach Could Benefit from Additional Tools

In our discussions with IRS revenue officers concerning some of the egregious payroll tax offenders included in our case studies, the officers noted that having certain additional tools available to them could allow them to more effectively deal with recalcitrant businesses. In discussions with a number of state tax collection officials, we found that several states had already developed and were effectively using the types of tools IRS revenue officers said would be beneficial to them.

For example, while the Internal Revenue Code prohibits IRS from publicly disclosing federal tax information without taxpayer consent,<sup>33</sup> an increasing number of states—at least 19, including New Jersey, Connecticut, Indiana, Louisiana, and California—are seeking to increase tax collections by publicizing the names of those with delinquent tax bills. In California, a recent law mandates the state to annually publish the names of the top 250 personal and corporate state tax debtors with at least \$100,000 in state tax debt.<sup>34</sup> Public disclosure of tax debtors can be very effective. Just threatening to publish the names of tax offenders can bring some into compliance, while actually appearing on a tax offender list can bring about societal pressure to comply. In California, 26 tax debtors threatened with public disclosure stepped forward to settle their tax debts and thus avoided appearing on the list; in Connecticut, the state claims the public disclosure of tax debtors has resulted in over \$100 million in collections from the first 4 years of the program. The potential public disclosure of tax debtors may also encourage greater tax compliance among the general population of taxpayers to avoid potentially being on the list.

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<sup>32</sup>IRS *Data Book 2007*, Publication 55B (Washington, D.C.: March 2008).

<sup>33</sup>26 U.S.C. § 6103.

<sup>34</sup>Cal. Rev. & Tax. Code § 19195. The listing does not include those who are fighting the tax bills in courts, have sought bankruptcy protection, or have set up payment plans with the state.

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As another example, while IRS has the authority to levy a tax debtor's income and assets when there is a demand for payment and there has been a refusal or an inability to pay by the taxpayer subject to the levy,<sup>35</sup> IRS officials stated that they often have difficulty using levies to collect unpaid payroll taxes. They noted that the levy may be made against funds in a bank account at a certain point in time when little or no funds are available. They also noted, and in our case studies we found, that IRS sometimes has difficulty identifying which banks or financial institutions a tax debtor is using. This is the case because tax debtors will often change financial institutions to avoid IRS levies. However, several states use legal authorities to assist in identifying levy sources. States such as Kentucky, Maryland, Massachusetts, Indiana, and New Jersey have enacted legislation for matching programs or entered into agreements with financial institutions to participate in matching bank account information against state tax debts. This matching allows states to more easily identify potential levy sources and simplifies the financial institution's obligations to respond to multiple levies. IRS is working with at least one state to investigate the potential for this matching, but in our discussions with IRS collection officials they stated that IRS has not sought legislation or agreements with financial institutions.

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### **Businesses Engaged in Abusive and Potentially Criminal Activity Related to the Federal Tax System**

Our analysis of unpaid payroll tax debt found substantial evidence of abusive and potentially criminal activity related to the federal tax system by businesses and their owners or officers. We identified tens of thousands of businesses that filed 10 or more tax returns acknowledging that the business owed payroll taxes, yet failed to remit those taxes to the government. While much of the tax debt may be owed by those with little ability to pay, some abuse the tax system, willfully diverting amounts withheld from their employees' salaries to fund their business operations or their own personal lifestyle.

In addition to owing payroll taxes for multiple tax periods and accumulating tax debt for years, many of the owners and officers of these

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<sup>35</sup>Levy is the legal seizure of the taxpayer's property to satisfy a tax debt. IRS may order a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy. IRS levies against bank accounts, brokerage accounts, or business account receivables are generally one-time levies of amounts in the account at the time the levy is served. However, IRS can also use a "continuous" levy against wages or certain federal payments. IRS officials stated that finding an account with money in it is often a "hit or miss" proposition since they are one-time levies.

businesses are repeat offenders. We identified owners who were involved in multiple businesses, all of which failed to remit payroll taxes as required. In total, IRS records indicate that over 1,500 owners/officers had been found by IRS to be responsible for non-payment of payroll taxes at 3 or more businesses and that 18 business owners/officers were found by IRS to be responsible for not paying the payroll taxes for over 12 separate businesses. It should be noted that these numbers represent only those responsible individuals who IRS found acted willfully in the non-payment of the businesses' payroll taxes and who were assessed TFRPs—these figures do not represent the total number of repeat offenders with respect to non-payment of payroll taxes. Table 2 shows the number of individuals with TFRPs for two or more businesses.

**Table 2: Number of Individuals with Trust Fund Recovery Penalties for Two or More Businesses**

Number of businesses associated with owner/officer	Number of individuals
2	7,716
3	1,011
4	290
5	101
6	60
7-12	72
Over 12	18
<b>Total</b>	<b>9,268</b>

Source: GAO analysis of IRS data as of September 30, 2007.

Our audits and investigations of 50 case study businesses with tax debt found substantial evidence of abuse and potential criminal activity related to the tax system. All of the case studies involved businesses that had withheld taxes from their employees' paychecks and diverted the money to fund business operations or for personal gain. Table 3 shows the results of 12 of the case studies we performed.<sup>36</sup>

<sup>36</sup>IRS noted that in half of the 12 case studies presented here IRS was stayed from collection action for various lengths of time because of factors such as bankruptcy filings. IRS noted that during those periods in which IRS collection action was stayed, some businesses continued to accumulate additional unpaid payroll taxes.

**Table 3: Businesses That Fail To Remit Payroll Taxes**

Case study	Nature of business	Unpaid payroll tax	Comments
1	Automotive	Over \$3.5 million for almost 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• Widely advertised business with dozens of employees.</li> <li>• For last decade the business has not remitted the payroll taxes withheld from its employees, paying less than a quarter of the payroll taxes owed.</li> <li>• For the last 2 years the owner reported making about \$100,000 in salary.</li> <li>• Owner transferred \$1.5 million in property after being assessed a trust fund recovery penalty.</li> <li>• Recently the owner's personal residence sold for over \$600,000.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
2	Health care	Almost \$2.5 million for over 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$500,000 in non-payroll tax debt.</li> <li>• Currently in business with over 100 employees.</li> <li>• IRS stated that the officers consistently avoided IRS action by filing bankruptcy. Business filed for bankruptcy three times, two of which were dismissed.</li> <li>• Around the time of bankruptcy filings, officers made large cash withdraws from the business of about \$700,000.</li> <li>• IRS found two officers of business were paying personal expenses through the business.</li> <li>• One officer purchased luxury vehicles and personal property while business was not remitting payroll taxes.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three officers willful and responsible for not remitting taxes withheld from employees and assessed them a TFRP.</li> </ul>
3	Janitorial	Almost \$500,000 for almost 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$10,000 in non-payroll tax debt.</li> <li>• Business is currently in business.</li> <li>• Owner has an extensive criminal history.</li> <li>• IRS agreed to allow business to pay via an installment agreement, but the payments will cover only a small percentage of the payroll tax debt owed.</li> <li>• Owner owns multiple rental properties and a \$500,000 personal residence.</li> <li>• IRS noted that owner had the ability to pay the tax liability.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
4	Legal services	Over \$500,000 for over 50 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$10,000 in non-payroll tax debt.</li> <li>• Owner is currently in business as a lawyer, but continues to accumulate unpaid payroll taxes.</li> <li>• Owner owes more than \$600,000 on over 10 years of personal taxes, and did not file most recent years' personal tax returns.</li> <li>• Owner has multiple real estate properties, including property on a tropical island.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS notes that owner has the ability to pay, but refuses.</li> </ul>
5	Dentist	Over \$500,000 for over 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$7,000 in non payroll tax debt.</li> <li>• Business is still operating with employees, but for over 15 years it has not remitted all required payroll taxes to IRS.</li> <li>• Owner lives in a large home with acreage valued at over \$700,000. The house is deeded under spouse's name, but spouse's income is insufficient to pay the interest on the mortgage. Owner admits to paying the mortgage.</li> <li>• Owner sold real estate to children for less than market value.</li> <li>• Owner drives a later model luxury vehicle registered under wife's name.</li> <li>• Owner stated he would pay all the business's expenses before paying taxes.</li> <li>• Owner is not compliant with personal taxes, owing over \$500,000.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
6	Consulting	Almost \$1.5 million for over 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$500,000 in non-payroll tax debt.</li> <li>• Business gave owner cash loans.</li> <li>• IRS found that business monies flowed into owner's personal accounts.</li> <li>• Owner has not filed personal tax returns since early 1990s and owes \$400,000 in personal taxes.</li> <li>• Owner has multiple businesses that have not filed returns since 1994.</li> <li>• According to IRS, owner kept changing legal representatives to stall collection efforts with repeated requests for the same information.</li> <li>• Owner sold assets to relative after receiving notice of potential TFRP issued by IRS.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees for this and another business and assessed a TFRP for this and another business.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
7	Manufacturing	Almost \$1.5 million for over 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• IRS revenue officer notes indicate business monies may have been flowing into owner's personal accounts while withheld payroll taxes were not being remitted.</li> <li>• IRS found owner hid business assets in personal name, keeping IRS from seizing them.</li> <li>• Owner is also delinquent on personal taxes.</li> <li>• IRS officials stated that owner used appeals and offers in compromise (OIC) to delay IRS collection efforts.</li> <li>• Owner defaulted on OIC for TFRPs.</li> <li>• IRS found owner had underreported tax liabilities for at least one tax quarter.</li> <li>• Business assets given to relative, who used them to start a new business.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees for both this business and assessed a TFRP for both this business and at least two previous businesses.</li> </ul>
8	Construction	Almost \$2.5 million for over 20 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$10,000.</li> <li>• IRS found business was underbidding contracts while using unpaid payroll taxes to subsidize its losses.</li> <li>• Business claimed that if it paid payroll taxes, it would be unable to pay employees or other business expenses and would have to close.</li> <li>• Business has not filed taxes for all tax quarters.</li> <li>• IRS considered, but did not pursue, business for fraud charges.</li> <li>• Business/owners have received four civil judgments against it/them and almost 20 liens.</li> <li>• Revenue officer notes state that the owners have repeatedly taken steps to avoid IRS collection action including the following: filed bankruptcy (which was dismissed), filed appeals against liens, requested abatements of penalties (which were denied), appealed the denial (which was sustained by Appeals), submitted a request for installment agreement (which was denied as being insufficient), then appealed the denial of the installment agreement (which was upheld by Appeals), "and every other conceivable action to delay or hinder IRS's collection efforts."</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>
9	Manufacturing	Almost \$1 million for almost 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$400,000 in non-payroll tax debt.</li> <li>• Owners and business investigated for bankruptcy fraud.</li> <li>• Revenue officer stated the business was a "sweat shop."</li> <li>• IRS found owner had closed several businesses with tax debt when investigated by IRS and opened new ones.</li> <li>• Business has not filed payroll returns since late 2005.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found two owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
10	Health care	Over \$8 million for nearly 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$20,000 in non-payroll tax debt.</li> <li>• Although owner has luxury cars and a multimillion dollar home, he claimed inability to pay taxes due to financial hardship.</li> <li>• Owner also owed city and state government agencies for taxes.</li> <li>• One commercial creditor seized and sold some of owner's assets to satisfy debts.</li> <li>• Owner has pled guilty to and was incarcerated for fraud and the business and owner together have almost 100 judgments and liens filed against them.</li> <li>• Owner evaded IRS levies by using check cashing businesses and continued to write checks out to himself.</li> <li>• A relative purchased a commercial building that had been sold to satisfy owner's debts, and the owner has since set up another business therein.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found the owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
11	Construction	Almost \$2.5 million for over 50 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• Owners owe multimillion dollar tax debt for multiple businesses since the early 2000s, and IRS records indicate that the owners have also under reported personal income.</li> <li>• Financial records indicate business may be guilty of illegal check kiting and money laundering.</li> <li>• Owners have several judgments outstanding and at least 10 lawsuits pending or settled.</li> <li>• IRS officials indicated that the owners consistently stalled collection efforts through such means as using multiple representatives and filing for bankruptcy, which has kept IRS from seizing assets.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found two owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>
12	Transportation	Almost \$1.5 million for over 20 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$100,000.</li> <li>• Business has not filed taxes for all tax quarters.</li> <li>• Business has 17 judgments and state and federal tax liens, while one officer has over 50 such judgments and liens.</li> <li>• Another officer has unpaid personal taxes and IRS has investigated the officer for potential criminal activity.</li> <li>• IRS records indicate the officers commingled business and personal funds and that they consistently evaded personal assessment by refusing to cooperate.</li> <li>• Officers misrepresented tax delinquencies to a potential lender.</li> <li>• Officers investigated by IRS for establishing networks of short-lived corporations that accrue significant tax liabilities and then close, leaving a large amount of uncollectible payroll taxes.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three officers willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>

Source: GAO analysis of IRS data, including unpaid federal tax debt as of September 30, 2007.

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## Concluding Comments

Businesses that withhold money from their employees' salaries are required to hold those funds in trust for the federal government. Willful failure to remit these funds is a breach of that fiduciary responsibility and is a felony offense. A business's repeated failure to remit payroll taxes to the government over long periods of time affects far more than the collection of the unpaid taxes. First, allowing businesses to continue to not remit payroll taxes affects the general public's perception regarding the fairness of the tax system, a perception that may result in lower overall compliance. Second, because of failure of businesses to remit payroll taxes, the burden of funding the nation's commitments, including Social Security and Hospital Insurance Trust Fund payments, falls more heavily on taxpayers who willingly and fully pay their taxes. Third, the failure to remit payroll taxes can give the non-compliant business an unfair competitive advantage because that business can use those funds that should have been remitted for taxes to either lower overall business costs or increase profits. Businesses that fail to remit payroll taxes may also under bid tax-compliant businesses, causing them to lose business and encouraging them to also become non-compliant. Fourth, allowing businesses to continue accumulating unpaid payroll taxes has the effect of subsidizing their business operations, thus enriching tax abusers or prolonging the demise of a failing business. Fifth and last, in an era of growing federal deficits and amidst reports of an increasingly gloomy fiscal outlook, the federal government cannot afford to allow businesses to continue to accumulate unpaid payroll tax debt with little consequence.

For these reasons, it is vital that IRS use the full range of its collection tools against businesses with significant payroll tax debt and have performance measures in place to monitor the effectiveness of IRS's actions to collect and prevent the further accumulation of unpaid payroll taxes. Businesses that continue to accumulate unpaid payroll tax debt despite efforts by IRS to work with them are demonstrating that they are either unwilling or unable to comply with the tax laws. In such cases, because the decision to not file or remit payroll taxes is made by the owners or responsible officers of a business, IRS should consider strong collection action against both the business and the responsible owners or officers to prevent the further accumulation of unpaid payroll taxes and to collect those taxes for which the business and owners have a legal and fiduciary obligation to pay.

IRS faces difficult challenges in balancing the use of aggressive collection actions against taxpayer rights and individuals' livelihoods. However, to the extent IRS does not pursue aggressive collection actions against businesses with multiple quarters of unpaid payroll taxes, there is a

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significant concern as to whether IRS is acting in the best interests of the federal government, the employees of the businesses involved, the perceived fairness of the tax system, or overall compliance with the tax laws. Therefore, it is incumbent upon IRS to revise its approach and develop performance measures that include the appropriate use of the full range of available enforcement tools against egregious offenders to prevent their businesses from accumulating tax debt. It is also incumbent upon IRS to proactively seek out and appropriately implement other tools (particularly those with demonstrated success at the state level) to enhance IRS's ability to prevent the further accumulation of unpaid payroll taxes and to collect those taxes that are owed. Although IRS does need to work with businesses to try to gain voluntary tax compliance, for businesses with demonstrated histories of egregious abuse of the tax system, IRS needs to alter its approach to include focusing on stopping the accumulation of additional unpaid payroll tax debt by egregious businesses.

Our companion report being released today contains six recommendations to IRS to address issues regarding its ability to prevent the further accumulation of unpaid payroll taxes and collect such taxes. The recommendations include (1) developing a process and performance measures to monitor collection actions taken by revenue officers against egregious payroll tax offenders and (2) developing procedures to more timely file notice of federal tax liens against egregious businesses and assess penalties to hold responsible parties personally liable for not remitting withheld payroll taxes.

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Mr. Chairmen and Members of the Subcommittee, this concludes my statement. I would be pleased to answer any questions that you or other members of the committee and subcommittee have at this time.

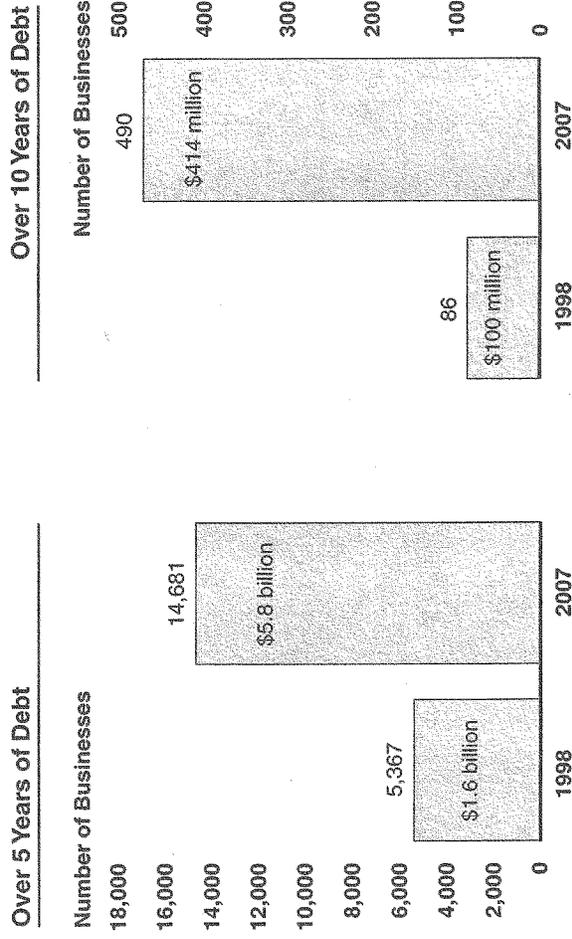
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## Contacts and Acknowledgment

For future contacts regarding this testimony, please contact Steven J. Sebastian at (202) 512-3406 or [sebastians@gao.gov](mailto:sebastians@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony.

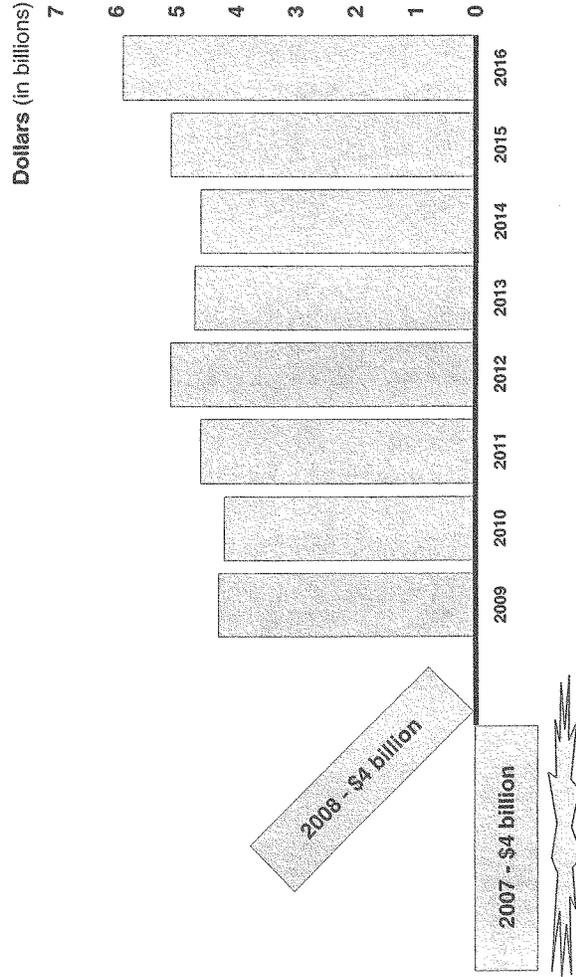


# Increases in Number of Businesses with Multiple Payroll Tax Debts



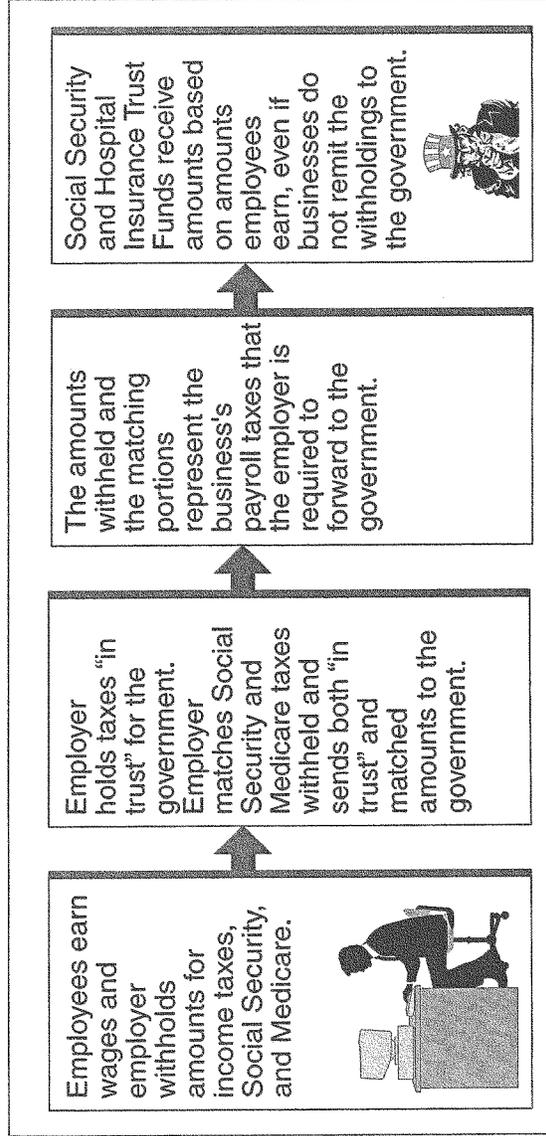
Source: GAO analysis of IRS data as of September 30, 2007.

# Billions in Payroll Tax Debt Will Expire Each Year If Not Collected



Source: GAO analysis of IRS data as of September 30, 2007.

# Payroll Tax Process



July 2008

## TAX COMPLIANCE

# Businesses Owe Billions in Federal Payroll Taxes

**This Report Is Temporarily Restricted Pending  
Official Public Release.**



July 2008

TAX COMPLIANCE

Businesses Owe Billions in Federal Payroll Taxes



Highlights of GAO-08-617, a report to Congressional Committees

**Why GAO Did This Study**

GAO previously reported that federal contractors abuse the tax system with little consequence. While performing those audits, GAO noted that much of the tax abuse involved contractors not remitting to the government payroll taxes that were withheld from salaries.

As a result, GAO was asked to review the Internal Revenue Service's (IRS) processes and procedures to prevent and collect unpaid payroll taxes. Specifically, GAO was asked to determine (1) the magnitude of unpaid federal payroll tax debt, (2) the factors affecting IRS's ability to enforce compliance or pursue collections, and (3) whether some businesses with unpaid payroll taxes are engaged in abusive or potentially criminal activities with regard to the federal tax system. To address these objectives GAO analyzed IRS's tax database, performed case study analyses of payroll tax offenders, and interviewed collection officials from IRS and several states.

**What GAO Recommends**

GAO makes six recommendations to IRS to address issues identified in this report, including development of (1) processes and performance measures to monitor collection actions against egregious payroll tax offenders and (2) procedures to timely file tax liens and assess penalties to hold responsible parties personally liable for not remitting withheld payroll taxes. IRS agreed to our recommendations.

To view the full product, including the scope and methodology, click on GAO-08-617. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

**What GAO Found**

IRS records show that, as of September 30, 2007, over 1.6 million businesses owed over \$58 billion in unpaid federal payroll taxes, including interest and penalties. Some of these businesses took advantage of the existing tax enforcement and administration system to avoid fulfilling or paying federal tax obligations—thus abusing the federal tax system. Over a quarter of payroll taxes are owed by businesses with more than 3 years (12 tax quarters) of unpaid payroll taxes. Some of these business owners repeatedly accumulated tax debt from multiple businesses. For example, IRS found over 1,500 individuals to be responsible for nonpayment of payroll taxes at three or more businesses, and 18 were responsible for not remitting payroll taxes for a dozen different businesses.

Although IRS has powerful tools at its disposal to prevent the further accumulation of unpaid payroll taxes and to collect the taxes that are owed, IRS's current approach does not provide for their full, effective use. IRS's overall approach to collection focuses primarily on gaining voluntary compliance—even for egregious payroll tax offenders—a practice that can result in minimal or no actual collections for these offenders. Additionally, IRS has not always promptly filed liens against businesses to protect the government's interests and has not always taken timely action to hold responsible parties personally liable for unpaid payroll taxes.

GAO selected 50 businesses with payroll tax debt as case studies and found extensive evidence of abuse and potential criminal activity in relation to the federal tax system. The business owners or officers in our case studies diverted payroll tax funds for their own benefit or to help fund business operations.

Examples of Tax-Related Abusive and Potentially Criminal Activity

Business	Unpaid payroll taxes	Activity
Construction	Almost \$2.5 million over 12 years	Potential illegal check kiting and money laundering
Health care	Almost \$2.5 million over 7 years	Officers took large cash withdrawals prior to filing bankruptcy multiple times
Dentist	Over \$500,000 over 10 years	Owner owed over \$500,000 in personal taxes, put property in spouse's name, and sold property to children for less than market value

Sources: GAO analysis of IRS, public, and other records.

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**Abbreviations**

ACS	Automated Collection System
FICA	Federal Insurance Contribution Act
IRC	Internal Revenue Code
IRM	<i>Internal Revenue Manual</i>
IRS	Internal Revenue Service
NAIC	North American Industry Classification
RRA	Restructuring and Reform Act of 1998
TIGTA	Treasury Inspector General for Tax Administration
TFRP	Trust Fund Recovery Penalty

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United States Government Accountability Office  
Washington, DC 20548

July 25, 2008

Congressional Committees

The operations of the Internal Revenue Service (IRS) potentially impact the lives of every American and are critical to the fiscal well being of the federal government. IRS's taxpayer service and enforcement efforts generate 96 percent of the federal revenue for the United States government. In 2007, IRS processed over 230 million tax returns and collected over \$2.7 trillion in taxes. Although the majority of businesses and individuals voluntarily comply with the nation's tax laws, many do not. For those that do not, IRS's enforcement programs collected over \$40 billion in taxes from businesses and individuals in 2007. In spite of these efforts, IRS has a significant gap between what taxpayers should pay and what IRS actually collects. IRS estimates that the annual net tax gap—the amount of taxes that go unidentified and uncollected each year—amounts to nearly \$300 billion.

One of the elements of this tax gap is unpaid payroll taxes. Payroll taxes are amounts employers withhold from employee's wages for federal income taxes, Social Security, and Medicare, as well as the employer's mandatory matching contributions for Social Security and Medicare taxes. In our previous reports and in related testimonies on federal contractors with tax debt,<sup>1</sup> we reported that tens of thousands of federal contractors were not paying billions of dollars in taxes owed and that most of those contractors had failed to remit to the government amounts they had

<sup>1</sup>GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (Washington, D.C.: Feb. 12, 2004); GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-414T (Washington, D.C.: Feb. 12, 2004); 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); GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax Systems with Little Consequence*, GAO-05-683T (Washington, D.C.: June 16, 2005); GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006); GAO, *Medicare: Thousands of Medicare Part B Providers Abuse the Federal Tax System*, GAO-07-587T (Washington, D.C.: Mar. 20, 2007); GAO, *Tax Compliance: Thousands of Federal Contractors Abuse the Federal Tax System*, GAO-07-742T (Washington, D.C.: Apr. 19, 2007); and GAO, *Medicaid: Thousands of Medicaid Providers Abuse the Federal Tax System*, GAO-08-239T (Washington, D.C.: Nov. 14, 2007).

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withheld from their employees' salaries to satisfy their tax obligations. The willful failure to remit payroll taxes is a felony under federal law.<sup>2</sup> Due to the continuing significance of this issue, you asked us to review IRS's overall approach to the prevention and collection of unpaid payroll taxes.

The specific objectives of this report were to determine (1) the magnitude of unpaid federal payroll tax debt, (2) the factors affecting IRS's ability to enforce compliance or pursue collections against businesses with unpaid payroll taxes, and (3) whether some businesses with unpaid payroll taxes are engaged in abusive<sup>3</sup> or potentially criminal activities with regard to the federal tax system.

To meet our objectives, we analyzed IRS's database of unpaid taxes as of September 30, 2007, to determine the magnitude of unpaid payroll taxes and to identify, to the extent possible, owners or officers who repeatedly abused the tax system by not remitting withheld payroll taxes. To determine IRS's procedures to prevent the accumulation of unpaid payroll taxes and to collect such taxes, we reviewed IRS's policies as laid out in its *Internal Revenue Manual* (IRM) and discussed those policies and procedures with cognizant IRS officials and revenue officers. We reviewed a sample of 76 businesses whose owners IRS found personally liable for the failure to remit payroll taxes withheld from employees' paychecks.<sup>4</sup> Although the sample was selected as a part of our audit of IRS's fiscal year 2007 financial statements, for the purposes of this report we reviewed

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<sup>2</sup>26 U.S.C. § 7202.

<sup>3</sup>We considered activity to be abusive when a business'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.

<sup>4</sup>Under section 6672 of the Internal Revenue Code (IRC), individuals who are determined by IRS to be responsible for collecting, accounting for, and paying over payroll taxes who willfully fail to collect or pay these taxes can be assessed a Trust Fund Recovery Penalty (TFRP). This penalty, typically assessed against owners or officers of a corporation, such as a president or treasurer, is assessed for the amount of taxes the business withheld from its employees' salaries but did not remit to the federal government, the so-called trust fund portion of payroll taxes. The business itself is still liable for the entire amount of the unpaid payroll taxes, but IRS can seek collection from the responsible owner/officers for the trust fund portion of the unpaid taxes when they are assessed this penalty.

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those cases to identify the timeliness of IRS's collection actions.<sup>5</sup> To further review IRS's collection actions, we also performed a macro-analysis of IRS's overall inventory of unpaid tax debts. Finally, to determine whether businesses with unpaid payroll taxes were engaged in abusive or potentially criminal activities with regard to the federal tax system, we reviewed documentation on IRS's collection actions and discussed the appropriateness of those actions or the absence of actions with IRS revenue officers for 50 businesses selected as case studies. See appendix I for more detailed information on the scope and methodology of our work. The results of 12 of the 50 case studies we audited are shown in table 3. The results of the other 38 case studies are included in appendix II.

We conducted this performance audit from April 2007 through May 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Results in Brief

While most businesses fulfill their fiduciary responsibility to the government to withhold taxes from their employee's salaries, make matching contributions, and remit these sums to the government, a significant number do not. As of September 30, 2007, IRS's records showed that over 1.6 million businesses owed over \$58 billion in unpaid payroll taxes, including interest and penalties. Of that amount, 70 percent of all unpaid payroll taxes are owed by businesses with more than a year (4 tax quarters) of unpaid federal payroll taxes, and over a quarter of unpaid payroll taxes were owed by businesses that accumulated tax debt for more than 3 years (12 tax quarters). Because unpaid payroll taxes include amounts owed for Social Security and Hospital Insurance (Medicare

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<sup>5</sup>The sample was originally selected as part of our audit of IRS's financial statements, see GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements*, GAO-08-166 (Washington, D.C.: Nov. 9, 2007). The primary purpose of the sample was to determine whether IRS was properly recording payments to all related parties. However, we also performed other tests of IRS's controls using this same sample. Although we identified issues related to IRS's assignment of cases among revenue officers and the timeliness of certain collection actions based upon that sample, we are unable to project these results because the sampling unit used for the financial statement audit was payments rather than accounts.

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Part A) taxes,<sup>6</sup> the federal government may have to transfer higher amounts from the General Fund to the Social Security and Hospital Insurance Trust Funds to make up for the amounts businesses fail to remit. IRS estimated that for the tax debt it had in its inventory of unpaid assessments as of November 1, 2007, the General Fund had transferred \$44 billion to the trust funds over what IRS collected.

IRS has a number of powerful tools at its disposal to prevent the accumulation of unpaid taxes and to collect the taxes that are owed. However, IRS acknowledges that its traditional collection methods do not always bring taxpayers into compliance and that there is a major compliance problem regarding the large number of businesses that repeatedly do not remit payroll taxes. In reviewing IRS's collection actions for egregious payroll tax offenders, we identified several issues that limit the effectiveness of IRS's current approach.

- IRS's overall approach to collection focuses primarily on gaining voluntary compliance, which can allow egregious payroll tax offenders to continue to accumulate payroll tax debt for years that may never be collected.
- IRS is not timely filing liens. Our analysis of IRS's inventory of unpaid payroll tax cases as of September 30, 2007, found that for over a third of all businesses with unpaid payroll taxes assigned to the field, IRS had not filed a lien. Over 80 percent of payroll cases in the queue awaiting assignment did not have a lien filed. Circumstances may not warrant a lien being filed in all cases, such as when businesses are highly leveraged or have few tangible assets. However, for cases in which IRS has not filed a lien, the government's interest in the tax debtor's property is not protected.
- IRS is not timely assessing penalties to individuals responsible for not remitting business's payroll tax debts. IRS has a powerful tool to hold responsible owners and officers personally liable for withheld payroll taxes—a Trust Fund Recovery Penalty (TFRP). We found that, in a sample of 76 TFRP assessments, it took IRS over 40 weeks, on average, to decide to pursue collection against responsible owners/officers and an additional 40 weeks to actually assess the TFRP. Delays in assessing a TFRP can result in lost opportunities to collect unpaid payroll tax debts from the owners/officers while allowing them to continue to use the business to

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<sup>6</sup>These amounts are collected pursuant to the Federal Insurance Contributions Act, 26 U.S.C. ch. 21.

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fund a personal lifestyle through the non-remittance of payroll taxes. We also found that IRS does not place as high a priority on collection efforts against the responsible owners/officers as it does the business, and treats the TFRP as a separate collection effort unrelated to the business.

- IRS actions do not always prevent egregious payroll tax offenders from accumulating additional unpaid payroll tax debt.
- IRS does not have performance measures to establish goals related to the collection and prevention of unpaid payroll taxes and to track its actual performance against these goals.

Further, we found that some states have additional tools they use to collect unpaid taxes at the state level and to help prevent the further accumulation of these unpaid taxes.

- Publishing tax debtor names: An increasing number of states—currently around 19 and the District of Columbia—now publish the names of tax debtors on Web sites as a means of both collecting unpaid taxes and stopping the further accumulation of these taxes. Currently, IRS is prohibited by law from publicly disclosing names of tax debtors in this manner.
- Identifying levy sources: Several states have initiated legislation or entered into agreements with financial institutions to match account information against tax debts, allowing states to more easily identify levy sources to aid in the collection of unpaid taxes.

Our analysis and data mining of IRS tax records indicated that some businesses were involved in abusive or potentially criminal activity related to the tax system. Some of these business owners repeatedly accumulated tax debt from multiple businesses. For example, IRS found over 1,500 individuals to be responsible for non-payment of payroll taxes at 3 or more businesses, and 18 had been found responsible for not remitting payroll taxes for 12 different businesses. We selected 50 businesses with payroll tax debt as case studies. Our analysis of those businesses showed some owners/officers abuse the tax system, willfully diverting amounts withheld from their employees' salaries to fund their business operations or their own personal lifestyle. For example, the owner of one of our case study businesses that owed almost \$2.5 million was under-reporting their personal income and was involved in possible check kiting and money laundering. Another had accumulated almost \$2.5 million in unpaid payroll taxes and made large cash withdrawals prior to filing bankruptcy multiple

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times. A third had accumulated over \$500,000 in unpaid payroll taxes over a 10-year period as well as another \$500,000 in personal taxes. The owner had put property in a spouse's name and sold property to children for less than market value to avoid IRS collection action.

To address the issues identified in this report, we are making six recommendations to the Commissioner of IRS. Five of those recommendations are for IRS to review or revise its collection policies to provide better monitoring or more detailed guidance on collection actions to be taken against egregious payroll tax offenders and to strengthen its existing collection tools. We are also recommending that IRS work with states to develop ways of more effectively identifying potential levy sources. In comments on a draft of this report, IRS concurred with all six of our recommendations and agreed that all appropriate tools must be used to bring payroll tax offenders into compliance. Specifically, IRS agreed to evaluate its existing practices and determine appropriate changes. IRS also said it would work with the states that are matching financial institution accounts to tax debt to identify levy sources to determine whether a similar program in IRS would be cost effective and consistent with privacy laws.

See the "Agency Comments and Our Evaluation" section of this report for a more detailed discussion of agency comments. We have reprinted IRS's written comments in appendix III.

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## 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. Since 1990, we have designated IRS's enforcement of tax laws as a governmentwide high-risk area.<sup>7</sup> In attempting to ensure that taxpayers fulfill their obligations, IRS is challenged on virtually every front. IRS's enforcement workload—measured by the number of tax returns filed—has continually increased, while the number of staff dedicated to collections has not.

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<sup>7</sup>Additionally, we designated IRS's financial management and systems modernization as high-risk areas in 1995. 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 non-compliance—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. GAO, *High-Risk Series, An Update*, GAO-05-207 (Washington, D.C.: January 2005).

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As of September 30, 2007, IRS's master file database of taxpayer accounts reflected about \$282 billion in outstanding taxes owed by businesses and individuals.<sup>8</sup> This amount understates the true cumulative amount of unpaid taxes. For example, IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the assessment.<sup>9</sup> After that period, IRS removes the tax debt from its records. Additionally, the amount of unpaid taxes is understated because many tax debts go unidentified and unrecorded on IRS's tax records due to non-filing or underreporting of tax liabilities. These unidentified and uncollected taxes are part of IRS's estimate of the annual tax gap. Therefore, the true cumulative amount of unpaid taxes would be far higher than \$282 billion.

The amount of unpaid taxes ranges from small amounts owed by individuals for a single tax period<sup>10</sup> to millions of dollars owed by businesses over multiple periods. For businesses, the taxes owed include corporate income, estate, excise, and payroll taxes, as shown in figure 1.

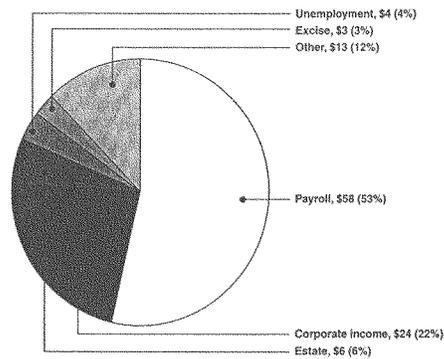
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<sup>8</sup>For financial reporting purposes, IRS reported \$263 billion for the total amount of unpaid taxes. IRS's financial statements reflect a lower amount of tax debt for a number of reasons, including the removal of duplicate tax assessments for multiple officers of a business assessed a TFRP.

<sup>9</sup>26 U.S.C. § 6502. The 10-year period can be extended or suspended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period in connection with an installment agreement, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS's records for decades.

<sup>10</sup>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.

Figure 1: Types of Business Taxes Owed (dollars in billions)



Source: GAO analysis of IRS data as of September 30, 2007.

The total amount of tax debt includes interest and penalties that are added to or accumulate on the original taxes owed.

## Payroll Taxes

Employers are required to withhold from their employees' salaries amounts for individual federal income taxes and for Federal Insurance Contribution Act (FICA) taxes, which includes Old-Age, Survivors and Disability Insurance (Social Security) and Hospital Insurance (Medicare Part A) taxes. In 2007, the FICA taxes to be withheld consisted of 6.2 percent of an employee's gross salary up to \$97,500 for Social Security taxes and an additional 1.45 percent of the gross salary for hospital insurance. Employers are also required to match the amounts withheld from an employee's salary for Social Security and hospital insurance taxes. Taken together, the amounts withheld from an employee's salary for federal individual income and FICA taxes, along with the employer's matching portion of FICA taxes, comprise the business's payroll taxes.<sup>11</sup>

<sup>11</sup>Federal unemployment taxes are also paid by employers. However, these taxes are not included in the unpaid payroll taxes discussed in this report.

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Employers are generally required to remit payroll taxes periodically through the Federal Tax Deposit system. The frequency of those deposits depends on the amount of taxes due and the frequency of the employer's payroll. Employers must remit payroll taxes either (1) semiweekly if their total tax liability is more than \$50,000 during a 12-month period ending June 30 of the prior year or (2) monthly if their total tax liability is \$50,000 or less during this same 12-month period. The business tax liability is reported to IRS either quarterly on Form 941 or annually on Form 944. Additionally, employers are required to report employees' earnings to the Social Security Administration annually.

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#### IRS's Payroll Tax Collection Process

When a business files a tax return indicating that it owes more in payroll taxes than it has deposited, IRS records or assesses the tax liability in its systems. IRS can also identify and assess tax liabilities through its enforcement efforts, such as its examination or nonfiler programs.<sup>12</sup> Once payroll tax debt is assessed and recorded in its database of unpaid taxes, IRS has a number of collection tools at its disposal to attempt to collect from tax debtors who do not voluntarily comply with the tax laws. Each case has unique aspects and therefore may require varying collection methods. However, for payroll tax cases, IRS generally follows a three-step collection process.

- *Step 1—Notification of tax debt*—Once a business fails to remit taxes owed, IRS sends the business a series of notice letters. Business tax debt typically stays in the notification phase about 15 weeks.
- *Step 2—Assignment for collection*—After tax debt leaves the notice phase, it may be placed in a queue awaiting assignment to collection personnel. If a tax debtor already has tax debt being worked on by collections personnel, it will generally bypass the queue and be assigned directly to the collection officer already working to collect the other tax debt. When a case leaves the queue and is assigned to the field for collections, it is first assigned to a manager. The manager has a waiting list of cases held for assignment to individual revenue officers. A case may be assigned to the field, but not be actively worked on because it is awaiting assignment by the manager.

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<sup>12</sup>Under the nonfiler program (26 U.S.C. § 6020(b)) IRS contacts businesses that have not filed tax returns. If they do not respond, for enforcement purposes, IRS independently prepares their tax returns and makes a proposed tax assessment. These assessments are generally based on very limited information.

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- *Step 3—Collection actions*—IRS pursues collection of taxes owed either through direct contact by revenue officers in the field (referred to as the collection field function) or through calls and correspondence by IRS's Automated Collection System (ACS).

IRS's ACS process consists primarily of telephone calls to the tax debtor through IRS's nationwide network of call centers. ACS generally handles less complex and lower priority taxes. Because IRS has designated the collection of payroll taxes as one of its top priorities, payroll tax cases generally do not go through the ACS process. Also, although cases may move through the steps sequentially, it is not necessary that they do so. Cases begin in the notice phase, but they may enter the queue or field collection repeatedly.

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#### IRS's Tax Collection Tools

IRS has numerous enforcement tools that it can use when businesses fail to remit payroll taxes as required. IRS's tools begin with a series of letters sent to the business in the notice phase to encourage voluntary compliance, which, if not accomplished, can lead to the use of increasingly more aggressive or invasive tools, including filing liens or seizing business assets, and filing for court-ordered injunctive relief.

Once assigned a tax debt for collection, the revenue officer will seek to get full payment from the tax debtor. If the tax debtor is unable to pay in full, the revenue officer will seek to get the debtor to agree to a repayment plan, either an installment agreement or an offer-in-compromise.<sup>15</sup> In general, the revenue officer will seek to get the tax debtor to become compliant and voluntarily pay the tax debt without IRS having to take more intrusive collection actions. In fiscal year 2007, IRS collected over \$17 billion of all types of taxes from almost 3 million tax debtors through installment agreements.

If, however, a tax debtor fails to agree to voluntarily pay the tax debt, the revenue officer can increase the invasiveness of their collection efforts and use its three primary tools to achieve compliance and tax collection: lien, levy, or seizure. If those are not successful at bringing a tax debtor into compliance, in certain circumstances, IRS can seek injunctive relief to close a non-compliant business or seek criminal prosecution for failing to

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<sup>15</sup>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.

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pay payroll taxes, particularly if there are indications of fraud. An overview of each of these tools follows.

**Liens**

Among IRS's tools to collect outstanding taxes is its ability to use the property of a taxpayer as security for an outstanding tax debt. This is accomplished by filing a notice of federal tax lien. The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property.<sup>14</sup> Although the tax lien exists under the law even before a notice is filed, the lien is perfected when IRS provides notice of its interest by filing the lien with a designated office, such as a local courthouse in the county where the taxpayer's property is located. If the Service does not file a Notice of Federal Tax Lien (NFTL) with a state or local recording office where the taxpayer's property is situated, the Government will have a more junior position to other creditors who have perfected their judgments or security.<sup>15</sup>

IRS reported filing more than 680,000 tax liens in fiscal year 2007.<sup>16</sup> Since a lien encumbers taxpayer property and because federal tax liens appear on commercial credit reports, IRS's ability to file a lien is a powerful tool in enforcing the tax laws. Filing a lien prevents the taxpayer from selling an asset, with clear title, without first paying off the outstanding tax debt.<sup>17</sup>

**Levies and Seizures**

Levies are legal seizures of tax debtors' assets to satisfy tax delinquencies.<sup>18</sup> A levy is different from a lien in that a lien is a claim used as security for the tax debt, while a levy actually takes the property to satisfy the tax debt. Generally, IRS is authorized to levy property of the tax debtor in the possession of a third party, such as bank accounts, federal

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<sup>14</sup>Under IRC sections 6321 and 6322, a federal tax lien arises by operation of law when the IRS assesses the tax debt and the taxpayer neglects or refuses to pay the liability upon receiving notice and demand for payment. The tax lien encumbers the taxpayer's property or rights to property.

<sup>15</sup>The federal tax lien is not valid against purchasers, holders of security interests, mechanics lienors, and judgment lien creditors until a NFTL has been filed (26 U.S.C. § 6323(a)).

<sup>16</sup>IRS can file multiple liens against a taxpayer to cover property the taxpayer owns in different geographical locations.

<sup>17</sup>Filing a federal tax lien makes it much more difficult for a taxpayer to sell or otherwise dispose of an asset because of the cloud on title created by the notice.

<sup>18</sup>26 U.S.C. § 6331.

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payments, and wages.<sup>19</sup> IRS records indicate that it filed over 3.7 million levy actions against tax debtors for property held by third parties in fiscal year 2007. IRS also may seize and sell real or personal property held directly by the tax debtor, such as business assets like business equipment, cars, or paintings. However, under reforms put in place under the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA),<sup>20</sup> IRS cannot seize assets before determining whether the tax debtor has equity in the property subject to seizure. For example, if an asset is fully encumbered with commercial loans, IRS may not seize the asset. Although IRS records indicate that the number of actions to seize and sell assets held by the tax debtor has been steadily rising over the past several years, reaching 676 seizure actions in fiscal year 2007, the number is far below the over 10,000 seizure actions taken in 1997 prior to the enactment of RRA.<sup>21</sup>

#### Injunctive Relief

In addition to actions it can take to collect unpaid taxes, IRS can also take action to attempt to stop businesses from continuing to accumulate unpaid taxes. One tool IRS has is injunctive relief.<sup>22</sup> Injunctive relief is a court ordered "prohibition of an act." If the act, or practice covered under the court order continues, the business can be found in contempt of court, and IRS can force it to cease operations. The IRM states that injunctive relief is an "extraordinary remedy" used only if previous actions have either been exhausted or it would have been futile to continue. Injunctive relief can be an important tool for IRS when businesses have no equity and therefore are impervious to seizure actions.

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<sup>19</sup>By law, some property cannot be levied or seized. For example, IRS may not seize any of the taxpayer's property when the expense of selling the property would be more than the fair market value of the property. 26 U.S.C. § 6331(f). Other items IRS may not levy or seize include: unemployment benefits; certain annuity and pension benefits; certain service-connected disability payments; workmen's compensation; salary, wages, or income included in a judgment for court-ordered child support payments; and certain public assistance payments. 26 U.S.C. § 6334(a).

<sup>20</sup>Pub. L. No. 105-206, 112 Stat. 685 (July 22, 1998) (pertinent section codified at 26 U.S.C. § 6331(j)).

<sup>21</sup>Section 1203 of RRA required the IRS Commissioner to terminate the employment of employees for misconduct in the seizure of taxpayers' property.

<sup>22</sup>Injunctive relief is a judicial remedy for non-compliance that requires a party either to refrain from certain actions or to perform certain actions. Federal courts have jurisdiction to issue injunctions when necessary to enforce internal revenue laws under section 7402(a) of the IRC.

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To obtain an injunctive relief order, IRS must demonstrate to the court the (1) tax debtor's persistent failure to comply with the law despite IRS's repeated efforts to bring the tax debtor into compliance and (2) likelihood of future violations (i.e., the tax debtor will continue to accumulate tax debt). To gain an injunction, IRS first issues a letter to the tax debtor that includes strong language, including threats of criminal prosecution for failure to comply.<sup>23</sup> The IRM notes that before seeking injunctive relief, the revenue officer should require the business to (1) file monthly employment tax returns (instead of quarterly), (2) establish a separate bank account for payroll taxes withheld, and (3) make all payroll tax deposits to that account within 2 days of paying employees.

#### Criminal Investigations

Although the willful failure to remit payroll taxes is a felony, IRS generally does not pursue a criminal prosecution unless fraud can be determined. In the past, we have reported that some IRS employees believe IRS and the District Counsel are reluctant to pursue prosecution against even egregious offenders.<sup>24</sup>

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#### Trust Fund Recovery Penalty

When businesses withhold funds from an employee's salary for federal income taxes and the employee's FICA obligations, they are deemed to have a fiduciary responsibility to hold these amounts "in trust" for the federal government. To the extent that the business does not forward withholdings to the federal government, it is liable for these amounts, as well as its matching FICA contribution. Officials of the business can also be held personally liable for payment of the withheld amounts.

Under section 6672 of the IRC, individuals who are determined by IRS to be responsible for collecting, accounting for, and paying over payroll taxes who willfully fail to collect or pay this tax can be assessed a TFRP. To show willfulness, IRS must show that the responsible individual was aware of the outstanding taxes and either deliberately chose not to pay the

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<sup>23</sup>This letter, known as the 903 Letter, says in part: "We may file a public notice (federal tax lien) showing that the government has a right to the interest in your property or seize (levy) your property or rights to property to enforce collecting taxes we've determined you owe based on information available to us. Under the law we may charge you criminal penalties, such as a fine up to \$100,000 and up to one year in jail upon conviction, if you don't comply with the special bank deposit requirements. We encourage you to comply with the employment tax deposit rules."

<sup>24</sup>GAO, *Payroll Taxes: Billions in Delinquent Taxes and Penalties Due But Unlikely to Be Collected*, GAO/T-AIMD/GGD-99-256 (Washington, D.C.: Aug. 2, 1999).

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taxes or recklessly disregarded an obvious risk that the taxes would not be paid. It should be noted that the deliberate intent or desire to defraud the federal government is not necessary for IRS to assess a TFRP. For example, an individual, in a business, who is responsible for collecting payroll taxes who decides to pay the business's monthly rent payment instead of remitting employee withholdings to the federal government, can be found to be acting willfully and thus assessed a TFRP. Typically, these responsible individuals are owners or officers of a corporation, such as a president or treasurer.

More than one person may be a "responsible individual" under section 6672, and thus multiple people in the business may be assessed a TFRP. The amounts assessed against each individual can vary depending on an individual's responsibility to collect payroll taxes and the extent of the willful failure to pay over this tax for multiple periods; however, each responsible individual can be assessed a TFRP for the total amount of the withholdings not paid. Additionally, the business itself is still liable for the entire amount of the unpaid payroll taxes. However, it has long been IRS's policy to only collect the unpaid tax once. For example, if, after IRS assesses a TFRP against an officer of a corporation, the business pays the entire balance of the unpaid payroll taxes, the officer would no longer be liable for the TFRP assessment. Similarly, if two officers are each assessed TFRPs related to their business covering the same period of unpaid payroll taxes and one of the officers makes a partial payment, the liabilities of both officers, as well as the liability of the business, are to be reduced by the amount of the payment.

IRS uses the TFRP as a tool to hold owners and other officials associated with a business individually liable for the business's failure to remit withheld payroll taxes. As such, the TFRP provides a means for IRS to seek collection from those responsible for failing to remit the withheld payroll taxes even if the business closes. The TFRP may also be used as a compliance tool to deter future non-payment of taxes by the business. TFRP assessments are also subject to the 10-year statutory collection limitation.

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## A Significant Number of Businesses Are Not Paying Billions of Dollars of Payroll Taxes

Employers are required to withhold from their employees' salaries amounts for both individual federal income taxes and FICA taxes, which include Social Security and Hospital Insurance taxes.<sup>25</sup> While the majority of businesses pay the taxes withheld from employees' salaries as well as the employer's matching amounts, a significant number of businesses do not. Our review of IRS tax records showed that over 1.6 million businesses owed over \$58 billion in unpaid payroll taxes to the federal government as of September 30, 2007. The failure by businesses to remit payroll taxes results in the loss of revenues to the federal government. In addition, it creates a situation in which the general revenue fund subsidizes the Social Security and Hospital Insurance trust funds to the extent that Social Security and Hospital Insurance taxes owed are not collected. Over time, the amount of this shortfall, or subsidy, is significant. IRS estimated that the General Fund has transferred to the trust funds \$44 billion<sup>26</sup> over what IRS collected in self employment and payroll taxes for the inventory of total unpaid taxes on record as of November 1, 2007. The estimate does not include an estimate for tax debts that have been written off of IRS's tax records in previous years due to expiration of the statutory collection period. As a result of the failure of these businesses to pay payroll taxes, the compliant taxpayer bears an increased burden to fund the nation's commitments. Although IRS has made the collection of unpaid payroll taxes one of its top priorities, most of the unpaid payroll tax inventory (52 percent, equal to \$30 billion) was classified as currently uncollectible by IRS. While IRS has assigned about \$7 billion to revenue officers for collection, about \$9 billion of unpaid payroll taxes are in a queue awaiting assignment. Our analysis of the unpaid payroll tax inventory shows that the number of businesses with more than 20 quarters of tax debt (5 years of unpaid payroll tax debt) more than doubled between 1998 and 2007. Because IRS is statutorily limited in the length of time it has to collect unpaid taxes—generally 10 years from the date the tax debt is assessed—

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<sup>25</sup> Amounts transferred by the Department of the Treasury to these trust funds are an estimate of taxes received determined by applying applicable tax rates to wage amounts certified by the Commissioner of Social Security (42 U.S.C. §§ 401, 1395i). Because wage information is provided only quarterly to IRS and only annually to the Social Security Administration, initial distributions to the trust funds are based on estimates prepared by Treasury's Office of Tax Analysis and the Social Security Administration's Office of the Chief Actuary, with adjustments subsequently made as a result of the Commissioner's certifications. Consequently, the amounts distributed to the Social Security and Hospital Insurance trust funds are based on the wages an individual earns, not the amount the employer actually forwards to the government.

<sup>26</sup> Accrued interest is included in this amount because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to IRS's interest accruals.

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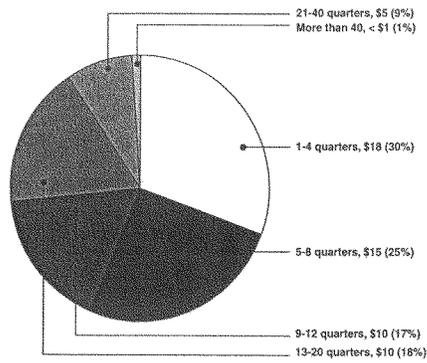
the federal government will lose its right to collect billions of dollars in payroll taxes each year if IRS does not obtain payment from tax debtors before the statutory period for collection expires.

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**Magnitude of Unpaid Payroll Tax Debt**

Of the \$282 billion in cumulative, identified, unpaid taxes owed to the federal government as of September 30, 2007, IRS records show that over \$58 billion (over 20 percent) is owed for unpaid payroll taxes. This total includes amounts, earned by employees, that were withheld from their salaries to satisfy their tax obligations, as well as the employers' matching amounts, but which the business diverted for other purposes. Over 1.6 million businesses have unpaid payroll tax debt. Many of these businesses repeatedly failed to remit amounts withheld from employees' salaries. For example, 70 percent of all unpaid payroll taxes are owed by businesses with more than a year (4 tax quarters) of unpaid payroll taxes, and over a quarter of unpaid payroll taxes are owed by businesses that have tax debt for more than 3 years (12 tax quarters). Figure 2 shows the total dollar amount of payroll tax debt summarized by the number of unpaid payroll tax quarters outstanding.

Figure 2: Summary of Payroll Tax Debt Categorized by Number of Tax Quarters Outstanding (dollars in billions)

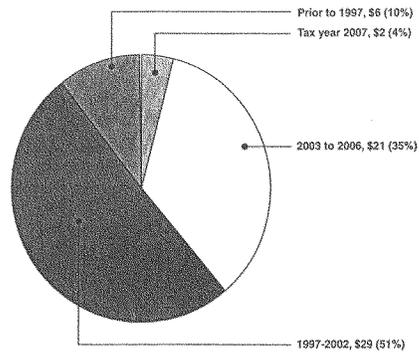


Source: GAO analysis of IRS data as of September 30, 2007.

Much of the unpaid payroll tax debt has been outstanding for several years. As reflected in figure 3, our analysis of IRS records shows that over 60 percent of the unpaid payroll taxes was owed for tax periods from 2002 and prior years.<sup>27</sup>

<sup>27</sup>The tax period may not always correspond to the age of the tax debt. For example, tax debt may be fairly new even if it is for an earlier tax period when a taxpayer files a tax form years after the due date or when IRS assesses additional taxes for an earlier tax period.

Figure 3: Summary of Payroll Tax Debt by Tax Year (dollars in billions)

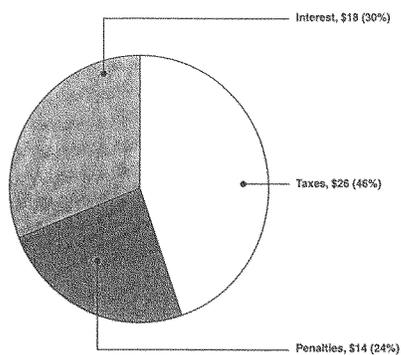


Source: GAO analysis of IRS data as of September 30, 2007.

Prompt collection action 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.<sup>28</sup> Further, the continued accrual of interest and penalties on the outstanding federal taxes can, over time, eclipse the original tax obligation. Figure 4 shows that over half of the unpaid payroll taxes owed is for interest and penalties on the original tax debt.

<sup>28</sup> 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).

Figure 4: Breakdown of Components of Payroll Taxes by the Amount of Unpaid Interest, Tax, and Penalties (dollars in billions)

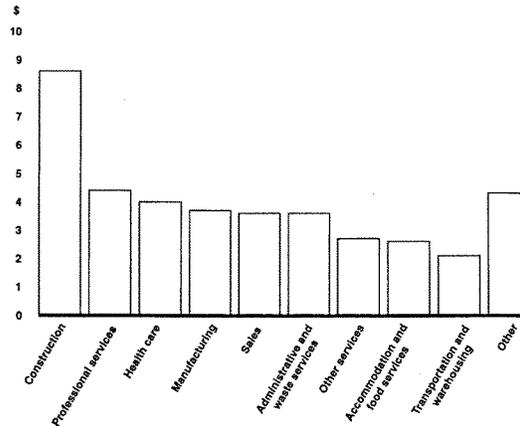


Source: GAO analysis of IRS data as of September 30, 2007.

Using IRS's database of unpaid taxes, we were able to identify many of the industry types associated with businesses owing payroll taxes. Figure 5 presents the major industries with outstanding unpaid payroll taxes according to IRS records.<sup>29</sup>

<sup>29</sup>We analyzed IRS's database of unpaid taxes and the information on the North American Industry Classification (NAIC) system codes in that database. The NAIC system is used by federal statistical agencies in classifying business establishments. Using those codes, we were able to identify the industry type for about 70 percent of the payroll tax debt.

Figure 5: Summary of Unpaid Payroll Taxes by Related Industry (dollars in billions)



Source: GAO analysis of IRS data as of September 30, 2007.

**Unpaid Payroll Taxes Result in the General Fund Subsidizing Social Security and Hospital Insurance Trust Funds**

When businesses fail to remit taxes withheld from employees' salaries, the payroll tax receipts are then less than the payroll taxes due, and the Social Security and Hospital Insurance trust funds will have less financial resources available to cover current and future benefit payments. However, the trust funds are funded based on wage estimates and not actual payroll tax collections. Therefore, the General Fund transfers to the trust funds amounts that should be collected but are not necessarily collected, resulting in the General Fund subsidizing the trust funds for amounts IRS is unable to collect. As of November 1, 2007, IRS estimated that the amount of unpaid taxes and interest attributable to Social Security and hospital insurance taxes in IRS's \$282 billion unpaid assessments

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balance was approximately \$44 billion.<sup>30</sup> This estimate represents a snapshot of the amount that needed to be provided to the Social Security and Hospital Insurance trust funds based on the outstanding tax debt on IRS's books at the time. It does not include an estimate for tax debts that have been written off of IRS's tax records in previous years due to expiration of the statutory collection period.<sup>31</sup> Recent IRS data indicate that the shortfall is about \$2 billion to \$4 billion annually due to uncollected payroll taxes.

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**Collection Status of  
Payroll Tax Debt**

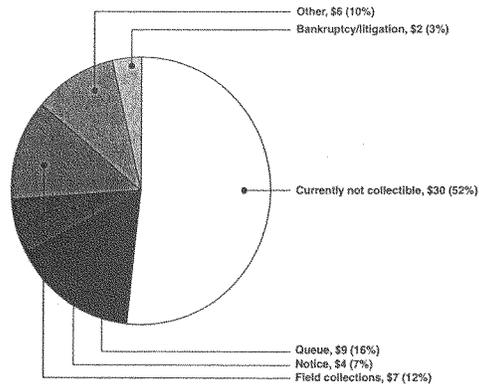
Of the \$58 billion in unpaid payroll taxes as of September 30, 2007, IRS categorized about \$4 billion as going through IRS's initial notification process. The notification process results in significant collections, particularly with respect to generally compliant taxpayers who respond to the notices by paying off the outstanding taxes owed or entering into installment agreements to pay off the tax debt over time. IRS records indicate that over half of all unpaid tax collections result from the notification process. Because IRS has made the collection of payroll taxes one of its highest priorities, once a case completes the notification process, it is generally sent to IRS's field collections staff for face-to-face collection action. However, IRS does not have sufficient resources to immediately begin collection actions against all of its high-priority cases. As a result, IRS holds a large number of cases in a queue awaiting assignment. Of the \$54 billion in unpaid payroll taxes that had completed the notification process, about \$7 billion was being worked on by IRS revenue officers for collection and about \$9 billion was in a queue awaiting assignment for collection action. Most of the unpaid payroll tax inventory was classified as currently uncollectible by IRS. As shown in figure 6, IRS considered \$30 billion—52 percent of all payroll tax debt—to be currently not collectible.

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<sup>30</sup>IRS's \$282 billion in unpaid assessments are as of September 30, 2007. Although the dates of IRS's estimate of total unpaid Social Security and hospital insurance taxes, and IRS's total unpaid assessments, are about 1 month apart, we believe that for comparison purposes it is appropriate. About \$21 billion of the \$44 billion was due to businesses' unpaid payroll taxes, while \$23 billion was the result of unpaid individual self-employment taxes.

<sup>31</sup>Because of its statutory limitation, this amount represents an estimate of the subsidy provided over approximately a 10-year period.

Figure 6: Summary of Payroll Tax Debt by Collection Status (dollars in billions)

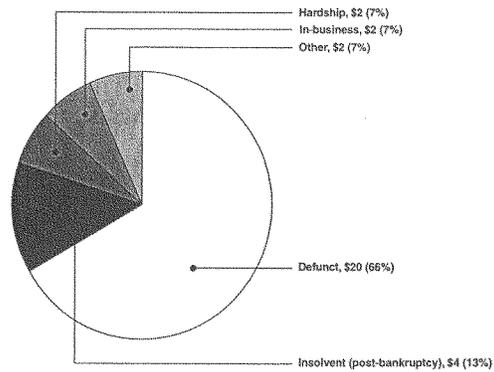


Source: GAO analysis of IRS data as of September 30, 2007.

IRS classifies tax debt cases as currently not collectible for several reasons, including (1) the business owing the taxes is defunct,<sup>32</sup> (2) the business is insolvent after bankruptcy, or (3) the business is experiencing financial hardship. As shown in figure 7, of those unpaid payroll tax cases IRS has classified as currently not collectible, almost two-thirds were as a result of a business being defunct.

<sup>32</sup>IRS defines a defunct business as one that is inactive with no leviable assets.

Figure 7: Summary of Payroll Taxes Considered Currently Not Collectible (dollars in billions)



Source: GAO analysis of IRS data as of September 30, 2007.

Note: The category "in-business" generally refers to a business that IRS deems does not have the resources to pay taxes owed and therefore no further collection will be attempted. Similarly, primarily for sole proprietors, if IRS determines the owner is financially unable to pay taxes, it categorizes both the owner's personal account and the related business as being in financial hardship so that no further collection action is taken against them until their financial condition improves. The "other" designation includes cases in which IRS has been unable to locate or contact the business owing the payroll tax debt.

Although IRS has taken a number of steps to improve collections by prioritizing cases with better potential for collectibility, the collection of payroll taxes remains a significant problem for IRS. From 1998, when we performed our last in-depth review of payroll taxes,<sup>28</sup> to September 2007, we found that while the number of businesses with payroll tax debt decreased from 1.8 million to 1.6 million, the balance of outstanding payroll taxes in IRS's inventory of tax debt increased from about \$49 billion to \$58 billion. Our analysis of the unpaid payroll tax inventory shows that the number of businesses with more than 20 quarters of tax debt (5 years of unpaid payroll tax debt) more than doubled between 1998

<sup>28</sup>GAO, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AMTD/GGD-99-211 (Washington, D.C.: Aug. 2, 1999).

and 2007, from just over 5,000 businesses in 1998 to over 14,000 as of September 30, 2007. The number of businesses that had not paid payroll taxes for over 40 quarters (10 years or more) during this period increased almost 500 percent, from 86 businesses to 490 businesses. These figures are shown in table 1.

**Table 1: Changes In Payroll Tax Debt, 1998 to 2007**

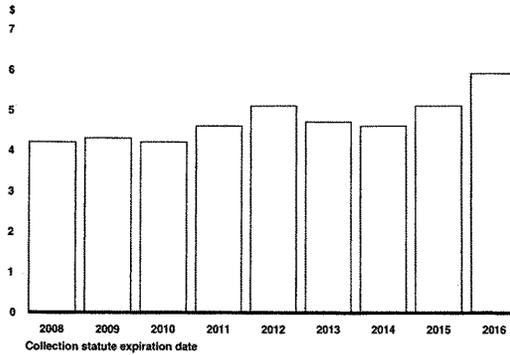
	As of September 30, 1998	As of September 30, 2007	Percentage increase
Businesses with over 20 quarters of payroll tax debt	5,367	14,681	174
Businesses with over 40 quarters of payroll tax debt	86	490	470

Source: GAO analysis of IRS data as of September 30, 2007.

As discussed previously, IRS is statutorily limited in the length of time it has to collect unpaid taxes—generally 10 years from the date the tax debt is assessed.<sup>26</sup> Once that statutory period expires, IRS can no longer attempt to collect the tax. IRS records indicate that over \$4 billion of unpaid payroll taxes will expire in each of the next several years due to this statutory period. Figure 8 shows the amount of unpaid payroll taxes that will statutorily expire and be written off by IRS over the next several years if IRS is unable to collect the taxes.

<sup>26</sup>26 U.S.C. § 6502.

**Figure 8: Summary of Outstanding Payroll Tax Debt by Year of Statutory Collection Period Expiration (dollars in billions)**



Source: GAO analysis of IRS data as of September 30, 2007.

As figure 8 indicates, the federal government will lose its right to collect billions of dollars in payroll taxes each year if IRS does not obtain payment from tax debtors before the statutory period for collection expires.<sup>35</sup>

**IRS's Collection Approach Does Not Always Prevent the Accumulation of Unpaid Payroll Taxes**

Our audit of payroll tax cases identified several issues that adversely affect IRS's ability to prevent the accumulation of unpaid payroll taxes and to collect these taxes. Foremost is that IRS's approach focuses on getting businesses—even those with dozens of quarters of payroll tax debt—to voluntarily comply. We found IRS often either did not use certain collection tools, such as liens or TFRPs, or did not use them timely, and that IRS's approach does not treat the business's unpaid payroll taxes and responsible party's penalty assessments as a single collection effort.

<sup>35</sup> A certain percentage of unpaid payroll taxes that will expire include taxes due on accounts that have been investigated and determined to be uncollectible. Specifically, the unpaid payroll taxes of an out of business and defunct corporation will be reported as currently not collectible and allowed to expire as prescribed by law. IRS may use a TFRP to collect from the responsible individuals.

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Additionally, although unpaid payroll taxes are one of their top collection priorities, IRS did not have performance measures to evaluate the collection of unpaid payroll taxes or the related TFRP assessment. Finally, we found some state revenue agencies are using tools to collect or prevent the further accumulation of unpaid taxes that IRS is either legally precluded from using or which it has not yet developed.

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**IRS's Approach Focuses On Voluntary Compliance, Even for Egregious Payroll Tax Offenders**

As discussed previously, IRS has a number of powerful tools at its disposal to help prevent the accumulation of unpaid taxes and to collect the taxes that are owed. Those tools include the ability to file liens on a tax debtor's property, levy available funds from bank accounts and other financial sources, and seize and sell property owned by the tax debtor to help satisfy the tax debt. However, even with such tools, we found that some businesses continued to accumulate payroll tax debt for dozens of tax quarters. This is partly because IRS's approach to collection focuses first on gaining voluntary compliance, even for more egregious payroll tax offenders. IRS acknowledges that in some instances its collection methods do not bring taxpayers into compliance.

We have previously reported that IRS subordinates the use of some of its collection tools in order to seek voluntary compliance, and that IRS's repeated attempts to gain voluntary compliance often results in minimal or no actual collections.<sup>36</sup> Our audit of businesses with payroll tax debt and our analysis of businesses with multiple quarters of unpaid payroll taxes again found revenue officers continuing to work with a business to gain voluntary compliance while the business continued to accumulate unpaid payroll taxes. As discussed earlier, our analysis of IRS's inventory of unpaid payroll taxes found that over 14,000 businesses owed payroll taxes for 20 or more quarters—5 years or more.

One of our case studies illustrates the extent to which unpaid payroll taxes can accumulate using a voluntary compliance approach for unpaid payroll taxes. In this case, the business was opened in 1994, after its owner closed a similar business that owed payroll taxes. From its inception, the case study business was not compliant with tax laws, making some tax payments, but not filing any of the required tax returns. In July 1999, IRS identified that the business was not filing its required payroll tax returns

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<sup>36</sup>GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-05 (Washington, D.C.: Feb. 12, 2004).

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and assigned the case to a revenue officer for investigation. After working with the business for 5 months, the revenue officer secured 22 quarters of delinquent payroll tax returns. Those returns indicated a total tax debt, including interest and penalties, of almost \$500,000. In March 2000, the business requested to be put on an installment agreement to repay over time the known outstanding taxes it owed. However, the business was not eligible for an installment agreement because it was not compliant with its filing requirements. The revenue officer worked with the business for another 9 months attempting to obtain the financial information needed to initiate an installment agreement. Meanwhile, the business continued to accumulate unpaid payroll tax debt of about \$20,000 each quarter. The revenue officer continued to work with the business to gain voluntary compliance, but the business did not provide the needed financial information until the revenue officer filed levies against the business's known bank accounts in early 2001. The levies resulted in collections of less than \$5,000 toward the unpaid tax debt. After 2-1/2 more years, in August 2003, the revenue officer noted that, though IRS had been seeking compliance for several years, the business was still not compliant with filing requirements, had not provided current financial information, and was generally unresponsive. Although the revenue officer continued to obtain some delinquent tax returns and some payroll tax payments as a result of the officer's efforts, the business continued to accumulate additional tax debt. As of July 2007, the business had accumulated payroll taxes from over 30 quarters totaling almost \$1 million, and other taxes, including business income taxes, of almost \$400,000. Those unpaid taxes stretch back to the inception of the business in 1994. Additionally, the business has not filed required payroll tax returns since the fourth quarter of 2004—potentially accruing a quarter million dollars in additional unpaid payroll tax debt.

Failing to take more aggressive collection actions against businesses that repeatedly fail to remit payroll taxes has a broader impact than on just a single business. If left to accumulate unpaid payroll taxes, businesses gain an unfair business advantage over their competitors at the expense of the government. As we have found previously,<sup>37</sup> in at least one of our case study businesses, IRS determined that the non-compliant business obtained contracts through its ability to undercut competitors due in part to the business's reduced costs associated with its non-payment of payroll

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<sup>37</sup>GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006).

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taxes. Similarly, in another case the revenue officer noted that the business was underbidding on contracts and was using unpaid payroll taxes to offset the business's losses.

Failure to take prompt actions to prevent the further accumulation of unpaid payroll taxes can also have a detrimental impact on the business and the associated owners/officers. As we have reported in the past, non-compliant businesses can accumulate substantial unpaid taxes as well as associated interest and penalties.<sup>38</sup> Over time, these unpaid balances may compound beyond the business's ability to pay—ultimately placing the business and responsible officers in greater financial jeopardy.

It should be noted that IRS is legally precluded from taking collection actions during certain periods, such as when a tax debtor is involved in bankruptcy proceedings. During those periods, even though IRS may not be able to take collection actions, tax debtors may continue to accumulate additional tax debt. However, IRS's focus on voluntary compliance has negatively affected IRS's collection efforts for years. Our current findings on IRS's focus on voluntary compliance are similar to those of the Treasury Inspector General for Tax Administration (TIGTA) in a study from 8 years ago. In its 2000 study, TIGTA found that revenue officers were focused on IRS's customer service goals and therefore were reluctant to take enforcement actions. As a result, they continued to work with tax debtors to gain voluntary payment rather than using more aggressive enforcement tools such as levies or seizures. TIGTA found that in 116 cases they reviewed, revenue officers did not file a lien, issue a summons, or levy or seize assets in almost a third of the cases. Revenue officers considered seizing assets in just 3 of the 116 cases, but actually seized assets in just 1 case.<sup>39</sup> TIGTA also reported that as a result of IRS not taking effective collection actions, the cases (while under review by TIGTA) accrued more unpaid taxes while assigned to revenue officers than the revenue officers were able to collect. Again in 2005, TIGTA reported that IRS allowed tax debtors to continue to delay taking action

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<sup>38</sup> GAO, Tax Administration: IRS's Efforts to Improve Compliance with Employment Tax Requirements Should Be Evaluated, GAO-02-92 (Washington, D.C.: Jan. 15, 1992).

<sup>39</sup> Treasury Inspector General for Tax Administration, *Improvements Are Needed In Resolving In-Business Trust Fund Delinquencies to Prevent Tax Liabilities from Pyramiding*, 2000-30-111 (Washington, D.C.: August 2000).

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on their tax debt by failing to take aggressive collection actions.<sup>40</sup> TIGTA found that IRS did not take timely follow-up action for half of the cases for which tax debtors missed specific deadlines.

IRS has recently strengthened its IRM to include some specific steps for dealing with businesses that repeatedly fail to remit payroll taxes and to stress the importance of preventing the further accumulation of unpaid payroll taxes. The revised IRM advises revenue officers to take all appropriate remedies to bring the tax debtor into compliance and that they should consider seizing assets and pursuing TFRP assessments against responsible parties. It is important for IRS to support taxpayers in remaining compliant and to facilitate businesses becoming compliant; however, having a primary focus on voluntary compliance can lead to delays in taking stronger actions against flagrant tax debtors who refuse to comply with the tax laws and accumulate dozens of quarters of payroll tax debt. Having a reticence to use enforcement tools may, over time, actually diminish voluntary compliance and collections. IRS's guidance states that businesses that fail to comply with the tax law jeopardize the public perception of tax enforcement, which has a detrimental effect both on compliance and collections.

One official from a state taxing authority told us that the state benefited from IRS's approach because it allowed the state to collect its unpaid taxes from business tax debtors before IRS. In one of our case study businesses, although IRS successfully levied some financial assets, a mortgage holder and state and local officials seized the business's assets to satisfy the business's debts. In another case, IRS did not seize assets, but received some collections because local officials seized and sold the business owner's house. We noted this issue in our previous report on DOD contractors with tax debt.<sup>41</sup>

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#### IRS's Approach Can Result in Delayed Enforcement Actions

In reviewing specific collection actions taken by IRS, we found that revenue officers often did not timely take basic steps to protect the government's interest in a tax debtor's property by filing a lien or to hold the business's owners and officers personally responsible for willfully

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<sup>40</sup>Treasury Inspector General for Tax Administration, *The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities*, 2005-30-142 (Washington D.C.: Sept. 21, 2005).

<sup>41</sup>GAO-04-95.

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failing to remit withheld payroll taxes. Our analysis indicated that IRS had not filed a lien to protect the government's interest in a business property in over 30 percent of all payroll tax cases assigned to the field for collection effort. Additionally, our review of recent IRS actions to assess TFRPs against owners/officers of businesses with payroll tax debt found that revenue officers took 40 weeks on average to determine that a TFRP should be assessed and an additional 40 weeks on average to actually assess the penalty.

Failure to take timely action to file liens or assess TFRPs has been a long-standing problem. In 2005, TIGTA reported that IRS's revenue officers often failed to take timely collection actions on payroll tax cases and concluded that not taking timely and aggressive collection actions on cases allowed businesses to continue to accumulate unpaid payroll taxes.<sup>42</sup> IRS's own analysis of TFRP assessments, also done in 2005, found that less than half of all TFRP cases had a lien filed to protect the interest of the government.<sup>43</sup>

#### IRS Does Not Always File Tax Liens Timely

Our audit found that for payroll tax debt, one of its highest collection priorities, IRS does not always file liens to protect the government's interest in property and, when it does so, it does not always do so timely. Our analysis of IRS's inventory of unpaid payroll taxes as of September 30, 2007, found that IRS had not filed liens on over one-third of all businesses with payroll tax debt cases assigned to the field for collection efforts – over 140,000 businesses. IRS guidance states that filing a lien is extremely important to protect the interests of the federal government, creditors, and taxpayers in general, and that the failure to file and properly record a federal tax lien may jeopardize the federal government's priority right against other creditors.<sup>44</sup>

The ability to file a tax lien in the public records is a powerful tool for IRS. The lien appears on credit reports for both individuals and businesses and

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<sup>42</sup>Treasury Inspector General for Tax Administration, *The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities*, 2005-30-142 (Washington D.C.: Sept. 21, 2005).

<sup>43</sup>Internal Revenue Service Small Business /Self Employed (SB/SE) internal research report, *Research Report on the Collectibility of Trust Fund Recovery Penalty (TFRP) Assessments*, 03.01.001.05 (Denver project, Aug. 31, 2005).

<sup>44</sup>Internal Revenue Service noted that there are a number of factors that serve to delay the filing of a lien, including cases being placed in the queue for extended periods of time.

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can stay there for approximately 10 years. For an individual, the presence of a tax lien can make it more difficult to obtain credit, in turn making it more difficult to buy a home, rent an apartment, or buy a car. Tax debtors that are able to get credit may have to pay higher credit rates. For businesses, the presence of a tax lien can result in a creditor no longer shipping inventory unless paid for by cash and banks withdrawing lines of credit. This can ultimately cause businesses to fail. Lien filing may also increase the likelihood of collection by IRS. The 2005 IRS study of TFRP cases found that cases where a lien had been filed had more average payments—about a third more—than where a lien had not been filed.<sup>46</sup>

Although the IRM does not explicitly state that liens should be filed, it does emphasize the need to do so to protect the interest of the federal government. Because businesses may be highly leveraged or have few tangible assets, the filing of a lien may not always be advantageous to the government; other situations may also make it counterproductive to file a lien. The IRM does allow revenue officers to not file a lien in order to allow a business to obtain a loan or to otherwise continue operating so that the business may become compliant and pay the past due tax debt. However, failure to file a lien can have a negative impact on tax collections. For example, IRS assessed the business owner in one of our case studies a TFRP to hold the owner personally liable for the withheld payroll taxes owed by the business. However, IRS did not assign the assessment to a revenue officer for collection, and thus did not file a Notice of Federal Tax Lien on the owner's property. Because there was no lien filed, the owner was able to sell a vacation home in Florida and IRS did not collect any of the unpaid taxes from the proceeds of the sale.

As in the case above, IRS's case assignment policy can delay the filing of liens for payroll tax cases. Because payroll tax cases are one of IRS's top collection priorities, once the notification process is complete, IRS bypasses its ACS process and routes these cases to revenue officers for collection. However, IRS generally must place cases in a queue until a revenue officer is available to work the cases. Cases can be in the queue for extended periods of time awaiting assignment. For the period that a case is in the queue, revenue officers are not assigned to file liens and take

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<sup>46</sup>Internal Revenue Service Small Business /Self Employed (SB/SE) internal research report, *Research Report on the Collectibility of Trust Fund Recovery Penalty (TFRP) Assessments*, 03.01.001.05 (Denver project, Aug. 31, 2005).

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other collection actions.<sup>46</sup> Our analysis found that for the \$9 billion of payroll tax cases in the queue awaiting assignment as of September 30, 2007, over 80 percent of the cases did not have a lien filed. As a result, lower priority tax cases that go through the ACS process may have liens filed faster than the higher priority payroll tax cases.

IRS has been aware of this issue. Its own study in 2005 found less than half of payroll tax cases in which IRS assessed the business owner or officer a TFRP had a lien filed to protect the interest of the government, and only 27 percent of TFRP assessments that were under a year old had a lien filed. As the previously discussed case study illustrates, the timeliness of lien filing is critical in such cases to protect the government's interest in the owner's personal property and to encourage the owners/officers to make the business compliant.

IRS is taking some steps to address these issues. For example, IRS is investigating the feasibility of routing payroll tax cases that might otherwise be sent to the queue through the ACS process to have a lien filed. Additionally, in recent years IRS has begun to put in the IRM timeliness guidelines for the use of certain collection tools, including lien filings. The IRM now calls for revenue officers to make a determination to file a lien within 10 days of initial contact. These are positive steps which could help improve the timeliness of IRS's lien filings in the future. However, while not all cases warrant having a lien filed, our analysis has shown that, overall, 60 percent of all unpaid payroll tax cases currently in IRS's inventory do not have a lien filed to protect the government's interest in tax debtors' property.

**IRS Does Not Always Assess  
Trust Fund Recovery Penalties  
Timely**

Although IRS has a powerful tool to hold responsible owners and officers personally liable for unpaid payroll taxes through assessing a TFRP, we found that IRS often takes a long time to determine whether to hold the owners/officers of businesses personally liable and, once the decision is made, to actually assess penalties against them for the taxes. In reviewing the sample of TFRP assessments selected as part of our audit of IRS's fiscal year 2007 financial statements, we found that from the time the tax debt was assessed against the business, IRS took over 2 years, on average,

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<sup>46</sup>Cases may move in and out of the queue several times, so some cases may have liens filed even though the business or owner/officer case is currently in the queue.

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to assess a TFRP against the business owners/officers.<sup>47</sup> We found that revenue officers, once assigned to a payroll tax case, took an average of over 40 weeks to decide whether to pursue a TFRP against business owners/officers and an additional 40 weeks on average to formally assess the TFRP.<sup>48</sup> For 5 of the 76 sampled cases, IRS took over 4 years to assess the TFRP. We did not attempt to identify how frequently IRS assesses a TFRP against responsible owners/officers. However, in TIGTA's 2005 report on its review of IRS's collection field function, it noted that for cases where a TFRP was applicable, revenue officers did not initiate or conduct the interview to begin the TFRP process in over a quarter of the cases TIGTA reviewed.<sup>49</sup>

The timely assessment of TFRPs is an important tool in IRS's ability to prevent the continued accumulation of unpaid payroll taxes and to collect these taxes. Once a TFRP is assessed, IRS can take action against both the owners/officers and the business to collect the withheld taxes. For egregious cases, such as some of those in our case studies, taking strong collection actions against the owners' personal assets may be the best way to either get the business to become tax compliant or to convince the owners to close the business, thus preventing the further accumulation of unpaid taxes. Failure to timely assess a TFRP can result in businesses continuing to accumulate unpaid payroll taxes and lost opportunities to collect these taxes from the owners/officers of the businesses. For example, one business had tax debt from 2000, but IRS did not assess a TFRP against the business's owner until the end of 2004. In the meantime, the owner was drawing an annual salary of about \$300,000 and had sold property valued at over \$800,000. Within 1 month of IRS assessing the

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<sup>47</sup>Taxpayers have 60 days from the date of proposed assessment to make an appeal of the TFRP assessment. According to IRS, during the period July 10, 2007 through July 11, 2008, approximately 6.1% individual TFRP recommendations were sent to Appeals. IRS stated that, on average, its process took 236 days to resolve the appeal. IRS's lengthy appeals process also contributes to long delays in making some TFRP assessments.

<sup>48</sup>The results of this sample, while statistically selected, are not projectible to the universe because the sample was not specifically designed to assess the timeliness of collection actions.

<sup>49</sup>Treasury Inspector General for Tax Administration's sample included 166 businesses for which a TFRP interview was applicable. TIGTA 2005-30-142.

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TFRP, the owner closed the business, which by then had accumulated about \$3 million in unpaid taxes.<sup>60</sup>

Lack of timeliness in assessing TFRPs has been a long-standing problem for IRS. Our annual audit of IRS's financial statements in the late 1990's identified this problem and we made recommendations for IRS to analyze and determine the factors causing delays in both processing and recording TFRP assessments. Although IRS has taken many steps to improve the timeliness of TFRP assessments, such as centralizing TFRP assessment processing and implementing a new Web-based application, these actions have not been fully effective in resolving this issue. During our audit of IRS's fiscal year 2007 financial statements, we continued to find long delays in IRS's processing and posting of TFRP assessments.<sup>61</sup>

For most of the time our case study businesses were being worked on by revenue officers, the IRM required them to make a determination of whether to pursue a TFRP assessment within 180 days—about 26 weeks. However, the IRM was silent about how long it should take to actually assess the TFRP once revenue officers determined that the failure by the responsible individuals to remit payroll taxes was willful. Additionally, although IRS had a 180-day requirement to make a determination, revenue officers could make the determination to delay the assessment, thus making a timely determination while still not moving forward to formally assess the TFRP against the responsible individuals.

In September 2007, IRS implemented new IRM requirements to address the timeliness of TFRP assessments. Under the new policy, revenue officers are now required to make the determination as to whether to pursue a TFRP within 120 days of the case being assigned and to complete the assessment within 120 days of the determination. However, the revised IRM maintains the provision to allow the revenue officer, with manager authorization, to delay the TFRP determination. Additionally, the IRM does not include a requirement for IRS to monitor the new IRM standards for assessing TFRPs.

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<sup>60</sup>This example was originally reported in our prior report on GSA contractors, GAO, *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, GAO-06-492T (Washington, D.C.: Mar. 14, 2006). For this report, we performed additional analysis of the business.

<sup>61</sup>GAO-08-166.

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IRS's Approach for  
Businesses and  
Responsible Parties Is  
Inconsistent

IRS assigns a higher priority to collection efforts against the business with unpaid payroll taxes than against the business's responsible owners/officers. Further, it treats the TFRP assessments as a separate collection effort unrelated to the business tax debt, even though the business payroll tax liabilities and the TFRP assessments are essentially the same tax debt. As a result, once the revenue officer assigned to the business payroll tax case decides to pursue a TFRP against the responsible owners/officers, the TFRP case does not automatically remain with this revenue officer. Accordingly, IRS often does not assign the TFRP assessment to a revenue officer for collection, and when it does, it may not assign it to the same revenue officer that is responsible for collecting unpaid taxes from the business. In reviewing the sample of TFRP assessments selected as part of our audit of IRS's fiscal year 2007 financial statements, we found that half of the TFRP assessments had not been assigned to a revenue officer by the time of our audit.<sup>85</sup> Of those that had been assigned, over half of the TFRP assessments had not been assigned to the same revenue officer that was working the related business case.

Assigning the collection efforts against the business and the TFRP assessments to different revenue officers can result in the responsible owners/officers being able to continue to use the business to fund a personal lifestyle while not remitting payroll taxes. For example, in one of our case studies the owner was assessed a TFRP, but continued to draw a six-figure income while not remitting amounts withheld from the salaries of the business's employees.

In contrast, having either a single revenue officer assigned or coordinating the efforts of multiple revenue officers could provide IRS with several advantages, including the following:

- For egregious cases, taking strong collection actions against the owner's personal assets may be a more effective means of either getting the business to be compliant or convincing the owner to close the unprofitable business to prevent the further accumulation of unpaid payroll taxes.
- Assigning a single revenue officer could expedite the assignment of TFRP assessments and collection efforts against those cases. For example, one

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<sup>85</sup>The sample consisted of 76 TFRP payments in 2007. We were able to obtain sufficient data to perform our analysis for 60 percent of the cases in the sample (45 of the 76 cases). We were unable to project these results because the sampling units used for the financial statement audit were payments rather than accounts.

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of our case study businesses was assessed a TFRP, but since the TFRP had a lower priority, it was sent to the queue. Because the case had not been assigned, IRS did not file a tax lien on the owner of the business and thus the assessment of the TFRP had very little impact. Additionally, since IRS has a statutory time limitation to collect against a tax debt, this owner was almost half-way through the statutory period before the case was ever worked on.

- Assigning a single revenue officer could help improve IRS's ability to ensure assessments are made, transaction codes are input, and collections are properly posted against trust fund amounts to all related parties, a long-standing problem identified as a part of our financial statement audits.<sup>53</sup>

IRS collection officials said the agency categorizes the unpaid payroll tax debt of the business as a high priority to ensure that higher-level revenue officers are assigned mainly to the more complex business cases.<sup>54</sup> IRS may also assign the business payroll tax debt and the TFRP assessment to different collection officials because the business and the responsible owners/officers are not located in the same zip code area. For example, if an officer is in a different state than the business, the collection efforts would be handled by separate officials to facilitate face-to-face collection efforts and to allow the revenue officer to physically go to courthouses to perform property searches. IRS collection officials also stated that attempting to assign the same revenue officer both the TFRP assessments and the business payroll tax case for collection would overload the revenue officers with work and result in fewer high-priority payroll tax cases being worked on. This view, however, stems from separating the collection efforts of the business and the individual and not considering the business's unpaid payroll taxes and the TFRP assessment as a single case. In essence, the TFRP assessment is the same tax debt as the business's payroll tax debt; the assessment is merely another means through which IRS can attempt to collect the monies withheld from a business's employees for income, Social Security, and hospital insurance

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<sup>53</sup>GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements*, GAO-08-166 (Washington, D.C.: Nov. 9, 2007).

<sup>54</sup>IRS officials told us that IRS's procedures allow the revenue officer in charge of the business case to take control of the collection efforts of the related owners/officers so long as the revenue officer and owners/officers are in the same assignment area (usually a zip code).

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taxes that were not remitted to the government.<sup>55</sup> This view that the payroll tax debt and the TFRP assessment are essentially the same tax debt is reinforced by IRS's own practice of crediting all related parties' accounts whenever a collection is made against either assessment.

Prior studies have found that IRS's practice of assigning TFRP assessments a lower priority than business cases has not been very successful for collecting the unpaid taxes. In its own August 2005 study, IRS reported that it had assessed over \$11.9 billion in TFRP assessments (including interest) between 1996 and 2004, yet had collected only 8 percent of those assessments. IRS reported that for those assessments made in 1996, for which IRS had been attempting collection for at least 8 years, the collection rate was only 13 percent. For all responsible owners/officers that were assessed a TFRP, 43 percent never made a payment on their trust fund penalty. IRS reported that of those TFRP assessments that had been resolved, almost half were resolved in the first year of the assessment, and almost 93 percent were resolved in the first 4 years.<sup>56</sup>

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**IRS's Approach Does Not Prevent Egregious Accumulation of Unpaid Payroll Taxes**

IRS policies have not resulted in effective steps being taken against egregious businesses to prevent the further accumulation of unpaid payroll taxes. Our audit found thousands of businesses that had accumulated more than a dozen tax quarters of unpaid payroll tax debt. The IRM states that revenue officers must stop businesses from accumulating payroll tax debt, and instructs revenue officers to use all appropriate remedies to bring the tax debtor into compliance and to immediately stop any further accumulation of unpaid taxes. It further states that if routine case actions have not stopped the continued accumulation of unpaid payroll taxes, revenue officers should consider seizing the business's assets or pursuing a TFRP against the responsible parties. However, IRS successfully pursued less than 700 seizure actions in fiscal year 2007. We were unable to determine how many of those seizure actions were taken against payroll tax debtors. Regarding TFRPs, as discussed previously, IRS does not always assess the TFRPs timely and

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<sup>55</sup>Under the law, TFRP assessments, while equal to the total amount of unpaid payroll taxes, constitute a separate liability from the payroll taxes. However, it is IRS's policy to collect only the amount of the unpaid payroll tax debt, whether from the business, in the form of a TFRP, or a combination of both.

<sup>56</sup>Internal Revenue Service SB/SE Research Denver, Project 03.01.001.05.

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IRS does not prioritize the TFRP assessment against the owner as highly as it does the business payroll taxes. This can result in little collection action being taken against the parties responsible for the failure to remit withheld payroll taxes.

When a business repeatedly fails to comply after attempts to collect, the IRM states that the business should be considered an egregious offender and IRS should take aggressive collection actions, including threats of legal action that can culminate in court-ordered injunctions for the business to stop accumulating unpaid payroll taxes or face business closure. However, IRS obtained less than 10 injunctions in fiscal year 2007 to stop businesses from accumulating additional payroll taxes. Revenue officers we spoke to believe the injunctive relief process to be too cumbersome to use effectively in its present form.<sup>87</sup> One revenue officer stated that because of the difficulty in carrying out the administrative and judicial process to close a business through injunctive relief, he had not attempted to take such action in over a decade. We have reported in the past that the U.S. Attorney's Office and the District Counsel prefer not to seek such injunctions due to the time and expense required to prosecute these cases.<sup>88</sup> IRS is taking some action to attempt to address this issue by piloting a Streamline Injunctive Relief Team to identify cases and develop procedures to quickly move a case from administrative procedures to judicial actions.<sup>89</sup> These procedures will be used for the most egregious taxpayers when the revenue officer can establish that additional administrative procedures would be futile.

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<sup>87</sup>The IRM places a high standard for seeking an injunction against a business. It states that the revenue officer must be able to show irreparable harm and that IRS has no adequate remedy at law other than the injunction.

<sup>88</sup>GAO/GGD/AIMD-99-211.

<sup>89</sup>According to IRS, it is developing and testing streamlined injunctive relief procedures for requesting a suit for injunctive relief without the burden of proceeding with trust fund compliance procedures, including monthly filing and special bank accounts. The cases being tested are those in which the facts show that the taxpayer knows about the federal tax deposit laws, and show that further administrative activity would be futile due to the egregious nature of the taxpayer's history of non-compliance. Taxpayers to whom these streamlined procedures are designed to apply include the following: (1) taxpayers who may have received a Letter 903 in the past; (2) taxpayers who were previously assessed a Trust Fund Recovery Penalty; (3) taxpayers who have engaged in multiple entities to avoid paying trust fund taxes; (4) taxpayers who have a history of filing bankruptcies to avoid employment tax collection or continue to pyramid taxes while in bankruptcy.

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Similar to IRS, all of the state tax collection officials we contacted told us that their revenue department's primary goal was to prevent businesses from continuing to flaunt tax laws and to stop them from accumulating additional tax debt. They said that after a business had been given a period of time to comply with its current tax obligations and begin paying past taxes, state tax collection officials changed their focus to one of "stopping the bleeding." As such, some have made the policy decision to seek to close non-compliant businesses, as discussed in the following two examples.

- One Georgia state official we spoke to said the state had passed laws to allow businesses to be closed through administrative procedures within the department of revenue without judicial intervention. The procedure is tied to the state's ability to seize the assets of the business. The state may seize the assets of businesses that do not comply with their tax obligations as a means of closing the business to prevent the further accumulation of unpaid taxes, even if the sale of those assets do not result in collections to reduce the business's current tax debt.<sup>80</sup> The official we spoke to stated that it is a routine part of the state's collection arsenal and the state closed several dozen businesses this way in 2007 to prevent the further accumulation of unpaid trust fund taxes.
- Kentucky developed a procedure to close businesses that does not involve the seizure of the business's assets. That state centralized the judicial proceedings for closing a business in a single court that is experienced in tax-related injunctions and therefore is willing and able to move through the process quickly. One official told us the state closed about 100 businesses a month through such proceedings to prevent the further accumulation of unpaid payroll tax debt.

To the extent IRS is not taking effective steps to deal with egregious payroll tax offenders that repeatedly fail to comply with the tax laws, businesses may continue to withhold taxes from employees' salaries but divert the funds for other purposes.

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#### IRS's Approach Does Not Measure Effectiveness

Although IRS has made the collection of unpaid payroll taxes one of its top priorities, IRS has not established goals or measures to assess its progress in collecting or preventing the accumulation of payroll tax debt.

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<sup>80</sup>As noted earlier, IRC 6331(f) prohibits IRS from taking seizure action on a case where the expenses of seizure exceed the fair market value of the asset.

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Performance measurement and monitoring supports resource allocation and other policy decisions to improve an agency's operations and the effectiveness of its approach. Performance monitoring can also help an agency by measuring the level of activity (process), the number of actions taken (outputs), or the results of the actions taken (outcomes).

Although IRS does have a broad array of operational management information available to it, we did not identify any specific performance measures associated with payroll taxes or TFRP assessments. IRS has caseload and other workload reports for local managers (to measure process and outputs); however, these localized reports are not rolled up to a national level to allow IRS managers to monitor the effectiveness or efficiency of its collection and enforcement efforts. Additionally, these operational reports do contain information about unpaid payroll tax and TFRP case assignments, but rather are used primarily to monitor workload issues, not program effectiveness. For example, IRS has developed some reports that identify "over-aged" cases (those that have not been resolved within a certain length of time), and to identify businesses that continue to accrue additional payroll tax debt, but those reports are designed for workload management.

To report on its outcomes or the effectiveness of its operations, IRS reports on overall collection statistics and presents that information in the Management Discussion and Analysis accompanying its annual financial statement and in its IRS Data Book.<sup>61</sup> However, IRS does not specifically address unpaid payroll taxes as a part of those discussions. IRS officials stated that they do not have specific lower-level performance measures that target collection actions or collection results for unpaid payroll taxes or TFRP assessments. Such performance measures could be useful to assist IRS in measuring the success of its efforts to collect or prevent the further accumulation of unpaid payroll taxes and to formulate more effective approaches to dealing with this compliance issue.

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#### IRS's Approach Could Benefit from Additional Tools

In our discussions with IRS revenue officers concerning some of the egregious payroll tax offenders included in our case studies, they noted that having certain additional tools available to them could allow them to more effectively deal with recalcitrant businesses. Those tools include (1)

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<sup>61</sup>Data Book 2007, Internal Revenue Service Publication 55B (Washington, D.C.: March 2008).

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the ability to publish the names of tax debtors and (2) improved methods of identifying business assets for levy.<sup>62</sup>

Revenue officers stated, and we acknowledge, that IRS faces challenges in balancing voluntary compliance with the need to enforce the tax laws. Many businesses have accumulated dozens of tax quarters worth of payroll tax debt, sometimes accumulating over a million dollars in unpaid payroll taxes. In those egregious situations, including many of our case studies, IRS's policy to encourage voluntary compliance and use of available collection tools neither resulted in the collection of the unpaid portion nor prevented the further accumulation of more unpaid payroll taxes. As part of our audit, we spoke with a number of state revenue department officials to identify specific collection approaches and tools used by those states to pursue payment of unpaid taxes. We found that several states had already developed and were effectively using the types of tools IRS revenue officers said would be beneficial to them.

#### IRS Cannot Publish Tax Debtor Information

The IRC generally prohibits IRS from publicly disclosing federal tax information without taxpayer consent.<sup>63</sup> Although IRS tax liens are public information, IRS does not centrally publish its lien filings or otherwise make available information about businesses or individuals with tax debt. However, during our discussions, IRS officials told us that being able to do so could increase IRS's ability to collect payroll tax debts.

In contrast, an increasing number of states—at least 19 including New Jersey, Connecticut, Indiana, and California—are seeking to increase tax collections by publicizing the names of those with delinquent tax bills.<sup>64</sup> For example, a recent California law mandates the state to publish each year the names of the top 250 personal and corporate state tax debtors with at least \$100,000 in state tax debt.<sup>65</sup> The list does not include those

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<sup>62</sup>Some collection officials thought the tools IRS currently has at its disposal were sufficient to prevent and collect unpaid payroll taxes. They stated that what was needed was timelier contact and more diligent follow-up on deadlines.

<sup>63</sup>26 U.S.C. § 6103. Subsection 6103(k) provides exceptions to the disclosure prohibition. For example, IRS can disclose the amount of the taxpayer's outstanding debt secured by a lien to persons with evidence of rights in the property subject to the lien.

<sup>64</sup>The 19 states we identified that disclose information about those with unpaid tax debt were California, Colorado, Connecticut, Delaware, Georgia, Indiana, Illinois, Kansas, Kentucky, Maryland, Minnesota, Montana, North Carolina, New Jersey, Pennsylvania, Rhode Island, South Carolina, Washington, and Wisconsin.

<sup>65</sup>Cal. Rev. & Tax. Code § 19195.

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who are fighting the tax bills in courts, have sought bankruptcy protection, or have set up payment plans with the state. Public disclosure of tax debtors can be very effective. Just threatening to publish the names of tax offenders can bring some into compliance, while actually appearing on a tax offender list can bring about societal pressure to comply. For example, in California 26 tax debtors threatened with public disclosure stepped forward to settle their tax debts and thus avoided appearing on the list. In Connecticut, the state claims the public disclosure of tax debtors has resulted in over \$100 million in collections from the first 4 years of the program. The potential public disclosure of tax debtors may also encourage greater tax compliance among the general population of taxpayers to avoid potentially being on the list.

#### IRS Cannot Always Identify Levy Sources

As discussed previously, IRS has the authority to levy a tax debtor's income and assets when there is a demand for payment and there has been a refusal or an inability to pay by the taxpayer subject to the levy.<sup>65</sup> Although IRS has this authority, IRS officials stated that they often have difficulty using levies to collect unpaid payroll taxes because, for example, the levy may be made against funds in a bank account at a certain point in time when little or no funds are available. Additionally, IRS officials told us, and in our case studies we found, that IRS sometimes has difficulty identifying which banks or financial institutions a tax debtor is using. This is the case because tax debtors will often change financial institutions to avoid IRS levies. Once a levy is served against an account, a tax debtor will often close the account and open an account in a different financial institution. IRS must then search for where the tax debtor is now doing business and attempt to serve a new levy. One IRS official stated that IRS may serve levies on multiple banks while searching for the new accounts. Such a process of searching for accounts is very time consuming for both the revenue officers and the financial institutions being served the levies and is a burden to these financial institutions.

Several states use legal authorities to assist in identifying levy sources. States such as Kentucky, Maryland, Massachusetts, Indiana, and New

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<sup>65</sup>As discussed previously, levy is the legal seizure of the taxpayer's property to satisfy a tax debt. IRS may order a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy. IRS levies against bank accounts, brokerage accounts, or business account receivables are generally one-time levies of amounts in the account at the time the levy is served. However, IRS can also use a "continuous" levy against wages or certain federal payments. IRS officials stated that finding an account with money in it is often a "hit or miss" proposition since they are one-time levies.

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Jersey have enacted legislation for matching programs or entered into agreements with financial institutions to participate in matching bank account information against state tax debts. This matching allows states to more easily identify potential levy sources and simplifies the financial institution's obligations to respond to multiple levies. IRS is currently working with at least one state to investigate the potential for this matching, but in our discussions with IRS collection officials, they stated that IRS has not sought legislation or agreements with financial institutions to enhance its levying powers.

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### **Businesses Engaged in Abusive and Potentially Criminal Activity Related to the Federal Tax System**

Our analysis of unpaid payroll tax debt found substantial evidence of abusive and potentially criminal activity related to the federal tax system by businesses and their owners or officers. As noted, over 1.6 million businesses owe unpaid payroll taxes. We identified tens of thousands of businesses that filed 10 or more tax returns acknowledging that the business owed payroll taxes, yet failed to remit those taxes to the government. While much of the tax debt may be owed by those with little ability to pay, some abuse the tax system, willfully diverting amounts withheld from their employees' salaries to fund their business operations or their own personal lifestyles.

In addition to owing payroll taxes for multiple tax periods and accumulating tax debt for years, many of the owners and officers of these businesses are repeat offenders. We identified owners who were involved in multiple businesses, all of which failed to remit payroll taxes as required. For example, in one of our case studies in which a business owed almost \$2.5 million, the owner was involved in multiple other businesses, all of which owed unpaid payroll taxes. IRS records indicated that the owner was also underreporting personal income to avoid paying personal income taxes. Additionally, the owner was the subject of at least 10 lawsuits either pending or settled and was involved in possible check kiting and money laundering. In total, IRS records indicate over 1,500 owners/officers had been found by IRS to be responsible for non-payment of payroll taxes at 3 or more businesses, and 18 business owners/officers had been found by IRS to be responsible for not paying the payroll taxes for over 12 separate businesses. It should be noted that these numbers represent only those responsible individuals IRS found acted willfully in the non-payment of the businesses' payroll taxes and who were assessed TFRPs—they do not represent the total number of repeat offenders with respect to non-payment of payroll taxes. Table 2 shows the number of individuals with TFRPs for two or more businesses.

**Table 2: Number of Individuals with Trust Fund Recovery Penalties for Two or More Businesses**

Number of businesses associated with owner/officer	Number of individuals
2	7,716
3	1,011
4	290
5	101
6	60
7-12	72
Over 12	18
<b>Total</b>	<b>9,268</b>

Source: GAO analysis of IRS data as of September 30, 2007

Our audits and investigations of the 50 case study businesses with tax debt found substantial evidence of abuse and potential criminal activity related to the tax system; 12 of these case studies follow. All of the case studies involved businesses that had withheld taxes from their employees' paychecks and diverted the money to fund business operations or for personal gain. Employers are required by law to remit withheld taxes, and the employer's matching contributions, to IRS or face potential civil or criminal penalties. Although we reviewed tax records and other information for all 50 cases, we performed a more in-depth review of 12 case study businesses for this report. IRS had filed a lien to protect the government's interests for all of the 12 case studies, and had filed liens for all but 5 of the 38 cases presented in appendix II.<sup>67</sup> Table 3 shows the results of 12 of the case studies we performed.

<sup>67</sup>IRS noted that in half of the 12 case studies presented here IRS was stayed from collection action for various lengths of time due to factors such as bankruptcy filings. IRS noted that during those periods in which IRS collection action was stayed, some businesses continued to accumulate additional unpaid payroll taxes.

**Table 3: Businesses That Fail To Remit Payroll Taxes**

Case study	Nature of business	Unpaid payroll tax	Comments
1	Automotive	Over \$3.5 million for almost 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• Widely advertised business with dozens of employees.</li> <li>• For last decade the business has not remitted the payroll taxes withheld from its employees, paying less than a quarter of the payroll taxes owed.</li> <li>• For the last 2 years the owner reported making about \$100,000 in salary.</li> <li>• Owner transferred \$1.5 million in property after being assessed a TFRP.</li> <li>• Recently the owner's personal residence sold for over \$600,000.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
2	Healthcare	Almost \$2.5 million for over 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$500,000 in non-payroll tax debt.</li> <li>• Business is currently in business with over 100 employees.</li> <li>• IRS stated that the officers consistently avoided IRS action by filing bankruptcy. Business filed for bankruptcy three times, two of which were dismissed.</li> <li>• Around the time of bankruptcy filings, officers made large cash withdraws from the business of about \$700,000.</li> <li>• IRS found two officers of business were paying personal expenses through the business.</li> <li>• One officer purchased luxury vehicles and personal property while business was not remitting payroll taxes.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three officers willful and responsible for not remitting taxes withheld from employees and assessed them a TFRP.</li> </ul>
3	Janitorial	Almost \$500,000 for almost 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$10,000 in non-payroll tax debt.</li> <li>• Business is currently in business.</li> <li>• Owner has an extensive criminal history.</li> <li>• IRS agreed to allow business to pay via an installment agreement, but the payments will cover only a small percentage of the payroll tax debt owed.</li> <li>• Owner owns multiple rental properties and a \$500,000 personal residence.</li> <li>• IRS noted that owner had the ability to pay the tax liability.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
4	Legal services	Over \$500,000 for over 50 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$10,000 in non-payroll tax debt.</li> <li>• Owner is currently in business as a lawyer, but continues to accumulate unpaid payroll taxes.</li> <li>• Owner owes more than \$600,000 on over 10 years of personal taxes, and did not file most recent years' personal tax returns.</li> <li>• Owner has multiple real estate properties, including property on a tropical island.</li> <li>• IRS notes that owner has the ability to pay, but refuses.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
5	Dentist	Over \$500,000 for over 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$7,000 in non-payroll tax debt.</li> <li>• Business is still operating with employees, but for over 15 years it has not remitted all required payroll taxes to IRS.</li> <li>• Owner lives in a large home with acreage valued at over \$700,000. The house is deeded under spouse's name, but spouse's income is insufficient to pay the interest on the mortgage. Owner admits to paying the mortgage.</li> <li>• Owner sold real estate to children for less than market value.</li> <li>• Owner drives a later model luxury vehicle registered under wife's name.</li> <li>• Owner stated he would pay all the business's expenses before paying taxes.</li> <li>• Owner is not compliant with personal taxes, owing over \$500,000.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>
6	Consulting	Almost \$1.5 million for over 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$500,000 in non-payroll tax debt.</li> <li>• Business gave owner cash loans.</li> <li>• IRS found that business monies flowed into owner's personal accounts.</li> <li>• Owner has not filed personal tax returns since early 1990s and owes over \$400,000 in personal taxes.</li> <li>• Owner has multiple businesses that have been delinquent since 1994.</li> <li>• According to IRS, owner kept changing legal representatives to stall collection efforts with repeated requests for the same information.</li> <li>• Owner sold assets to relative after receiving notice of potential TFRP issued by IRS.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP for this and other businesses.</li> </ul>
7	Manufacturing	Almost \$1.5 million for over 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• IRS revenue officer notes indicate business monies may have been flowing into owner's personal accounts while withheld payroll taxes were not being remitted.</li> <li>• IRS found owner hid business assets in personal name, keeping IRS from seizing them.</li> <li>• Owner is also delinquent on personal taxes.</li> <li>• IRS officials stated that owner used appeals and offers in compromise (OIC) to delay IRS collection efforts.</li> <li>• Owner defaulted on OIC for TFRPs.</li> <li>• IRS found owner had underreported tax liabilities for at least one tax quarter.</li> <li>• Business assets given to relative, who used them to start a new business.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP for both this business and at least two previous businesses.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
8	Construction	Almost \$2.5 million for over 20 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$100,000.</li> <li>• IRS found business was underbidding contracts while using unpaid payroll taxes to subsidize its losses.</li> <li>• Business claimed that if it paid payroll taxes, it would not be able to pay employees or other business expenses and would have to close.</li> <li>• Business has not filed taxes for all tax quarters.</li> <li>• IRS considered pursuing business for fraud charges, but did not pursue.</li> <li>• Business/owners have received four civil judgments against it and almost 20 liens.</li> <li>• Revenue officer notes state that the owners have repeatedly taken steps to avoid IRS collection action including the following: filed bankruptcy (which was dismissed), filed appeals against liens, requested abatements of penalties (which were denied), appealed the denial (which was sustained by appeals), submitted a request for installment agreement (which was denied as being insufficient), then appealed the denial of the installment agreement (which was upheld by appeals), "and every other conceivable action to delay or hinder IRS's collection efforts."</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>
9	Manufacturing	Almost \$1 million for almost 40 quarters	<ul style="list-style-type: none"> <li>• Business also owes over \$400,000 in non-payroll tax debt.</li> <li>• Owners and business investigated for bankruptcy fraud.</li> <li>• Revenue officer stated the business was a "sweat shop."</li> <li>• IRS found owner had closed several businesses with tax debt when investigated by IRS and opened new ones.</li> <li>• Business has not filed payroll returns since late 2005.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found two owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>
10	Healthcare	Over \$8 million for nearly 30 quarters	<ul style="list-style-type: none"> <li>• Business also owes almost \$20,000 in non-payroll tax debt.</li> <li>• Although owner has luxury cars and a multimillion dollar home, he claimed inability to pay taxes due to financial hardship.</li> <li>• Owner also owed city and state government agencies for taxes.</li> <li>• One commercial creditor seized and sold some of owner's assets to satisfy debts.</li> <li>• Owner has pled guilty to and was incarcerated for fraud and the business and owner together have almost 100 judgments and liens filed against them.</li> <li>• Owner evaded IRS levies by using check cashing businesses and continued to write checks to himself.</li> <li>• A relative purchased a commercial building that had been sold to satisfy owner's debts and the owner has since set up another business therein.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found owner willful and responsible for not remitting taxes withheld from employees and assessed a TFRP.</li> </ul>

Case study	Nature of business	Unpaid payroll tax	Comments
11	Construction	Almost \$2.5 million for over 50 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$70,000.</li> <li>• Owners owe multi-million dollar tax debt for multiple companies since the early 2000s, and IRS records indicate that the owners have also underreported personal income.</li> <li>• Financial records indicate business may be guilty of illegal check kiting and money laundering.</li> <li>• Owners have several judgments outstanding and at least 10 lawsuits pending or settled.</li> <li>• IRS officials indicated that the owners consistently stalled collection efforts through such means as using multiple representatives and filing for bankruptcy, which has kept IRS from seizing assets.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found two owners willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>
12	Transportation	Almost \$1.5 million for over 20 quarters	<ul style="list-style-type: none"> <li>• Business also owes non-payroll tax debt of almost \$100,000.</li> <li>• Business has not filed taxes for all tax quarters.</li> <li>• Business has 17 judgments and state and federal tax liens, while one officer has over 50 such judgments and liens.</li> <li>• Another officer has unpaid personal taxes and IRS has investigated the officer for potential criminal activity.</li> <li>• IRS records indicate the officers commingled business and personal funds and that they consistently evaded assessment by refusing to cooperate.</li> <li>• Officers misrepresented tax delinquencies to a potential lender.</li> <li>• Officers investigated by IRS for establishing networks of short-lived corporations that accrue significant tax liabilities and then close, leaving a large amount of uncollectible payroll taxes.</li> <li>• IRS filed a lien against the business for unpaid taxes.</li> <li>• IRS found three officers willful and responsible for not remitting taxes withheld from employees and assessed them TFRPs.</li> </ul>

Source: GAO analysis of IRS data, including unpaid federal tax debt as of September 30, 2007.

Our audits and investigations of the 50 case study businesses with tax debt, 12 of which are detailed in table 3, showed abuse and potential criminal activity related to the tax system. The following provides some illustrative examples of several of these cases.

- **Case 1** The owner of this automotive firm continued to draw about a six-figure income from the business and owned substantial real property while the business accumulated more than \$3.5 million in unpaid federal payroll taxes over a 10-year period. For the last decade, this business has withheld taxes from its employees but remitted less than a quarter of the taxes actually owed. IRS found the owner of the company willful and responsible for not remitting the taxes, and IRS records indicate the owner avoided paying taxes and trust fund amounts by transferring \$1.5 million

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in property after being assessed the TFRP and selling a personal residence valued at over \$600,000.

- **Case 2** This healthcare business, which owes almost \$2.5 million of unpaid payroll taxes, repeatedly refused to remit withheld federal payroll taxes and the officers used the business to pay personal expenses. In addition, IRS records indicated the business's officers attempted to avoid paying taxes by filing Chapter 11 bankruptcy on three separate occasions, two of which were dismissed. Around the time of the bankruptcy filings, the officers withdrew about \$700,000 of cash from the business. IRS found three officers of the business to be willful and responsible for not remitting payroll taxes.
- **Case 6** This consulting business accumulated almost \$1.5 million in unpaid federal payroll taxes beginning over 10 years ago and over a half-million dollars in other federal taxes. The owner had multiple businesses that have not filed required tax returns. Additionally, the business owner has not filed personal returns since the early 1990s and owes over \$400,000 in personal taxes. The owner received several cash loans from the business while not paying taxes, and business monies were diverted into the owner's personal bank accounts. This business owner avoided IRS by changing representatives and attorneys, which has had the effect of stalling IRS actions with repeated requests for the same information. To avoid collection action, the owner sold assets to a relative after receiving notice that IRS was about to assess a TFRP.
- **Case 7** This manufacturing business owes almost \$1.5 million in unpaid payroll taxes for over 40 tax quarters. The owner also underreported tax liabilities and was found willful and responsible for not remitting payroll taxes from two other businesses. IRS found that business monies may be flowing into personal accounts, and that the owner has hidden business assets in his own name in order to prevent IRS seizures. The owner also gave business assets to a relative who has used them to start a new business. The owner used appeals and offers in compromise as a means to delay IRS collection efforts, and has already defaulted on an offer in compromise for earlier TFRPs.
- **Case 10** This healthcare business has accumulated over \$8 million in unpaid payroll taxes for almost 30 quarters. The owner was convicted of tax fraud. Despite living in a multi million dollar home, the taxpayer claimed inability to pay taxes due to financial hardship, and evaded IRS levies by using check cashing businesses and writing checks to himself, even paying himself a salary while incarcerated. Some of the owner's properties were sold by creditors, and the owner set up a new business in

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one of the business's properties bought by a relative. Although other creditors seized and sold property to settle debts, we found no evidence of IRS taking such actions.

- **Case 11** The owners of this construction company accumulated almost \$2.5 million in unpaid payroll taxes from over 50 tax quarters (over 12 years of non-payment). The owners also had tax debt from other businesses dating back to the early 2000s. IRS records indicate that the business owners underreported their personal income. Financial records indicate that the owners may be involved in illegal check kiting and money laundering dating back to the late 1990s, have several judgments outstanding, and at least 10 lawsuits pending or settled. IRS officials indicated that the owners have consistently stalled collection efforts through such means as filing for bankruptcy, which has kept IRS from seizing assets.

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## Conclusions

Businesses that withhold money from their employees' salaries are required to hold those funds in trust for the federal government. Willful failure to remit these funds is a breach of that fiduciary responsibility and is a felony offense. A business's repeated failure to remit payroll taxes to the government over long periods of time affects far more than the collection of the unpaid taxes. First, allowing businesses to continue to not remit payroll taxes affects the general public perception regarding the fairness of the tax system, which may result in lower overall compliance. Second, because of failure of businesses to remit payroll taxes, the burden of funding the nation's commitments, including payments to the Social Security and Hospital Insurance trust funds, falls more heavily on taxpayers who willingly and fully pay their taxes. Third, the failure to remit payroll taxes gives the non-compliant business an unfair competitive advantage because that business can use those funds that should have been remitted for taxes to either lower overall business costs or increase profits. Businesses that fail to remit payroll taxes may also under bid tax-compliant businesses, causing them to lose business and encouraging them to also become non-compliant. Fourth, allowing businesses to continue accumulating unpaid payroll taxes has the effect of subsidizing their business operations, thus enriching tax abusers or prolonging the demise of a failing business. Fifth and last, in an era of growing federal deficits and amidst reports of an increasingly gloomy fiscal outlook, the federal government cannot afford to allow businesses to continue to accumulate unpaid payroll tax debt with little consequence.

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For these reasons, it is vital that IRS use the full range of its collection tools against businesses with significant payroll tax debt and have performance measures in place to monitor the effectiveness of its actions to collect and prevent the further accumulation of unpaid payroll taxes. IRS has stated that the collection of unpaid payroll taxes is one of its highest priorities. However, IRS's collection philosophy focuses on gaining voluntary compliance, even for recalcitrant businesses that repeatedly fail to remit payroll taxes and whose actions indicate no intention to become compliant. Businesses that continue to accumulate unpaid payroll tax debt despite efforts by IRS to work with them are demonstrating that they are either unwilling or unable to comply with the tax laws. In such cases, because the decision to not file or remit payroll taxes is made by the owners or responsible officers of a business, IRS should consider strong collection action against both the business and the responsible owners and officers to prevent the further accumulation of unpaid payroll taxes and to collect those taxes for which the business and owners have a legal and fiduciary obligation to pay.

IRS faces difficult challenges in balancing aggressive collection actions against taxpayer rights and individuals' livelihoods. However, to the extent IRS does not pursue aggressive collection actions against businesses with multiple quarters of unpaid payroll taxes, IRS is not acting in the best interests of the federal government, the employees of the businesses involved, the perceived fairness of the tax system, or overall compliance with the tax laws. Therefore, it is incumbent upon IRS to revise its approach and develop performance measures to provide for the effective use of the full range of available enforcement tools against egregious offenders to prevent those businesses from continuing to accumulate payroll tax debt. It is also incumbent upon IRS to proactively seek out and appropriately implement other tools (particularly those with demonstrated success at the state level) to enhance its ability to prevent the further accumulation of unpaid payroll taxes and to collect those taxes that are owed. Although IRS does need to work with businesses to try to gain voluntary tax compliance, for businesses with demonstrated histories of egregious abuse of the tax system, IRS needs to alter its approach to include focusing on stopping the accumulation of additional unpaid payroll tax debt by egregious businesses.

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### Recommendations for Executive Action

To provide better monitoring and more detailed guidance on collection actions to be pursued against egregious payroll tax offenders, to strengthen existing collection tools, and to develop additional enforcement tools to effectively identify potential levy sources, we recommend that the Commissioner of Internal Revenue take the following six actions:

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- Develop a process to monitor collection actions taken by revenue officers against egregious payroll tax offenders to ensure collection actions appropriately utilize all available collection tools contained in the IRM.
  - Review current case prioritization and assignment practices to determine if IRS's enforcement and collection procedures could be enhanced by requiring, to the maximum extent feasible, businesses with egregious payroll tax debt and the responsible owners/officers with a TFRP assessment be treated as a single unified and coordinated collection effort assigned to a single revenue officer.
  - Develop and implement procedures to expeditiously file a Notice of Federal Tax Lien against property as soon as possible after payroll tax debt is identified (including cases in the queue awaiting assignment) and ensure liens are filed on both businesses with unpaid payroll taxes and owners/officers assessed a TFRP.
  - Develop and implement procedures to monitor and report on revenue officers' compliance with the new TFRP assessment time frames to ensure revenue officers are making TFRP determinations and assessments in a timely manner.
  - Develop performance goals and measures that specifically evaluate the accumulation of unpaid payroll taxes by businesses (especially egregious businesses with over 20 quarters of payroll tax debt), the extent and timeliness of TFRP assessments, and the effectiveness of actions taken to collect unpaid payroll taxes and TFRP assessments.
  - Work with states that have developed procedures for matching financial accounts to tax debts to evaluate the potential for IRS to either develop and implement similar measures or partner with states that currently have that tool to leverage their efforts to assist revenue officers in identifying a business's leviable assets.

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### Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS recognized that all appropriate tools must be used to bring payroll tax offenders into compliance and concurred with all six of our recommendations. IRS noted that it had implemented numerous actions to improve its tax collection processes and procedures as well as to prioritize assignment of cases. It also noted that it continues to explore other opportunities. In particular, IRS cited its projects to increase its focus on businesses that accumulate

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multiple periods of unpaid payroll taxes and to improve the timeliness of lien filing and TFRP determinations.

With respect to our five recommendations for IRS to review or revise its collection policies and to strengthen its existing collection tools to be used in dealing with egregious payroll tax offenders, IRS agreed to evaluate its practices and develop appropriate changes. Specifically, IRS agreed to (1) explore the value of using existing data to evaluate collection actions taken by revenue officers, (2) assign a single revenue officer to collect both a business's egregious unpaid payroll tax debt and the responsible owners/officers with a TFRP assessment when feasible, (3) evaluate its existing practices and determine appropriate changes to its lien filing procedures to allow liens to be filed as soon as a payroll tax liability is identified, (4) consider ways to use its TFRP reports to monitor and report on revenue officers' compliance with new TFRP assessment time frames, and (5) evaluate the effectiveness and feasibility of establishing performance goals and measures on the timeliness of TFRP assessments.

With respect to our recommendation to work with states that have developed procedures for matching financial accounts to tax debts to identify levy sources, IRS agreed with our recommendation. IRS said it would work with those states to determine the effectiveness of their programs and whether a similar program in IRS would be cost effective and consistent with privacy laws.

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As agreed with your offices, unless you announce its contents earlier, we will not distribute this report until 30 days from its date. At that time, we will send copies of this report 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>.

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If you or your staff have any questions concerning this report, please contact me at (202) 512-3406 or [sebastians@gao.gov](mailto:sebastians@gao.gov). 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 IV.



Steven J. Sebastian  
Director  
Financial Management and Assurance

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*List of Committees*

The Honorable Carl Levin  
Chairman  
The Honorable Norm Coleman  
Ranking Member  
Permanent Subcommittee on Investigations  
Committee on Homeland Security  
and Governmental Affairs  
United States Senate

The Honorable Max Baucus  
Chairman  
The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

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## Appendix I: Scope and Methodology

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- To identify the magnitude of unpaid payroll tax debt, we obtained IRS's database of unpaid taxes as of September 30, 2007. We extracted all payroll tax debt from that database and performed analysis to identify the number of businesses with tax debt and the total dollar value of tax debt associated with those businesses. We analyzed and summarized the overall payroll tax debt by
  - the number of tax quarters of payroll tax owed by businesses;
  - the tax period for which the debt was owed;
  - the amount of the tax debt associated with interest, penalties, and assessed taxes; and
  - the collection status of the debt, such as whether it is awaiting assignment, assigned in the field for collections, or coded as being currently not collectible.

We also analyzed the tax debt to determine the date on which IRS will be statutorily prohibited from seeking collection from tax debtors and will remove the tax debt from its records.<sup>1</sup>

We requested that IRS perform specific data analysis of its tax records to identify amounts that should have been remitted by businesses for those trust funds, but were not, to develop an estimate of the total amount that the General Fund subsidizes the Social Security and Medicare Part A trust funds due to unpaid taxes. To validate IRS's estimate, we compared that analysis to one prepared by IRS as of September 30, 1998, during one of our previous audits.<sup>2</sup> At that time, IRS estimated the cumulative amount of the subsidy to be \$38 billion. Because IRS removes tax debt from its records once the debt's statutory collection period expires (generally 10 years from the date the tax is assessed), those estimates represented approximately a 10-year subsidy. To further validate the 10-year estimate, we obtained from IRS the annual increase in the subsidy based on unpaid taxes. IRS determined the subsidy to be between \$2 billion to \$4 billion annually. IRS developed its estimates based on data contained in its

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<sup>1</sup>IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the assessment. After that period, IRS removes the tax debt from its records.

<sup>2</sup>GAO/AIMD/GGD-99-211.

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masterfile of tax information, which we audit as part of IRS's annual financial statement audit.

To identify IRS's reports and measures to manage unpaid payroll taxes, we discussed IRS's tracking of cases with cognizant managers and revenue officers. In addition, we reviewed IRS's reported measures in both the IRS Databook and IRS's Management Discussion and Analysis accompanying its annual financial statements.

To determine IRS policies and procedures in place to prevent the non-payment of payroll taxes and to collect outstanding payroll taxes, we reviewed IRS's policies as laid out in the Internal Revenue Manual (IRM) and discussed those policies and procedures with cognizant IRS officials and revenue officers. We also reviewed certain Treasury Inspector General for Tax Administration (TIGTA) and IRS reports related to the collection of unpaid payroll taxes. To supplement our discussions with IRS officials on tax collection activities, we also interviewed a number of state tax collection officials, including officials from Georgia, Kentucky, Maryland, and North Carolina, regarding tools and procedures used by those states to collect unpaid taxes.

Additionally, we reviewed a sample of 76 businesses whose owners/officers IRS found personally liable for the failure to remit payroll taxes withheld from employees' paychecks.<sup>3</sup> The sample was originally selected as part of our audit of IRS's fiscal year 2007 financial statements. The primary purpose of the sample was to determine whether IRS was properly recording payments to all related parties. However, we also performed other tests of IRS's controls using this same sample. Although we identified issues related to the timeliness of certain collection actions based upon that sample, we are unable to project these results because the sampling units used for the financial statement audit were payments rather than accounts. We analyzed tax transcripts and other IRS records for those cases with assessed TFRPs to identify the dates that IRS revenue officers

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<sup>3</sup>Under section 6672 of the IRC, individuals who are determined by IRS to be responsible for collecting, accounting for, and paying over payroll taxes who willfully fail to collect or pay these tax can be assessed a TFRP. Typically, these individuals are owners or officers of a corporation, such as a president or treasurer. More than one individual can be found willful and responsible for a business's failure to pay the federal government withheld payroll taxes and thus be assessed a TFRP. The business itself is still liable for the entire amount of the unpaid payroll taxes. However, IRS policies require that it only collect the unpaid tax once.

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(1) initiated contact with the business, (2) made the determination to pursue the TFRP against the officers, and (3) assessed the TFRP.

To further review IRS's collection actions, we also performed a macro-analysis of IRS's overall inventory of unpaid payroll tax debts. We used macro-analysis to determine such factors as the percentage of payroll tax debt with liens. We also used macro-analysis to determine the most common types of industries with unpaid payroll taxes. We analyzed IRS's database of unpaid taxes and the information using the North American Industry Classification (NAIC) system codes in that database.<sup>4</sup> Using those codes, we were able to identify the industry type for about 70 percent of the payroll tax debt.<sup>5</sup>

To determine whether businesses with unpaid payroll taxes were engaged in abusive or potentially criminal activities with regard to the federal tax system, we used data mining techniques to identify 50 businesses as illustrative case studies based on criteria such as businesses with large dollar amounts of unpaid payroll taxes accumulated over multiple tax quarters. For those businesses, we reviewed IRS's collection actions and discussed the appropriateness of those actions or lack of actions with IRS revenue officers. We obtained copies of IRS's automated tax transcripts and other tax records (e.g., revenue officers' notes) from IRS. We also performed additional searches of financial and public records. In cases where record searches and IRS tax transcripts indicated that the owners or officers of a business were involved in other related businesses that had unpaid federal taxes, we performed additional analysis of those related businesses and the owners/officers.

We conducted this performance audit from April 2007 through May 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence

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<sup>4</sup>The NAIC was developed as the standard for use by federal statistical agencies in classifying business establishments in the U.S. The NAIC codes provide a guide to the type of activity the business is engaged in although it may be engaged in multiple activities, some of which are not reflected in its NAIC code.

<sup>5</sup>The remaining payroll tax debt could not be classified by industry either because the NAIC codes were not available or were not in a format we could analyze.

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obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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**Data Reliability  
Assessment**

For the IRS databases we used, we relied on the work we performed 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.

## Appendix II: Businesses with Unpaid Payroll Taxes

Table 3 provided data on 12 detailed case studies. Table 4 shows the remaining 38 case studies that we audited. As with the 12 cases, we also found substantial evidence of abuse or potentially criminal activity related to the federal tax system during our review of these 38 case studies.

**Table 4: Businesses That Fail To Remit Payroll Taxes**

Case study	Nature of business	Number of unpaid payroll tax quarters	Unpaid payroll taxes/other federal tax debt	Did IRS file a lien?	Comments
13	Construction	Over 30	Over \$500,000 / over \$100,000	Yes	Since the late 1990s the business has only paid a small amount of the payroll taxes due. At the time of our review, IRS was trying to seize commercial property from officer.
14	Transportation and warehousing	Almost 30	Over \$1 million / over \$100,000	Yes	Company went out of business but not before owners made cash withdrawals of over \$50,000. Owner has another company with payroll tax debt.
15	Construction	Almost 30	Over \$500,000 / under \$50,000	Yes	Owner closed this business with tax debt and started another, which has also accumulated unpaid payroll taxes.
16	Construction	Almost 30	Over \$2 million / under \$50,000	Yes	This business is a sole proprietorship. Owner withdrew over \$20,000 cash from business before going into bankruptcy.
17	Construction	Almost 30	Over \$1 million / over \$50,000	Yes	Although business has recently begun paying payroll taxes, it has unpaid payroll tax debt dating back to the mid-1990s. Owner had over \$1 million converted from the business's name to the owner's personal name.
18	Transportation and warehousing	Over 50	Over \$500,000 / over \$100,000	Yes	Business accumulated unpaid payroll tax debt for 10 years until mid-2000s, then declared bankruptcy and closed.
19	Mining	Over 40	Almost \$2.5 million / over \$50,000	Yes	Business accumulated unpaid payroll taxes since early 1990s and only stopped when business was destroyed by a natural disaster. At the time of our review, federal agencies were paying to clean up the business site.
20	Manufacturing	Almost 30	Over \$2 million / over \$50,000	Yes	Business accumulated unpaid payroll taxes since late 1990s. In the mid-2000s, the business entered into an installment agreement with IRS to pay on the debt.

**Appendix II: Businesses with Unpaid Payroll Taxes**

<b>Case study</b>	<b>Nature of business</b>	<b>Number of unpaid payroll tax quarters</b>	<b>Unpaid payroll taxes/other federal tax debt</b>	<b>Did IRS file a lien?</b>	<b>Comments</b>
21	Construction	Over 40	Over \$1 million / almost \$100,000	Yes	Business accumulated unpaid tax debt beginning in the late 1990s. IRS revenue officer notes showed little collection action taken against this business since then.
22	Construction	Over 30	Almost \$1.5 million / over \$100,000	Yes	Business accumulated unpaid payroll tax debt from the late 1990s to the early 2000s, became relatively compliant in the mid-2000s, but then began accruing more payroll tax debt. IRS designated the case as currently not collectible due to owner's financial hardship and has not been seeking collection of the unpaid taxes.
23	Other services	Over 40	Almost \$1 million / none	Yes	While accumulating unpaid payroll tax debt for over 10 years, the owner of this business withdrew almost \$500,000 in cash. Business has since closed leaving almost \$1 million in unpaid payroll taxes.
24	Construction	Over 30	Almost \$1 million / under \$50,000	No	Business has continued to accumulate unpaid payroll taxes since the early 1990s through the time of our review. IRS records indicated that this case has not been worked on even though the business continued to operate and not pay payroll taxes.
25	Construction	Over 30	Over \$500,000 / under \$50,000	Yes	Although IRS was attempting to seize business assets at the time of our review, this sole proprietor business has been accumulating unpaid payroll tax debt sporadically since the late 1990s. When contacted by IRS, owner claimed its bookkeeper was embezzling funds.
26	Professional, scientific, and technical services	Over 20	Over \$3 million / under \$50,000	Yes	This business has payroll tax debt dating back to the late 1990s, but IRS records indicate few collection actions have been taken. IRS has found owner personally liable for willful failure to remit payroll taxes.
27	Construction	Almost 30	Almost \$1 million / almost \$200,000	Yes	This business has unpaid payroll tax debt dating back to the early 1990s. Although business was given an installment agreement to pay the tax debt, it did not make payments. At the time of our review, the case had been in the queue since the mid-2000s awaiting assignment.

**Appendix II: Businesses with Unpaid Payroll Taxes**

<b>Case study</b>	<b>Nature of business</b>	<b>Number of unpaid payroll tax quarters</b>	<b>Unpaid payroll taxes/other federal tax debt</b>	<b>Did IRS file a lien?</b>	<b>Comments</b>
28	Healthcare and social assistance	Almost 80	Over \$500,000 / under \$50,000	Yes	This business has tax debt dating back to the early 1980s. Case was considered for possible criminal investigation, but not yet pursued.
29	Educational services	Almost 40	Over \$2 million / under \$50,000	Yes	This business has been accumulating tax debt for a decade. Although it was granted an offer-in-compromise to settle the tax debt for less than was owed, business did not make payments. Business has numerous judgments from creditors.
30	Transportation and warehousing	Almost 40	Over \$500,000 / over \$50,000	Yes	The owner of this business has a criminal record and has had various judgments from creditors. IRS chose not to assess a TFRP since the owner would be unable to pay. Business twice filed bankruptcy and each time it was dismissed.
31	Healthcare and social assistance	Over 40	Over \$1.5 million / over \$100,000	Yes	IRS has chosen not to take collection actions against this business due to the needs of the local community.
32	Other services (except public administration)	Over 20	Over \$1.5 million / none	Yes	This business has periodically not paid taxes for over 20 years. Business has applied various times for installment agreements or an offer-in-compromise. Business has multiple state and federal liens.
33	Construction	Over 40	Almost \$1 million / over \$50,000	Yes	This business has tax debt dating back to at least the early 1990s. It has multiple judgments against it including a tort suit, and multiple state and federal liens.
34	Construction	Over 50	Over \$1 million / under \$50,000	Yes	Business accumulated unpaid taxes for over 12 years, then closed with over \$1 million in tax debt. Although IRS considered the case for a fraud investigation, it did not pursue this due to health issues in the business officer's family.
35	Professional, scientific, and technical services	Almost 50	Over \$1 million / over \$50,000	Yes	Business has tax debt dating back to the late 1980s. The owner has sold commercial property to a related party, shielding it from IRS collection action, and has applied for an offer-in-compromise to pay less than it owes.
36	Professional, scientific, and technical services	Over 30	Over \$1 million / under \$50,000	Yes	This business has tax debt back to the early 2000s and has not filed returns since 2006.

**Appendix II: Businesses with Unpaid Payroll Taxes**

<b>Case study</b>	<b>Nature of business</b>	<b>Number of unpaid payroll tax quarters</b>	<b>Unpaid payroll taxes/other federal tax debt</b>	<b>Did IRS file a lien?</b>	<b>Comments</b>
37	Accommodation and food services	Almost 40	Over \$200,000 / under \$50,000	Yes	This business has tax debt dating back to the late 1990s. Business has closed and IRS did not file TFRPs within the statutory period, thus missing an opportunity to collect unpaid payroll taxes from the responsible officers.
38	Accommodation and food services	Almost 20	Over \$100,000 / under \$50,000	No	Business owed tax debt back to the early 2000s, when officers made large cash withdrawals from the business. At the time of our review, business had been in the queue awaiting assignment since the mid-2000s. TFRPs were assessed on two officers. After the assessment but before IRS filed a federal tax lien, one officer sold property for almost \$150,000. IRS reached an installment agreement with one officer while another officer claimed inability to pay and filed bankruptcy. One officer was charged for concealing a weapon and driving under the influence, and has become a fugitive.
39	Construction	Almost 20	Under \$50,000 / under \$50,000	No	Business has accumulated payroll tax debt dating back to the late 1990s, but the tax debt has been in IRS's queue of cases awaiting assignment since July 2006. At the time of our review, IRS had neither filed a federal tax lien or assessed TFRPs.
40	Construction	Over 10	Almost \$1 million / under \$50,000	Yes	This business accumulated unpaid taxes for over 3 years. When IRS investigated, owner claimed employees were embezzling funds. At the time of our review, IRS was seeking to assess a TFRP, but the owner had filed an appeal of the action.
41	Other services (except public administration)	Almost 30	Almost \$100,000 / under \$50,000	No	This business has accumulated payroll tax debt dating back to the late 1990s and has multiple state and federal liens filed.

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**Appendix II: Businesses with Unpaid Payroll Taxes**


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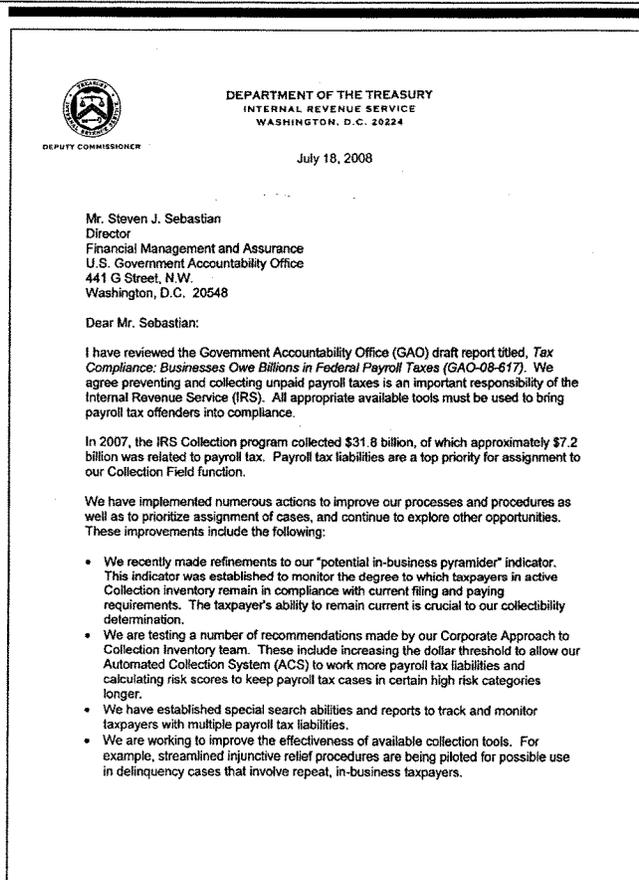
Case study	Nature of business	Number of unpaid payroll tax quarters	Unpaid payroll taxes/other federal tax debt	Did IRS file a lien?	Comments
42	Information services	Almost 30	Almost \$2.5 million / over \$100,000	Yes	The owner of this business was involved with over 30 businesses, including several defunct businesses for which the owner owed TFRPs since the 1980s. The owner was also sentenced to prison for willful failure to pay payroll taxes. In addition, owner had been investigated for check kiting, arrested for fraud, and had several lawsuits pending. Same officer was involved in our case study #44.
43	Accommodation and food services	Almost 20	Over \$12 million / almost \$2.5 million	Yes	This business, with tax debt dating back to the mid-1990s, was under criminal investigation by IRS. The owner has a long criminal history of involvement in many businesses with tax debt. The owner diverted funds from businesses to pay for luxury cars, planes, and a mansion in a foreign country, and has been involved in over a dozen bankruptcies.
44	Healthcare and social assistance	Almost 20	Almost \$5 million / almost \$100,000	Yes	This business has refused to pay any payroll taxes for almost 5 years. Because of the nature of the business, IRS has been reluctant to close the business, but did convict the owner on criminal charges related to failure to pay payroll taxes. Same officer was involved in our case study #42.
45	Administrative and support and waste management and remediation services	Over 40	Over \$16 million / almost \$1.5 million	Yes	Since the mid-1990s, business has not paid nor filed payroll taxes, neither has the owner paid or filed income taxes. When investigated by IRS, the business filed 30 quarters of payroll taxes at one time and went out of business. Business was being investigated for hiring illegal immigrants and the owner has a criminal history. IRS pursued a criminal investigation against the business and owner, and arrested the owner for income tax crimes.

**Appendix II: Businesses with Unpaid Payroll Taxes**

Case study	Nature of business	Number of unpaid payroll tax quarters	Unpaid payroll taxes/other federal tax debt	Did IRS file a lien?	Comments
46	Construction	Almost 30	Almost \$500,000 / under \$50,000	Yes	This sole proprietor accumulated almost a half million dollars of payroll tax debt. IRS designated the owner as being in financial hardship and has not pursued collection action against the company. Business owner stated that it could not pay taxes because its contractors took too long to pay him. Owner of the business made an offer-in-compromise to pay 2 cents on the dollar to settle the debt, but IRS rejected the offer.
47	Manufacturing	Over 10	Almost \$100,000 / under \$50,000	Yes	This business was a sole proprietor that accumulated payroll tax debt for 4 years. IRS's investigation found the owner to be an extremely poor manager with no knowledge of how to handle payroll taxes. Once IRS contacted the owner regarding the debt, the owner agreed to close the business.
48	Transportation and warehousing	Almost 10	Almost \$100,000 / under \$50,000	No	This business has periodically failed to pay payroll taxes since the early 2000s and has not filed returns in 2 years. IRS records indicated that the case has never been investigated for collections, has had no liens filed, and was recently "shelved" by IRS due to lack of resources to pursue collection of the tax debt.
49	Other services (except public administration)	Almost 20	Over \$200,000 / under \$50,000	Yes	This sole proprietor business has payroll tax debt dating back to the late 1990s. Although there were indications at the time of our review that the business was still operating, it has not filed a payroll tax return since the early 2000s; thus its tax debt may be much higher. IRS has designated the owner as being in financial hardship and has not investigated the case for collections.
50	Other services (except public administration)	Almost 40	Over \$500,000 / under \$50,000	Yes	This sole proprietor business has accumulated over 10 years of payroll tax debt. IRS has designated the owner as being in financial hardship and has not pursued collection action against the business, but the business continues to accumulate more unpaid payroll tax debt. Business assets were seized as part of a commercial foreclosure.

Source: GAO analysis of IRS data, including unpaid federal tax debt as of September 30, 2007.

## Appendix III: Comments from the Internal Revenue Service



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Appendix III: Comments from the Internal Revenue Service

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- We have taken steps to improve the timeliness of lien filing while recognizing the decision to file a lien is influenced by the impact lien filing will have on the taxpayer's ability to pay.
- We have added new timeframes to the Internal Revenue Manual to improve the timeliness of the Trust Fund Recovery Penalty determination and its ultimate assessment.
- We have fine-tuned the Federal Tax Deposit Alerts program. Reviews indicate our efforts to get the right alerts worked by revenue officers are resulting in more taxpayers benefiting from this compliance program.
- We continue to explore new ways to identify potential levy sources.

A separate enclosure specifically addresses each of your recommendations.

If you have any questions, or if you would like to discuss this response in more detail, please contact me or Frederick W. Schindler, Director, Collection Policy at (202) 283-7650.

Sincerely,

  
Linda E. Stiff

Enclosure

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Appendix III: Comments from the Internal  
Revenue Service

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GAO Recommendations and IRS Responses to  
GAO Draft Report Tax Compliance: Businesses Owe  
Billions in Federal Payroll Taxes  
GAO-08-617

**Recommendation:** Develop a process to monitor collection actions taken by revenue officers against egregious payroll tax offenders to ensure collection actions appropriately utilize all available collection tools contained in the IRM.

**Comments:** We agree to explore the value of a regular extract from our ENTITY program of taxpayers by area with a number to be determined of unpaid payroll tax quarters to be shared with the Director, Collection for discussion with the area director. Our quality reviews already examine cases for the appropriateness and timeliness of enforcement action.

**Recommendation:** Review current case prioritization and assignment practices to determine if IRS's enforcement and collection procedures could be enhanced by requiring, to the maximum extent feasible, businesses with egregious payroll tax debt and the responsible owners/officers with a TFRP assessment be treated as a single unified and coordinated collection effort assigned to a single revenue officer.

**Comments:** We agree that, when feasible, egregious payroll tax assessments and TFRP assessments should be assigned to a single revenue officer. Treating payroll tax and TFRP assessments as a single unified and coordinated collection effort may achieve the advantages outlined in the report. Timely determinations, recommendations and assessment of the TFRP will accelerate the statutory notice requirements and may enable the revenue officer to more effectively leverage the assessments to gain compliance and/or prevent accumulation of additional unpaid payroll taxes.

**Recommendation:** Develop and implement procedures to allow liens to be filed against property as soon as possible after payroll tax debt is identified (including cases in the queue awaiting assignment) to ensure liens are placed on businesses with unpaid payroll taxes and owners/officers assessed a TFRP.

**Comments:** We agree to evaluate our existing practices and determine if a change should be made to our current case routing criteria in order to allow liens to be filed as soon as a payroll tax liability is identified.

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Appendix III: Comments from the Internal Revenue Service

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**Recommendation:** Develop and implement procedures to monitor and report on revenue officers' compliance with the new TFRP assessment timeframes to ensure revenue officers are making TFRP determinations and assessments in a timely manner.

**Comments:** We agree to consider ways to use the reports available on the timeliness of TFRP assessment.

**Recommendation:** Develop performance goals and measures that specifically evaluate the accumulation of unpaid payroll taxes by businesses (especially egregious businesses with over 20 quarters of payroll tax debt), the extent and timeliness of TFRP assessment, and the effectiveness of actions taken to collect unpaid payroll taxes and TFRP assessments.

**Comments:** We agree to evaluate the effectiveness and feasibility of establishing performance goals and measures based on the information in the reports tracking the timeliness of TFRP assessments.

**Recommendation:** Work with states that have developed procedures for matching financial accounts to tax debts to evaluate the potential for IRS to either develop and implement similar measures or to partner with states that currently have that tool to leverage their effort to assist revenue officers in identifying a business' leviable assets.

**Comments:** We agree with this recommendation. We will work with the states that have developed a program to match financial accounts with tax debts to determine the program's effectiveness and whether a similar program in IRS would be cost effective and consistent with privacy laws.

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## Appendix IV: GAO Contact and Staff Acknowledgments

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### GAO Contact

Steven J. Sebastian, (202) 512-3406 or sebastians@gao.gov

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### Acknowledgments

The following individuals made major contributions to this report: William J. Cordrey, Sean Bell, Russell Brown, Ray Bush, Kenneth Hill, Delores Lee, David Shoemaker, Lisa Warde, Tina Wu, and J. Mark Yoder.

**WRITTEN TESTIMONY OF  
LINDA STIFF  
DEPUTY COMMISSIONER  
SERVICES AND ENFORCEMENT  
INTERNAL REVENUE SERVICE  
BEFORE THE  
SENATE COMMITTEE ON HOMELAND SECURITY AND  
GOVERNMENTAL AFFAIRS  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
ON  
THE COLLECTION OF FEDERAL EMPLOYMENT TAXES  
  
JULY 29, 2008**

**Introduction**

Chairman Levin, Ranking Member Coleman, and members of the Subcommittee, thank you for the opportunity to testify today on the status of Internal Revenue Service's (IRS) efforts to collect Federal employment taxes. I appreciate the contribution this Subcommittee has made over the last four years with its investigations of Federal contractors who are delinquent on their taxes and of efforts by unscrupulous promoters and taxpayers to avoid taxation in the U.S. by moving income and assets offshore. The IRS has found valuable the opportunity to work with you and your staffs on each of these issues.

Similarly, we look forward to working with you to improve our efforts in the collection of Federal employment taxes. We have made great progress over the last five years, but as the Governmental Accountability Office (GAO) report released this morning demonstrates, we can still do better.

This morning I want to provide you a little background to our employment tax program including our efforts at both service and enforcement.

**Background**

Employment taxes were first established for collection of Social Security taxes in 1935, for Federal Income Taxes in 1943, and for Medicare taxes in 1965. These taxes constitute the primary source of revenue for the federal government. Employment taxes include:

- Federal Income Tax Withholding (FITW)
- Federal Insurance Contribution Act (FICA) – Social Security and Medicare

- Railroad Retirement taxes
- Federal Unemployment taxes (FUTA)

Today, employment taxes represent the largest portion of total tax dollars collected by the IRS. In FY 2007 for example, of the \$2.7 trillion in taxes collected by the IRS, \$1.7 trillion was payroll taxes. This means that approximately two out of every three dollars collected by the IRS are from required withholding on employment tax returns.

Of this \$1.7 trillion collected in withholding and FICA taxes, approximately \$778 billion was collected for Social Security and Medicare and approximately \$922 billion was collected for individual withholding taxes.

The magnitude of this program can be seen in other ways. For example, the number of employment tax returns filed in FY 2007 totaled over 30 million. The IRS is particularly concerned with the accuracy of employment tax filing in that it is through these filings that the Department of the Treasury transfers funds from the general fund to the Social Security Trust Fund to pay benefits to millions of retired and disabled Americans.

We are also seeing a shift in who files payroll tax returns. In addition to traditional employers, the filers of these returns now include payroll service providers, reporting agents, employee leasing companies, professional employer organizations, and other types of organizations.

This marks a significant departure from traditional employment tax filings, which were filed by the individual business. Now a single payroll tax provider may act as the withholding agent for multiple businesses.

This has added additional complexity to an already complex area thereby increasing risk to the Treasury. If a company that does payroll withholding for multiple businesses fails to file properly or stops filing completely the government potentially loses the employment taxes of all the businesses the payroll provider serves.

#### **Enforcement is a Priority at the IRS**

When Commissioner Shulman was going through his confirmation process, he was often asked whether he would be a Commissioner that emphasized service or enforcement. He responded that choosing one or the other represented a “false choice”. He emphasized that we must do a good job at both service and enforcement.

This balanced approach to service and enforcement represents a continuation of IRS’ approach for the last six years. This is reflected in a comparison of the enforcement numbers.

In FY 2001 the IRS collected an estimated \$33.8 billion in enforcement revenue. This number grew to over \$59 billion in FY 2007. Of these totals, collections increased from an estimated \$24.3 billion to \$31.8 billion, an increase of nearly 31 percent.

Similar increases can be seen in other enforcement metrics. The number of levies issued has increased over 400 percent – from 674,080 in FY 2001 to over 3.7 million in FY 2007. Liens have grown from 426,166 in FY 2001 to 683,659 in FY 2007.

Examinations of individual returns have nearly doubled since FY 2001 and the audit coverage rate has increased from 0.58 percent to 1.03 percent in FY 2007. Of this total, the greatest increases have been seen among high income individuals. In FY 2007 the coverage rate for individuals with incomes greater than \$1 million was 9.25 percent.

Examination of business returns has also risen. In FY 2001, we looked at just over 41,000 business returns as opposed to nearly 60,000 in FY 2007.

More relevant to this Subcommittee is the increase in employment tax audits. From FY 2005 to FY 2007 the number of audits increased by 66.8 percent, while the audit coverage rate rose from 0.11 percent to 0.20 percent.

We have also seen a significant rise in the number of overall tax cases that we are closing. Total closures from FY 2002 to FY 2007 more than doubled. They rose from 3.6 million in 2002 to 8.3 million in 2007.

#### **Helping Businesses Comply with the Law**

Even in a good economy, it is often difficult to start and maintain a business over a number of years. In addition to the considerable competitive pressures such businesses must face, they must also comply with myriad laws and regulations.

According to statistics from the Small Business Administration, more than a third of all small businesses do not last two years. Only half of all start-ups are still in business after four years, and that figure drops to 40 percent after six years.

These businesses are often undercapitalized. The owner often commits all of his or her personal financial resources to the business. As a business experiences problems, rather than submit the money they have withheld from employees for FICA and for Federal income taxes to the Federal government as required by law, the owners may use that money to fund payroll or to keep the utility company from cutting off power – to keep the business going in the hopes of better times.

This is a story we see repeated over and over again and is perhaps one of our greatest challenges in the collection of Federal payroll taxes.

To help avoid this situation, we work with small businesses upfront to ensure that they understand their obligations. The first aim of the IRS is to help employers avoid problems by educating them on employment tax responsibilities. One of the means to accomplish this is through the use of the Federal Tax Deposit Alert process, which helps to identify, at an early stage, taxpayers classified as bi-weekly depositors who have not made federal tax deposits during the current quarter, or have made deposits in substantially lower amounts from prior quarters.

Virtually all of the IRS functional and operating divisions participate in employment tax outreach and education. The IRS also provides substantial information about employment taxes on IRS.gov, on other Web sites through partnerships and work with other organizations, including groups that represent small businesses, and through electronic and print media.

Applicants for new Employer Identification Numbers receive considerable information based on what they indicate on their Form SS-4. Those who state they have or will have employees automatically get a copy of Circular E, Employer's Tax Guide; information for making Federal Tax Deposits; and enrollment information for the Electronic Federal Tax Payment System. The IRS.gov Web site has a newly redesigned section devoted to employment taxes, with information on worker classification, withholding and depositing taxes, employment tax forms and publications, and links to the Social Security Administration's (SSA) Employer's Web Page.

The IRS also works with other organizations to have them add employment tax information on their Web sites. To date in FY 2008, IRS has partnered with almost 700 tax professional and industry Web sites to add such information.

The IRS also works with community partners to present Small Business Tax Workshops throughout the United States. These workshops instruct new and prospective business owners in federal tax responsibilities, including employment taxes. To date in FY 2008, over 1,000 workshops have been conducted across the country.

Quarterly, the IRS sends out approximately seven million SSA IRS Reporter newsletters with Form 941, Employer's Quarterly Federal Tax Return. The newsletter contains information on subjects such as Social Security laws, the Electronic Federal Tax Payment System, or changes in Social Security or IRS electronic filing systems.

In addition, in 2007, the IRS developed a new brochure, Publication 4591 – Small Business Federal Tax Responsibilities, which includes information about employment taxes. Over 300,000 have been distributed to date including over 200,000 by state licensing agencies to people applying for new business licenses.

**Brief Background: Case Flow within the IRS**

The collection process within the IRS generally begins with a series of notices requesting payment. These notices allow us to collect nearly 80 percent of the outstanding deficiency as the taxpayers self-correct their returns.

The notices are followed by telephone contact in an attempt to secure payment. In FY 2007, we were able to resolve 3.5 million accounts via telephone contact.

If neither the notices nor the telephone contacts resolve the situation, cases are assigned to a field revenue officer for an attempt at in-person contact. In 2007, 1.2 million accounts were resolved by field contacts.

A slightly different process is used to collect employment taxes. The IRS sends fewer notices in employment tax cases so that personal contact can occur sooner. Our highest priority cases bypass the telephone operation in favor of making first contact in the field. Factors used in determining the priority of work include the age of the case (more recent cases are taken first) and the type of tax at issue (payroll taxes receive top priority).

**Addressing Noncompliance in Payroll Tax Remittances**

The tax code provides the IRS with tools to bring taxpayers into compliance and facilitate the payment of unpaid payroll tax liabilities.

These tools include:

- Notice of Federal Tax Lien – Filing of a Notice of Federal Tax Lien puts the public on notice that the taxpayer has outstanding Federal tax liabilities and establishes the government’s position with respect to other creditors.
- Levy or seizure – The Internal Revenue Code § 631 authorizes the IRS to levy –or seize – a taxpayer’s property to collect delinquent tax. Bank accounts and wages are among the most common assets levied. The term “seizure” is generally used to describe a levy on property that must then be sold by the IRS so that the proceeds can be applied to the taxpayers account. Most employment tax cases are included in the Federal Payment Levy Program (FPLP). This is an automated levy program that matches IRS balance-due information with pending Federal payment information provided by the Financial Management Services (FMS) function of the Department of the Treasury. This program is effective if the delinquent party is a Federal contractor or other creditor of the Federal government. In general, all employment tax accounts without an active payment plan or ongoing litigation are included in the FPLP.
- Summons – A summons is an administrative means of compelling the production of books, records or testimony. Summons authority is used when the desired

information cannot be secured voluntarily. If the summoned party does not comply, court action can be initiated.

- Substitute Returns - Internal Revenue Code § 6020(b) authorizes the IRS to prepare unfiled employment, excise, and partnership returns if the taxpayer fails to file the returns as required by law.
- Trust Fund Recovery Penalty (TFRP) – Officers and employees of a corporation who do not turn over monies they collect in trust for the government are subject to being assessed the TFRP. The total amount that was withheld from employees' wages for Federal income taxes and FICA, and not paid over to the government is the amount that is asserted against the officers and/or employees and becomes the TFRP.

In some instances, traditional administrative collection remedies are not effective in bringing taxpayers into compliance with their payroll tax obligations. For example, taxpayers often attempt to “pyramid” their liabilities as a means of deferring payment or delaying enforcement action. One form of pyramiding occurs when the same business fails to remit payroll taxes for multiple quarters. The second form of pyramiding occurs when the owner of a delinquent business closes down once enforcement action begins. The owner will then simply incorporate as another entity often selling the same products as before. If he fails to remit for that business and enforcement action begins, he will start a third business. Meanwhile, his payroll tax liabilities continue to pyramid higher.

When pyramiding occurs, the IRS has the ability to subject the taxpayer to more stringent filing and payment requirements. An employer with a history of noncompliance can be required to Form 941 monthly, as opposed to quarterly, or can be required to make employment tax deposits to at a specific bank. Failure to comply with these restrictions can carry criminal penalties.

If these administrative remedies and requirements are not effective in bringing the taxpayer into compliance with the payroll tax requirements, the IRS may try to obtain an injunction against the business.

An injunction is a court proceeding whereby the IRS seeks to prevent the taxpayer from taking (or not taking) actions that threaten to cause or are causing harm to the IRS. Currently, in order to obtain an injunction, the IRS must be able to show irreparable injury and the lack of an adequate remedy at law.

The IRS is developing and testing streamline procedures that will assist Field Collection when developing and requesting a suit for injunctive relief. Specifically, through an understanding with the Department of Justice, the IRS will be putting forward injunction suits that are based on more flexible standards for showing that the government is being irreparably harmed by the non-payment of employment taxes, that further administrative activity would be futile, and that no adequate remedy at law exists.

In addition to requesting injunctive relief when necessary, the IRS also pursues criminal prosecution in appropriate instances, which have important deterrent effects. In FY 2008, examples of criminal prosecutions include the following, all of which are a matter of public record:

- On June 17, 2008, in Pittsburgh, Pa., James C. Platts was sentenced to 30 months in prison to be followed by three years of supervised release on his conviction of Federal tax evasion. Platts was found guilty at a trial by jury in March 2008. According to the United States Attorney, Western District of Pennsylvania, the evidence presented at trial showed that Platts evaded the payment of Federal payroll taxes and FICA taxes which Platts's company, the Pinnacle Building Company, withheld from employees during four separate tax quarters in 1998 and 1999.
- On May 22, 2008, in Chicago, Ill., Thomas Shumate was sentenced to 46 months in prison for failing to pay income and payroll taxes to the United States. Shumate owned and operated Propay, Inc, a business that prepared and filed tax returns. Shumate contracted with 34 corporate clients to calculate their payroll taxes and pay over the money they owed to the IRS. According to the plea agreement signed by Shumate, between 2001 and 2006, he falsely understated the amount of money that 23 of his clients owed the IRS. For eight of his clients, he failed to file the employer tax returns and failed to forward the money to the IRS.
- On May 19, 2008, in Greenbelt, Md., Ernest Lee, Jr., of Clinton, MD., was sentenced to 18 months in prison, followed by three years of supervised release, and ordered to pay \$340,001 in taxes owed. According to his plea agreement, beginning in or about February 1995 through at least 2002, Lee, Jr. was responsible for maintaining the payroll and financial and accounting records for the family-owned, ceramic-tile installation business called ELT, Inc. As part of his duties, Ernest Lee, Jr. was responsible for remitting FICA, withholding and federal unemployment taxes owed by ELT, Inc. to the IRS and the Social Security Administration for ELT, Inc. employees. For tax years 1998-2000, Lee Jr. failed to pay approximately \$161,000 in FICA, withholding and Federal unemployment taxes owed by ELT.
- On May 19, 2008, in St. Louis, Mo., Paul Scott King, Jr. was sentenced to 33 months in prison for failing to pay \$400,000 in employment taxes. In a plea agreement signed in February 2008, King admitted that during 2001 and 2003, he owned two corporations: Nurses Now LLC and Ichor Health Services, Inc. These businesses provided the temporary services of hundreds of nurses and medical professionals to hospitals and nursing homes. King withheld income taxes and Social Security taxes from the employees' wages and did not pay them over to the IRS as required by law. King admitted in his guilty plea that he failed to pay \$432,191 in employment taxes.

- On May 7, 2008, in St. Paul, Minn., Scott M. Tovey, of Elk River, Minnesota, was sentenced to 24 months in prison for failing to pay employment taxes on his employees. Tovey, owner of Tovey Tile Co., a tile-setting business with locations in Medina and Minnetonka, pleaded guilty in January 2008 to one count of failure to account for and pay over employment taxes. According to Tovey's plea agreement, he admitted that he issued W-2 forms to his employees reflecting that Federal employment taxes were withheld from their wages, but, he did not provide the W-2 forms to the Social Security Administration as required. Tovey also admitted he willfully failed to account for and pay those taxes to the IRS. From March 1999 through September 2003, the total tax owed by Tovey was approximately \$574,485.

In many ways the success we have had in these criminal cases and many others demonstrate the level of progress that the IRS has made in the payroll tax arena.

The IRS also works to prevent non-filing by using matching programs that identify potential non-filers. The IRS also works closely with the SSA in identifying non-filers. The IRS and the SSA jointly administer the Combined Annual Wage Reporting or CAWR Program. This is a Document Matching Program that compares the Employee Wage Information reported by the employer on Forms 94X to the IRS with Forms W-2 reported to the SSA. In FY 2008 the CAWR programs are projected to close 356,832 cases and have already assessed \$567,053,750 in taxes and penalties through May 31, 2008.

### **GAO Report**

We have carefully reviewed and commented on the report that the Government Accountability Office (GAO) prepared for the Subcommittee on this matter. The \$58 billion in uncollected payroll taxes is an unacceptably high number, but as I hope my testimony illustrates, it represents a snapshot of unpaid employment taxes at the mid-point of a long-term improvement effort. Our numbers show dramatic improvement in the last several years, but we know we still have a long way to go.

After reviewing the findings in this report, I have directed the Service-wide Employment Tax Advisory Council (SETAC) Collections task force to re-focus its efforts to concentrate solely on the more effective use of enforcement tools in employment tax cases.

To support that effort, we are launching a series of research studies to be conducted by the IRS' Office of Research, Analysis, and Statistics (RAS), which together will give the Council the data necessary to determine the appropriate mix of taxpayer service and enforcement. Research areas will include: (1) effective use of the trust fund recovery penalty; (2) earlier consideration of the filing of liens; (3) greater use of automated collection tools throughout the collection process; and (4) whether there is a "point of no return" in employment tax cases (i.e., a number of quarters or amount of tax accrued) at which our enforcement posture should change.

The SETAC met last week and established an aggressive timeline for completing its review of the use of enforcement tools in employment tax cases.

We think these efforts will result in continued improvements in enforcement results and will allow us to take a more strategic approach to the collection of employment taxes.

We have also advised GAO that we agree with their recommendations and look forward to working with both internal and external stakeholders to improve our efforts in the collection of Federal employment taxes.

Specifically, GAO made six recommendations on how the IRS could improve its procedures. We agree to:

- Explore the value of regularly extracting information from internal data sources to identify the most egregious payroll tax offenders. The information could be shared with the Director of Collection to supplement discussions with Area directors regarding the quality and timeliness of case work.
- Assign, when feasible, egregious payroll tax assessments and TFRP assessments to a single revenue officer. Treating payroll tax and TFRP assessments as a single unified and coordinated collection effort may achieve the advantages outlined in the report. Timely determinations, recommendations and assessment of the TFRP will accelerate the statutory notice requirements and may enable the revenue officer to leverage the assessments more effectively to gain compliance and/or prevent accumulation of additional unpaid payroll taxes.
- Evaluate our existing practices and determine if a change should be made to our current case routing criteria in order to allow liens to be filed as soon as a payroll tax liability is identified.
- Consider ways to use the reports available on the timeliness of TFRP assessment as part of our on-going quality review process.
- Evaluate the effectiveness and feasibility of establishing performance goals and measures based on the information in the reports tracking the timeliness of TFRP assessments.
- Work with those states that have developed a program to match financial accounts with tax debts to determine the effectiveness of their program and whether a similar program in IRS would be cost effective and consistent with privacy laws. In fact, we have already begun meeting with states to learn about their matching programs and determine whether a similar model can be adopted at the Federal level.

As we move forward in the employment tax arena, there are several promising aspects on which we are working. The first of these is attacking the overall tax gap by improving

the collection of payroll taxes. In August 2007, the Department of the Treasury and the IRS released a comprehensive strategy to improve voluntary compliance and reduce the tax gap. That strategy incorporated a comprehensive, multi-year, integrated, cross-functional, corporate-level approach, including the following seven components:

- Reduce Opportunities for Evasion
- Make a Multi-Year Commitment to Research
- Continue Improvements in Information Technology
- Improve Compliance Activities
- Enhance Taxpayer Service
- Reform and Simplify the Tax Law
- Coordinate with Partners and Stakeholders

In each of these components, payroll tax collections will play a significant role as the strategy is implemented. For example, RAS provides support by providing historical information studies and reports, gathering and analyzing data for future purposes, as well as providing general guidance and direction. In the long-term, our research efforts will provide a method and foundation for the development of a multi-year employment tax approach for FY 2009 and beyond. RAS will also consider initiating a National Research Program (NRP) relating to employment taxes to measure the tax gap further while also refining the issues that may be associated with employment tax non-compliance.

As a foundation for the strategic planning process, RAS analyzes data and helps to identify emerging trends and sources of noncompliance within employment tax. RAS also works to establish benchmarks and measure the quantitative and qualitative effectiveness of IRS efforts.

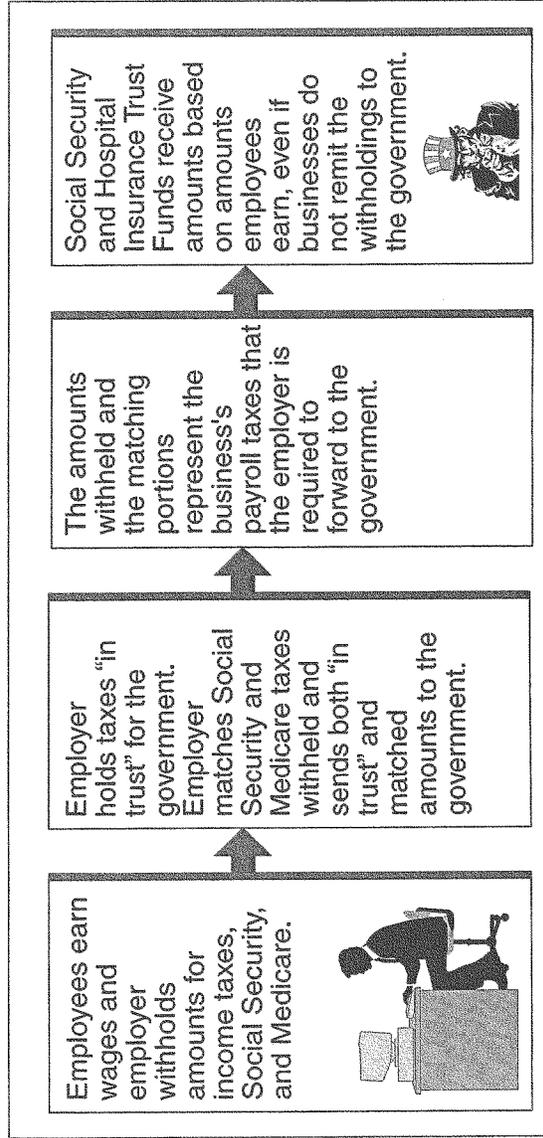
In addition to the tax gap plan, we are working on the Business Master File Case Creation Non-filer Identification Process (BMF CCNIP) project. This project will redesign and enhance the BMF Case Creation Program to allow for the selection of BMF inventory with the greatest potential for IRS intervention. The project will optimize limited resources, increase employee productivity, and reduce taxpayer burden. BMF CCNIP will improve workload selection and casework quality, resulting in improved customer and employee satisfaction.

### **Summary**

The IRS' commitment to employment taxes is service-wide, as is the Department of the Treasury's. The IRS and Treasury are committed to striking the proper balance between service and enforcement; to taking every possible step to minimize taxpayer burden; and to focusing on improving filing, reporting, and payment compliance.

Thanks for the opportunity to be here today, and I will be happy to respond to any questions.

# Payroll Tax Process





**A Comprehensive Strategy for Reducing the Tax Gap**

**U.S. Department of the Treasury**

**Office of Tax Policy**

**September 26, 2006**

### Executive Summary

In fiscal year 2005, Federal receipts totaled over \$2.2 trillion. More than 95 percent of net receipts were collected by the Internal Revenue Service (IRS) through its administration of the income, transfer and excise tax provisions of the Internal Revenue Code. The vast majority of these receipts is collected through our voluntary compliance system, under which taxpayers report and pay their taxes with no direct enforcement and minimal interaction with the government. The overall compliance rate achieved under this system is quite high. In 2001, the compliance rate was over 86 percent, after including late payments and recoveries from IRS enforcement activities. Nevertheless, an unacceptably large amount of the tax that should be paid every year is not, requiring compliant taxpayers to make up for the shortfall and giving rise to the “tax gap.”

The Administration is committed to working with Congress to reduce the tax gap. This document outlines the Administration’s aggressive strategy for addressing the tax gap. The strategy builds upon the current efforts of the Treasury Department and the IRS to improve compliance. As part of the deliberations in preparing the Administration’s fiscal year 2008 budget request to Congress, the Treasury Department and the IRS are working with the Office of Management and Budget to further develop this strategy to reduce the tax gap. This document is intended to provide a broad base on which to build. The more detailed elements of the tax gap strategy are, in part, contingent upon the budget process for fiscal year 2008 and beyond. Accordingly, the Treasury Department and the IRS will provide a more detailed outline of steps they will take to address the tax gap following release of the Administration’s fiscal year 2008 budget request early next year.

Four key principles guided the development of this strategy:

- First, unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Second, sources of noncompliance should be targeted with specificity.
- Third, enforcement activities should be combined with a commitment to taxpayer service.
- Fourth, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to reduce the tax gap. Our practical and effective overall strategy includes the following seven components:

1. Reduce Opportunities for Evasion. The Administration’s fiscal year 2007 budget includes five legislative proposals to reduce evasion opportunities and improve the efficiency of the IRS. The Treasury Department’s Office of Tax Policy is working with the IRS to develop additional legislative proposals for consideration as part of the fiscal year 2008 budget process. The Treasury Department and the IRS will also continue to

use the regulatory guidance process to address both procedural and substantive issues to improve compliance and reduce the tax gap.

2. Make a Multi-Year Commitment to Research. Research is essential to identify sources of noncompliance so that IRS resources can be properly targeted. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge. New research is needed on the relationship between taxpayer burden and compliance and the impact of customer service on voluntary compliance. Research is also essential to establish accurate benchmarks and to measure the effectiveness of IRS efforts, including the effectiveness of this comprehensive strategy to reduce the tax gap.
3. Continue Improvements in Information Technology. Continued improvements to technology would provide the IRS with better tools to improve compliance through early detection, better case selection, and better case management.
4. Improve Compliance Activities. By improving document matching, examination, and collection activities, the IRS would be better able to prevent, detect, and remedy noncompliance. These activities would increase compliance not only among those directly contacted by the IRS, but also among those who would be deterred from noncompliant behavior as a consequence of a more visible IRS enforcement presence. The IRS continues to reengineer examination and collection procedures and invest in technology, resulting in efficiency gains and better targeting of examination efforts. These efficiency gains translate into higher audit yields, expanded examination coverage, and reduced burden on compliant taxpayers.
5. Enhance Taxpayer Service. Service is especially important to help taxpayers avoid unintentional errors. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary contacts afterwards, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations. The statutorily mandated Taxpayer Assistance Blueprint, the next phase of which is expected to be delivered in January, will include a process for assessing the needs and preferences of taxpayers and will develop a decision model to prioritize service initiatives and funding. The IRS is also working to provide service more efficiently and effectively through new and existing tools, such as the IRS web site.
6. Reform and Simplify the Tax Law. Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws. For example, the Administration's fiscal year 2007 budget includes six proposals to simplify the tax treatment of savings and families by consolidating existing programs and clarifying eligibility requirements. The Office of Tax Policy is developing other simplification proposals for consideration in the Administration's fiscal year 2008 budget request. In addition, the Treasury Department is evaluating the report of the President's Advisory Panel on Federal Tax Reform and is considering options for reform. These initiatives will continue to be supplemented by IRS efforts to reduce taxpayer burden by simplifying forms and procedures.

7. Coordinate with Partners and Stakeholders. Closer coordination is needed between the IRS and state and foreign governments to share information and compliance strategies. Closer coordination is also needed with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice. Through contacts with practitioner organizations, the Treasury Department and the IRS learn about recent developments in tax practice and hear directly from practitioners about taxpayer concerns and potentially abusive practices. Similarly, contacts with taxpayers and their representatives, including small business representatives and low-income taxpayer advocates, provide the Treasury Department and the IRS with needed insight on ways to protect taxpayer rights and minimize the potential burdens of compliance strategies.

The success of this comprehensive strategy will depend, in significant part, on IRS resources and the agency's efficient and effective use of such resources. The IRS has made significant progress toward improving the efficient use of its allocated resources, especially in targeting enforcement efforts to areas where they will have the greatest direct and indirect impact on compliance. The IRS will continue to seek ways to make its operations more efficient and thus free resources to fund new compliance initiatives. In implementing this strategy, the Treasury Department and the IRS recognize that it will be important to establish benchmarks against which progress on each element of the strategy can be measured.

## I. The Size and Source of the Tax Gap

The “gross tax gap” is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time. In February 2006, the IRS released updated compliance estimates, showing that the gross tax gap was \$345 billion in tax year 2001.<sup>1</sup> As a percentage of tax liability for tax year 2001, this represents a compliance rate of about 83.7 percent.

This estimate, however, does not take into account taxes that were paid voluntarily but paid late, or recoveries from IRS enforcement activities. Taking these factors into account, the “net tax gap” was an estimated \$290 billion in tax year 2001, which represents a net compliance rate of 86.3 percent.

There are three key characteristics of the tax gap:

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

These characteristics suggest a targeted response designed to address the most significant areas of noncompliance. The following overview discusses these characteristics in more detail.

### Type of Tax

As indicated above, the IRS estimates that over 70 percent of the gross tax gap is attributable to the individual income tax. As Table 1 below shows, the remainder of the tax gap is associated with employment taxes (chiefly self-employment taxes), corporate income taxes, and estate taxes.

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<sup>1</sup> The estimates of underreporting of individual income and self-employment taxes were derived from analysis of the 2001 National Research Program (NRP). Most of the other estimates are projections derived from older compliance studies.

Type of Tax	Gross Tax Gap (\$ Billions)	Share of Gross Tax Gap (%) <sup>1</sup>
Individual Income	245	71
Corporate Income	32	9
Employment	59	17
Estate	8	2
Excise	Not Available	
<b>TOTAL</b>	<b>345</b>	<b>100</b>

<sup>1</sup> Totals may not add up to 100 percent due to rounding.

#### Type of Error

The IRS estimates that over 80 percent of the gross tax gap is caused by underreporting of tax (i.e., underreporting of income or overstating deductions and credits). Over 40 percent of the gross tax gap is attributable to underreporting of net business income by individuals (affecting both income and self-employment taxes). (See Table 2).

The remainder of the gross tax gap is split between two sources of errors:

- Roughly 10 percent of the gross tax gap is attributable to underpayments, a significant portion of which is due to employer failures to deposit withheld income and employment taxes.
- The remainder of the tax gap is due to failure to file tax returns, mostly for individual income taxes.

Type of Error	Gross Tax Gap (\$ Billions)	Share of Gross Tax Gap (%) <sup>1</sup>	
Underreporting <sup>2</sup>	<b>Individual Income Tax</b>		
	<i>Non-Business Income</i>	56	16
	<i>Business Income</i>	109	32
	<i>Adjustments, Deductions, Exemptions, and Credits</i>	32	9
	<b>Total</b>	<b>197</b>	<b>57</b>
	<b>Corporation Income Tax</b>	<b>30</b>	<b>9</b>
	<b>Employment Tax</b>		
	<i>FICA</i>	14	4
	<i>Self-Employment Income Tax</i>	39	11
	<b>Total</b>	<b>54</b>	<b>16</b>
	<b>Estate Tax</b>	<b>4</b>	<b>1</b>
<b>Total Underreporting</b>	<b>285</b>	<b>83</b>	
Underpayments <sup>3</sup>	<i>Individual Income Tax</i>	23	7
	<i>Employment Tax</i>	5	1
	<i>Other</i>	5	3
	<b>Total Underpayments</b>	<b>34</b>	<b>10</b>
Nonfiling <sup>4</sup>	<i>Individual Income Tax</i>	25	7
	<i>Estate</i>	2	1
	<b>Total Nonfiling</b>	<b>27</b>	<b>8</b>

<sup>1</sup> Totals may not add up to 100 percent due to rounding.

<sup>2</sup> Information regarding underreporting of excise taxes is not available.

<sup>3</sup> Underpayments include employer failures to deposit withheld income and employment taxes.

<sup>4</sup> Information regarding the nonfiling gap associated with corporate income taxes, employment taxes, or excise taxes is not available.

#### **Level of Transparency**

Tax compliance is greatest for income subject to mandatory withholding by the payer. Only one percent of the tax due on wage income (reported by employers) was not reported to the IRS by return filers in 2001.

Noncompliance rates are higher for income that is not subject to withholding, but that is reported separately to the IRS by a third party when payments are made. The net misreporting percentage is about 4.5 percent for interest income, dividends, social security benefits, pensions, and unemployment insurance, all of which are generally subject to third-party reporting. The net misreporting percentage is somewhat higher for income items that are subject to some, but not substantial, information reporting. For partnership and S corporation income, alimony, reportable exemptions and deductions, and capital gains, the net misreporting percentage is 8.6 percent.

Noncompliance rates are highest for income that is not subject to either withholding or third-party reporting requirements. About 54 percent of net income from proprietors (including farms), rents, and royalties is misreported. Underreporting of self-employment income also results in high noncompliance for self-employment taxes for social security and Medicare.

#### **Intentional Versus Unintentional Errors**

A common question is the extent to which the tax gap results from intentional evasion rather than unintentional errors by confused taxpayers. Determining taxpayer intent under a regular examination is very difficult. For obvious reasons, taxpayers do not concede that their erroneous reporting is intentional, and any analysis of the nature of the error by IRS examiners is inherently subjective. Some researchers have applied econometric techniques to compliance data to measure intentional evasion, but the results have been inconclusive. In all events, complexity provides those taxpayers who are predisposed to taking aggressive reporting positions the opportunity to argue that their errors are unintentional.

It is safe to conclude that both intentional and unintentional errors contribute to the tax gap and that any strategy to reduce the gap must address both intentional evasion as well as taxpayer confusion due to the complexity of the code.

#### **II. Challenges to Reducing the Tax Gap**

Addressing the tax gap involves improving voluntary compliance, reducing opportunities for evasion, and making it easier for the IRS to administer the tax laws. We must, however, have realistic expectations about the magnitude and timing of the impact of any reasonable strategy to reduce the tax gap, particularly if it is not accompanied by broader simplification and reform of the tax code, or significant advances in compliance technology.

Implementing a strategy to reduce the tax gap will take time. As a result, it will take time to realize the anticipated benefits. As part of this strategy, the IRS will, for example, acquire and analyze new data, improve document matching programs, refine examination selection criteria, purchase and test new technology, and train employees to handle new enforcement and customer service responsibilities.

Moreover, while it may be possible to develop a comprehensive strategy that reduces the tax gap, it is not possible to implement a policy that would come close to eliminating the tax gap without an unacceptable change in the fundamental nature of our tax compliance system.

### III. A Comprehensive Strategy to Reduce the Tax Gap

With an estimated net tax gap of \$290 billion, no single approach will be successful at substantially reducing noncompliance. A comprehensive, integrated, multi-year strategy is necessary, within the context of an annual budget process.

#### 1. Reduce Opportunities for Evasion

Without reliable third-party data, the IRS cannot easily detect errors in the absence of expensive and intrusive audits. The IRS receives over 1.5 billion information returns a year, reporting income from employers, financial institutions, third party payers, and state and Federal governments. However, the IRS still lacks reliable information on certain types of income, most notably income earned by the self-employed.

Penalties can deter noncompliance, but they may be set at the wrong level. Some penalties may be too low under current law to change behavior. Other penalties may be so high that examiners have been unable or unwilling to assert them, particularly when they believe that taxpayers may have made inadvertent errors.

The Administration's fiscal year 2007 budget contains five legislative proposals that would reduce evasion opportunities by focusing on employment taxes, information reporting, streamlining collection procedures, and problem return preparers. The legislative proposals in the Administration's fiscal year 2007 budget are an important step in reducing the tax gap. The Treasury Department is developing other proposals for consideration during the deliberations on the fiscal year 2008 budget, which would further reduce opportunities for evasion without unduly burdening honest taxpayers.

During these deliberations, we are exploring a number of different options including ways to:

- Strengthen reporting requirements;
- Expand IRS access to reliable data;
- Enhance examination and collections authority;
- Enable the IRS to detect and prevent multi-year noncompliance; and
- Set penalties at more appropriate levels.

The issuance of regulations and administrative guidance by the Treasury Department and the IRS will also continue to play an important role in effectively administering the tax law and responding to the tax gap problem. Guidance clarifies ambiguous areas of the law, increasing voluntary compliance. Guidance also targets specific areas of noncompliance, and prevents abusive behavior, such as tax shelters. Each year, the Treasury Department and the IRS publish a Priority Guidance Plan. The 2006-2007 plan

includes 264 guidance projects scheduled for completion between July 2006 and June 2007. Many of the 264 guidance items included in this year's plan address potential areas of noncompliance. A representative sample of these items includes:

- Guidance regarding transfer-pricing arrangements involving cost-sharing under section 482;
- Guidance under section 671 regarding information reporting by widely-held fixed investment trusts (WHFITs);
- Final regulations under section 860G(b) regarding withholding obligations of partnerships allocating income from real estate mortgage investment conduit (REMIC) residual interests to foreign persons; and
- Final regulations under section 6655 regarding estimated tax payments by corporations.

The Treasury Department and the IRS have also successfully used the guidance process to help curb the involvement of taxpayers and practitioners in abusive tax avoidance transactions. For example, following enactment of the American Jobs Creation Act of 2004 ("AJCA"), the Treasury Department and the IRS released eleven separate guidance items to put into effect new reportable transaction disclosure and penalty rules. A major guidance project is currently underway to incorporate these rules into regulations. In addition, building on provisions in the AJCA, the Treasury Department and the IRS have taken significant steps to tighten and enforce the ethical rules that apply to tax practitioners, targeting improper tax advice as a significant contributor to noncompliance and the tax gap.

The publication of instructions and forms also contributes to increased efficiencies in tax administration. For example, the IRS and the Treasury Department developed the Schedule M-3 for large business taxpayers to disclose and reconcile book-tax differences. The Schedule M-3 increases the transparency of book-tax differences, resulting in a material increase in the IRS's ability to detect sources of noncompliance. The Treasury Department and the IRS are expanding Schedule M-3 coverage to S corporations and partnerships.

Following release of the Administration's fiscal year 2008 budget request, the Treasury Department and the IRS will issue a more detailed outline of the steps we will take to reduce opportunities for evasion and address the tax gap. In addition, the Treasury Department and the IRS will continue to identify guidance projects targeted to compliance and include them in regular updates to the Priority Guidance Plan.

## **2. Make a Multi-Year Commitment to Research**

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, allocate resources more effectively, and reduce the tax gap.

The National Research Program (NRP) demonstrates the importance of comprehensive compliance data. As part of the NRP, the IRS reviewed approximately 46,000 randomly sampled individual income tax returns from tax year 2001 – the first comprehensive compliance study for individual income tax returns since 1988. Returns for which reported information could not be independently verified were audited. An NRP reporting compliance study of 5,000 S corporation tax returns filed in 2003 and 2004 is currently underway.

Data from the NRP reporting compliance study have been used to estimate the individual income tax component of the tax gap and to identify sources of noncompliance. Accurate NRP data provides a critical benchmark for determining the sources of noncompliance and for measuring changes in compliance rates over time. The IRS is also using the findings from the NRP to target examinations and other compliance activities better, thus increasing the dollar-per-case yield and reducing “no change” audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

More compliance research is needed. Without new reporting compliance studies, the IRS is forced to rely on old studies, conducted over 20 years ago, to estimate compliance for areas other than individual income tax or S corporations. Moreover, with each passing year, the data from the 2001 study on individual income tax compliance becomes more outdated. Without up-to-date studies in all areas, the IRS is hampered in its ability to respond rapidly to emerging vulnerabilities in the tax system. A multi-year commitment to research would ensure that the IRS can efficiently target its resources and effectively respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas because this reduces the burden of unnecessary taxpayer contacts. Research is also critical in helping the IRS to establish benchmarks against which to measure progress in improving compliance.

The IRS is considering new research projects in the following areas:

- *Regularly update NRP reporting compliance studies.* NRP studies (such as the 2001 reporting compliance study of individual taxpayers) must be regularly and frequently scheduled to ensure that the IRS has the most up-to-date compliance data.
- *Initiate new NRP reporting compliance studies.* To provide the IRS with more comprehensive data on the magnitude and sources of noncompliance, NRP studies could extend to partnerships, other business entities, employment taxes, exempt organizations, and government entities.
- *Supplement NRP reporting compliance studies with smaller and more targeted compliance studies.* By focusing on specific areas of noncompliance, smaller studies can yield more information about the sources of noncompliance. Targeted studies can also provide insight into the effectiveness of different types of compliance strategies.

- *Examine the linkages between taxpayer services and compliance.* Research would provide a better understanding of the relationship between taxpayer burdens and compliance and the impact of taxpayer service on voluntary compliance, two areas where there has been limited work to date. Understanding the link between taxpayer service and voluntary compliance could help the IRS better target taxpayer services as well as develop programs that would both ease taxpayer burden and improve voluntary compliance.
- *Develop new tools to uncover patterns of noncompliance.* Research must be done to understand the changing patterns of noncompliance and to develop tools to discover and address it. Improved abilities to link data sets and to recognize similarities in abusive tax reduction strategies allow the IRS to target examination resources on the most egregious cases.
- *Improve the allocation of resources.* Research could help the IRS better match enforcement and service resources with the types of noncompliance, thereby maximizing the overall impact on compliance.

### **3. Continue Improvements in Information Technology**

Tax administration in the 21<sup>st</sup> century requires improved IRS information technology (IT). The IRS is committed to continuing to make improvements in technology, including:

- Replacing antiquated core account management systems and technology. The Customer Account Data Engine (CADE) is the technological foundation that will enable the IRS to manage its tax accounts better and provide the data for a modernized IRS. Over time, the existing data base (the Individual Master File) and retrieval system (the Integrated Data Retrieval System) will be replaced with new technologies, new data bases, and new applications.
- Expanding and enhancing compliance activities through early detection, better case selection, and better case management.
- Delivering effective customer service, including E-File systems and web services, at reduced cost.
- Investing in infrastructure necessary to perform operations more efficiently, thus freeing up resources for enforcement and taxpayer service projects.

Upon release of the Administration's fiscal year 2008 budget request, the IRS will report on specific steps that will be taken to continue to improve its information technology.

### **4. Improve Compliance Activities**

The IRS has an annual budget of roughly \$10.5 billion for fiscal year 2006 to process roughly 140 million individual, partnership, and corporate income tax returns and 1.5

billion information returns, provide guidance to taxpayers and their preparers, enforce the tax law, and collect over \$2 trillion of taxes. The IRS can address only a small part of the tax gap each year through its enforcement activities. In 2005 taxpayer contacts by the IRS included: 3.2 million notices sent to individual taxpayers who made mathematical or clerical errors on their 2004 tax returns, 3.5 million notices sent to taxpayers who underreported income on their tax returns or did not file returns, and 1.2 million examinations of individual income tax returns.

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. For example, to combat abusive tax avoidance transactions, the IRS is expanding its front-line enforcement activities by redirecting employees. As detailed in the following section, the IRS continues to take advantage of technological advances, such as the Internet, to improve taxpayer services. Not only do these technological advances ease taxpayer burden, but they free valuable IRS resources to be devoted to enforcement activities.

The IRS will continue to reengineer its examination and collection procedures to reduce time, increase yield, and expand coverage. As part of its regular examination program, the IRS is expanding the use of cost-efficient audit techniques first pioneered in the NRP. By increasing its use of reliable third-party data to verify information reported by taxpayers, the IRS can better target its audit resources. The IRS is expanding its efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as non-filers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

However, efficiency gains in existing programs alone will not significantly reduce the tax gap. Some of the new steps described elsewhere in this strategy, such as providing the IRS with access to more third-party data and simplifying the tax code, would also help make compliance activities more effective.

To reduce the tax gap further, new initiatives, such as the following, are needed:

- *Expand information reporting.* If legislation were enacted to strengthen reporting requirements, the IRS could use the new information to increase and better target its enforcement activities. Voluntary compliance would also improve, freeing IRS resources to focus on more questionable returns.
- *Improve document matching program.* Increasing the number of inquiries to taxpayers when there are discrepancies between amounts reported on tax returns and third-party information returns would improve compliance.
- *Refine detection programs.* Refining and expanding detection programs to target enforcement efforts on noncompliant taxpayers would ensure that IRS resources are used effectively.
- *Increase examinations in selected areas.* Some types of noncompliance (such as the large amount of noncompliance attributable to unreported business income) can only

be detected and prevented through labor-intensive, expensive examinations. Reducing the tax gap will require more examinations in areas where they are most cost-effective in recovering amounts attributable to past noncompliance and deterring future noncompliance. As noted above, the IRS is continuing to reengineer the examination process, allowing for some increase in coverage.

Implementation of these initiatives would have both direct and indirect benefits. Improving compliance activities would result in an increase in enforcement revenues as more noncompliant taxpayers are contacted and examined (the direct benefit). In addition, a more visible IRS enforcement presence would deter other taxpayers from evading their tax obligations, thus leading to an increase in voluntary compliance (the indirect benefit).

#### **5. Enhance Taxpayer Service**

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the Internet, taxpayer assistance centers, and volunteer income tax assistance (VITA) and tax counseling for the elderly (TCE) sites. Assisting taxpayers with their tax questions before they file their returns reduces burdensome notices and other correspondence from the IRS after returns are filed and reduces inadvertent noncompliance overall.

Since the enactment of the IRS Restructuring and Reform Act of 1998, the IRS has significantly improved customer service. For example: (1) in the 2006 filing season, over 56 percent of all individual taxpayers filed electronically (more than double the number who filed electronically in fiscal year 1999); (2) Low-Income Taxpayer Clinics have been established to provide free or nominal charge representation for low-income taxpayers in Federal tax disputes, and to provide tax education and outreach for taxpayers who speak English as a second language; (3) the number of hits on the IRS web site ("IRS.gov"), which enables taxpayers to more easily obtain forms, track refunds, and get answers to their questions, grew to over 135 million during 2006, up nearly 8 percent from 2005; (4) other services, including the provision of transcripts of tax returns and matching of taxpayer identification numbers for third-party payers, are now being provided on-line; and (5) a pilot Compliance Assurance Process (CAP) program, which allows large corporations to work with the IRS to determine tax return accuracy prior to filing, provides these corporations with greater accuracy on their tax returns and greater certainty about their tax liability at an earlier date.

In report language accompanying the fiscal year 2006 Appropriations bill for the Treasury Department, the Senate Committee on Appropriations requested that the IRS develop a five-year plan to improve taxpayer services. The Taxpayer Assistance Blueprint, the next phase of which will be delivered in January, will include a process for assessing taxpayer needs and preferences, develop a decision model to prioritize service initiatives and funding, recommend service improvement initiatives, create customer-centric performance and outcome measures, and outline a multi-year research plan. The

Taxpayer Assistance Blueprint will also provide an important tool to help establish benchmarks against which improvements in customer service can be measured.

#### **6. Reform and Simplify the Tax Law**

The current tax code is too complicated. The complexity of the tax code makes the tax law too difficult for taxpayers to understand and for the IRS to administer. Special rules and subtle distinctions in the tax law foster a sense of unfairness in our tax system, discouraging compliance and increasing the tax gap.

Taxpayers who want to comply with the tax code often make unintentional errors on their returns, as they struggle to understand complicated rules and forms. Complexity also provides opportunities for those who are willing to exploit the system. Furthermore, complexity makes it difficult for the IRS to detect noncompliance. Simplifying the tax code will reduce unintentional errors by well-meaning taxpayers and reduce opportunities for evasion. A simpler tax code will also be easier for the IRS to administer.

The complexity of the tax law also contributes to the tax gap because limited IRS resources are increasingly committed to administering a wide array of targeted tax provisions created to meet social policy goals. These targeted provisions, which themselves are growing increasingly complicated, divert IRS resources from basic compliance efforts.

The Administration's fiscal year 2007 budget contains six proposals that would simplify the tax treatment of savings and families. The Treasury Department will continue to develop additional legislative proposals to simplify the tax code in ways that will reduce the tax gap. In addition, the Treasury Department is studying the report of the President's Advisory Panel on Tax Reform and is considering options for reform. Simplification proposals aimed at reducing the tax gap would be part of a reform proposal.

Legislative initiatives will continue to be supplemented by administrative efforts to reduce taxpayer burdens. In recent years, the IRS has taken a number of steps to reduce taxpayer burden, including the establishment of the Office of Taxpayer Burden Reduction (TBR). Recent improvements in IRS forms, processes and procedures include simplifying the filing requirements for Form 944 (Employer's Annual Federal Tax Return), eliminating the need for filing Form 2688 (Application for Additional Extension of Time to File U.S. Individual Income Tax Return) by allowing the taxpayer to get an automatic six month extension to file, and the creation of the EITC Assistant, an on-line tool that helps taxpayers determine their eligibility for the earned income tax credit (EITC) and the estimated EITC amount. Additional projects to simplify tax forms and processes are currently under review by TBR.

#### **7. Coordinate with Partners and Stakeholders**

The Treasury Department and the IRS extensively coordinate with state and foreign governments, taxpayer representative groups and practitioners to increase compliance, gain efficiencies in tax administration, improve taxpayer services and minimize taxpayer

burden. Increasing the level of such coordination activities will be an important part of a successful effort to reduce the tax gap.

- *International Exchange of Information.* Through tax treaties and tax information exchange agreements, the United States is able to obtain from foreign tax authorities information needed to enforce U.S. tax laws. In addition, the United States participates in information sharing regarding broader, non-taxpayer-specific information. For example, through the Joint International Tax Shelter Information Centre (JITSIC), the IRS and tax authorities in other participating countries will continue to share information regarding abusive tax avoidance transactions.
- *Federal-State Partnerships.* The IRS continues to work with state governments to develop strategies to address trends in noncompliance. For example, combined Federal-state employment tax reporting allows extensive coordination between the IRS and state governments with respect to employer noncompliance with employment tax obligations. In addition, the Treasury Department's Financial Management Service and the IRS will launch a pilot program with two states in January 2007 to enable taxpayers to pay all their Federal and certain state taxes online by means of the Treasury's Electronic Federal Tax Payment System (EFTPS). This initiative will provide one stop for taxpayers to make their Federal and state tax payments. Additional actions to address the tax gap in the next 18 months will include:
  - Exploring the use of state data-mining capabilities, designed to utilize proprietary state data, to refine further and prioritize IRS audit leads;
  - Testing the use of state Department of Revenue audit reports as an efficient basis for IRS audit assessments;
  - Testing the use of State Workforce Agency employment tax audit reports as an efficient basis for similar IRS audit assessments;
  - Expanding coordination with other Federal agencies with the goal of leveraging their resources and securing data pertinent to IRS compliance programs;
  - Identifying state and Federal resources and programs that can be used to communicate tax gap messages; and
  - Identifying non-traditional methods utilizing state and Federal resources to communicate the societal impact of the tax gap.
- *Practitioner Liaison and Education.* The Treasury Department and the IRS conduct liaison and education activities with practitioners in order to learn about developments in tax return preparation and to ensure that advisors provide appropriate tax advice. The IRS maintains active relationships with several national practitioner groups, small business representatives, and industry organizations to provide information related to the most current IRS positions and guidance. The creation of the Office of Professional Responsibility has helped restore credibility to enforcement of professional standards. Over the next 12 months, the IRS will enhance outreach efforts with these practitioner and industry stakeholders to engage in a discussion of key components of the tax gap including:

- Proper reporting of gross receipts;
  - Correct computation of business deductions such as cost of goods sold, depreciation, travel and entertainment expenses, and motor vehicle expenses; and
  - Third party information reporting.
- *Taxpayer Representatives.* The Treasury Department and the IRS often communicate with taxpayer representative groups to learn about taxpayer concerns, including issues regarding taxpayer rights in administering the tax code. For example, comments received from organizations representing low-income taxpayers significantly improved new EITC procedures that are currently being tested by the IRS. Recent meetings with representatives of small businesses have focused on the importance of balancing the IRS's need for action in areas of noncompliance with taxpayer concerns about increased burdens. Ongoing interaction with these groups is an integral part of this tax gap strategy.

#### **Conclusion**

The Administration is committed to reducing the tax gap. In doing so, the Administration recognizes that the most effective way to reduce the tax gap is to increase compliance rates through a combination of initiatives (including targeted legislative and administrative changes, taxpayer service, and enforcement efforts) that are sensitive to taxpayer rights and minimize taxpayer burden. Simplification of the tax law is also critically important to this effort. This document provides a broad strategy for reducing the tax gap. The Administration is committed to working with Congress to further refine and implement it.

**Tax Gap Strategy Timeline for Fiscal Year 2007**

2006	
September	<ul style="list-style-type: none"> <li>• Initial tax gap strategy</li> </ul>
October	<ul style="list-style-type: none"> <li>• Stakeholder meetings to review initial tax gap strategy</li> </ul>
November	<ul style="list-style-type: none"> <li>• Development of Administration legislative proposals for inclusion in fiscal year 2008 budget request</li> <li>• Development of Administration's budget request for the IRS for fiscal year 2008</li> </ul>
December	<ul style="list-style-type: none"> <li>• Proposal for next NRP Reporting Compliance Study</li> </ul>
2007	
January	<ul style="list-style-type: none"> <li>• Taxpayer Advocate's Annual Report to Congress</li> <li>• Update of 2006-2007 Treasury Department/IRS Priority Guidance Plan</li> <li>• Launch of Federal/State Electronic Federal Tax Payment System (EFTPS).</li> <li>• Deliver Taxpayer Assistance Blueprint Phase II Report to Congress</li> </ul>
February	<ul style="list-style-type: none"> <li>• Administration's fiscal year 2008 budget request, including anticipated legislative proposals for compliance initiatives, tax code simplification and IRS funding</li> </ul>
March/April	<ul style="list-style-type: none"> <li>• Detailed outline of IRS tax gap strategy reflecting provisions in Administration's fiscal year 2008 budget request <ul style="list-style-type: none"> <li>○ Outline steps to reduce opportunities for evasion</li> <li>○ Outline IRS research initiatives</li> <li>○ Outline IRS information technology initiatives</li> <li>○ Outline IRS compliance initiatives</li> <li>○ Outline IRS taxpayer service initiatives</li> <li>○ Outline steps to reform and simplify the tax law</li> </ul> </li> </ul>
May	<ul style="list-style-type: none"> <li>• Stakeholder meetings to discuss Administration's fiscal year 2008 budget request</li> </ul>
June	<ul style="list-style-type: none"> <li>• Treasury Department review of practitioner compliance initiatives</li> </ul>
July	<ul style="list-style-type: none"> <li>• 2007-2008 Treasury Department/IRS Priority Guidance Plan.</li> </ul>

# *Reducing the Federal Tax Gap*

## **A Report on Improving Voluntary Compliance**

Internal Revenue Service

U.S. Department of the Treasury

August 2, 2007

Reducing the Federal  
Tax Gap

A Report on Improving  
Voluntary Compliance

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# EXECUTIVE SUMMARY

## INTRODUCTION

In Fiscal Year (FY) 2006, federal receipts totaled over \$2.4 trillion. More than 95 percent of the net receipts were collected by the Internal Revenue Service (IRS) through its administration of the income, employment, transfer, and excise tax provisions of the Internal Revenue Code. Virtually all of these receipts were collected through a tax system under which taxpayers voluntarily report and pay their taxes with no direct enforcement and minimal interaction with the government.

The overall compliance rate achieved under the United States revenue system is quite high. For the 2001 tax year, the IRS estimates that, after factoring in late payments and recoveries from IRS enforcement activities, over 86 percent of tax liabilities were collected. Nevertheless, an unacceptably large amount of the tax that should be paid every year is not, such that compliant taxpayers bear a disproportionate share of the revenue burden, and giving rise to the "tax gap." The gross tax gap was estimated to be \$345 billion in 2001. After enforcement efforts and late payments, this amount was reduced to a net tax gap of approximately \$290 billion.

The Treasury Department and IRS are committed to improving current compliance levels and continuing to address all forms of noncompliance. The IRS Oversight Board has adopted an 86 percent voluntary compliance goal by 2009 and Senate Finance Committee Chairman Max Baucus has asked for a 90 percent voluntary compliance goal by 2017. This report sets forth steps that will be taken to improve compliance and enhance the IRS' ability to measure compliance. Once implemented, these steps will improve the IRS' ability to gauge progress in achieving specific long-term compliance objectives.

This report outlines steps that the IRS will take to increase voluntary compliance and reduce the tax gap. It builds on the Comprehensive Strategy for Reducing the Tax Gap (the Treasury Strategy) that was released in September 2006 by the Treasury Department's Office of Tax Policy and provides more detail for that strategy.

The IRS regularly addresses compliance improvement measures in its planning and budgeting processes. The Administration's annual budget request identifies the resources the IRS will need to meet specific performance goals to achieve its strategic priorities. This document combines and addresses current tax gap efforts. In addition, the IRS has long been conducting research in compliance and the tax gap, and resulting data is incorporated throughout this document.

The steps outlined in this report are, in many respects, only initial steps toward improving compliance. As described below, one of the primary challenges that the IRS faces in improving compliance is to get a better understanding of the current sources of noncompliance by improving research in this area. Until that understanding is clarified, efforts to improve compliance may be misdirected and progress may not be measurable. The IRS has taken significant steps in this direction, most importantly through the National Research Program (NRP), which is the source of updated estimates of compliance among individual taxpayers for 2001. The IRS is committed to furthering its work in this area through updated individual taxpayer NRP examinations and a current study focusing on compliance among Subchapter S corporations (S corporations).

In implementing the steps set forth in this document, it is important to have realistic expectations and perspectives. Based on the limited information available, compliance rates appear to have remained relatively stable at around 85 percent for decades. To make a meaningful improvement in this number without a fundamental change in the relationship between taxpayers and the government will require a long-term, focused effort. Implementation of the steps outlined in this document and in the Administration's Fiscal Year (FY) 2008 Budget request for the IRS will be subject to the uncertainties associated with the annual budget process. Moreover, it must be recognized that the causes of noncompliance are numerous and that only a portion of the tax gap results from intentional avoidance or evasion of the law. An equally or perhaps more important part of the problem lies in the growing complexity of the tax laws, which will continue to frustrate efforts to improve compliance.

The Administration is committed to working with Congress and other stakeholders to reduce the tax gap. The Administration's FY 2008 Budget request includes \$11.1 billion for the IRS, a 4.7 percent increase over the budget enacted for FY 2007. A total of \$410 million is for new enforcement initiatives as part of a strategy to improve compliance by:

- Increasing front-line enforcement resources;
- Increasing voluntary compliance through improved taxpayer service options and enhanced research;
- Investing in technology to reverse infrastructure deterioration, accelerate modernization, and improve the productivity of existing resources; and
- Implementing legislative and regulatory changes.

Since 2001 (the tax year studied by the NRP), IRS tax collections have increased significantly, audit rates have improved across all taxpayer segments, and measurements of taxpayer service have risen to historic levels. While specific data is not available, there is every reason to believe that these improvements have contributed to a general shift away from aggressive tax planning and an improvement in compliance levels over the past six years. In calling for a significant increase in IRS funding, the Administration's budget recognizes, however, that much work remains to be done. Based on historic experience, the IRS estimates that the overall return on new investments in compliance averages 4:1, with an additional indirect impact resulting from the improved overall compliance that comes from more targeted and effective enforcement of the tax law. However, direct spending on compliance improvements does not lend itself to traditional revenue-estimating analysis, given the difficulty in quantifying the effect that such improvements have on taxpayer behavior.

This report provides detail on how the additional funds requested in the Administration's FY 2008 Budget will build on improvements the IRS has made in recent years to taxpayer service, modernization, and enforcement, all of which are critical elements in the long-term strategy to improve compliance. In particular, this report describes six separate initiatives in the FY 2008 Budget request that are aimed at improving enforcement. The report also details how additional funds requested will be targeted to improving taxpayer service, including implementation of the recommendations made in the recently released Taxpayer Assistance Blueprint (TAB). In addition, the report outlines how additional funds will accelerate implementation of IRS modernization programs, to permit better document matching, faster and more accurate processing of returns, and more timely access to taxpayer account information. A detailed

timeline for implementing these various programs is included as an Appendix to this report.

The Treasury Department and IRS will continue to evaluate resource demands for improving taxpayer compliance. In addition, future budget requests will identify ways to utilize resources efficiently and effectively to target enforcement efforts to areas where they will have the greatest direct and indirect impact on compliance. The steps for improving compliance that are detailed in this report will continue to evolve over time as our understanding of the problem improves and as changes in the economy and changes in the tax law present new compliance challenges.

#### The Treasury Department's Comprehensive Strategy for Reducing the Tax Gap

Four key principles guided the development of the Treasury Strategy and continue to guide IRS efforts to improve compliance:

- First, both unintentional taxpayer errors and intentional taxpayer evasion should be addressed.
- Second, sources of noncompliance should be targeted with specificity.
- Third, enforcement activities should be combined with a commitment to taxpayer service.
- Fourth, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to reduce the tax gap. Guided by these key principles, the Treasury Strategy outlines seven components which form the basis for the detailed compliance improvement efforts set forth in this document:

**1. Reduce Opportunities for Evasion.** The Administration's FY 2008 Budget request contains 16 legislative proposals to reduce evasion opportunities and improve the efficiency of the IRS. Three of these proposals were recently enacted in modified form. The 16 provisions would result in an estimated \$29.5 billion of additional revenues over the next ten years. The Treasury Department and the IRS also continue to use the regulatory guidance process to address both procedural and substantive issues to improve compliance and reduce the tax gap.

**2. Make a Multi-Year Commitment to Research.** Research is essential to identify sources of noncompliance so that IRS resources can be targeted properly. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge. New research is needed on the relationship between taxpayer burden and compliance and on the impact of customer service on voluntary compliance. Research also is essential to establish accurate benchmarks and metrics to assess the effectiveness of IRS efforts, including the effectiveness of the Treasury Strategy.

**3. Continue Improvements in Information Technology.** Continued improvements to technology, including continued development of and additions to Modernized e-File, will provide the IRS with better tools to improve compliance through early detection, better case selection, and better case management.

4. **Improve Compliance Activities.** IRS actions have produced a steady climb in enforcement revenues since 2001, and an increase in both the number of examinations and the coverage rate in virtually every major category. By further improving examination, collection, and document matching activities, the IRS will be better able to prevent, detect, and remedy noncompliance. These activities will increase compliance – not only among those directly contacted by the IRS, but also among those who will be deterred from noncompliant behavior as a consequence of a more visible IRS enforcement presence. Aided by results from the recent NRP study of individual taxpayers, the IRS continues to reengineer examination and collection procedures and invest in technology, resulting in efficiency gains and better targeting of examination efforts. These efficiency gains translate into expanded examination coverage, higher audit yields, and reduced burden on compliant taxpayers.

5. **Enhance Taxpayer Service.** Service is especially important to help taxpayers avoid unintentional errors. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary post-filing contacts, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations. The IRS also is working to provide service more efficiently and effectively through new and existing tools, such as the IRS website. The Taxpayer Assistance Blueprint (TAB), which was completed in April 2007, outlines a five-year strategic plan for taxpayer service. The TAB includes a process for assessing the needs and preferences of taxpayers and partners and a decision model for prioritizing service initiatives and funding.

6. **Reform and Simplify the Tax Law.** Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws. For example, the Administration's FY 2008 Budget request includes proposals to simplify tax credits for families and tax treatment of savings by consolidating existing programs and clarifying eligibility requirements. These initiatives will continue to be supplemented by IRS efforts to reduce taxpayer burden by simplifying forms and procedures.

7. **Coordinate with Partners and Stakeholders.** Enhanced coordination is needed between the IRS and state and foreign governments to share information and compliance strategies. Expanded coordination also is needed with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice. Through contacts with practitioner organizations, the Treasury Department and IRS learn about recent developments in tax practice and hear directly from practitioners about taxpayer concerns and potentially abusive practices. Similarly, contacts with taxpayers and their representatives, including small business representatives and low-income taxpayer advocates, provide the Treasury Department and the IRS with needed insight on ways to protect taxpayer rights and minimize the potential burdens associated with compliance strategies.

#### The IRS Strategic Planning Process

The more detailed steps outlined for improving compliance are, in part, contingent upon the budget process for FY 2008 and beyond. Accordingly, adoption of the Administration's proposed FY 2008 Budget for the IRS along with the enactment of the legislative recommendations included as part of that budget are critical components of the strategy to reduce the tax gap.

The IRS has an extensive annual strategic planning process through which each of its operating divisions develop and estimate resource requirements needed to achieve functional priorities and performance targets based on budget allocations. Detailed action plans, which are part of the IRS' strategic planning process and are coordinated with this report, identify specific sub-goals and measures as well as accountable parties. Progress toward these plans is monitored internally and reported to the Treasury Department and the Office of Management and Budget (OMB) throughout the year.

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## UNDERSTANDING THE TAX GAP

The Internal Revenue Code places three primary obligations on taxpayers: (1) to file timely returns; (2) to make accurate reports on those returns; and (3) to pay the required tax voluntarily and timely. Taxpayers are compliant when they meet these obligations. Noncompliance – and the tax gap – results when taxpayers do not meet these obligations.

The tax gap is defined as the aggregate amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely. True tax liability for any given taxpayer means the amount of tax that would be determined for the tax year in question if all relevant aspects of the tax law were correctly applied to all of the relevant facts of that taxpayer's situation. For a variety of reasons, this amount often differs from the amount of tax that a taxpayer reports on a return. The taxpayer might not understand the law, might make inadvertent mistakes, or might misreport intentionally.

To be paid voluntarily, a tax liability must be paid without direct IRS intervention. Taxpayers have the responsibility to determine and report their correct tax liability, and to make sure that amount is paid (whether through withholding, estimated tax payments, payments with a filed return, etc.). The IRS focuses its enforcement where it is needed most, but the overall rate of tax compliance in the United States is as high as it is because the vast majority of taxpayers meet their obligations with little or no involvement from the IRS. To be paid timely, a tax liability must be paid in full on or before the date on which all payments for the given tax year were legally due.

It is important to emphasize that IRS estimates of the tax gap are associated with the legal sector of the economy only. Although tax is due on income from whatever source derived, legal or illegal, the tax attributable to income earned from illegal activities is extremely difficult to estimate. Moreover, the government's interest in pursuing this type of noncompliance is, ultimately, to stop the illegal activity, not merely to tax it.

Although they are related, the tax gap is not synonymous with the "underground economy." Definitions of the "underground economy" vary widely. However, most people characterize it in terms of the value of goods and services that elude official measurement. Furthermore, there are some items in the "underground economy" that are not included in the tax gap (such as tax due on illegal-source income), and there are contributors to the tax gap that no one would include in the "underground economy" (such as the tax associated with overstated exemptions, adjustments, deductions, or credits, or with claiming the wrong filing status). The greatest area of overlap between these two concepts is sometimes called the "cash economy," in which income (usually of a business nature) is received in cash, which helps to hide it from taxation.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to tax law complexity that results in errors of ignorance, confusion, and carelessness. This distinction is important even though, at this point, the IRS does not have sufficient data to distinguish clearly the amount of noncompliance that arises from willful, as opposed to unintentional, mistakes. Moreover, the line between intentional and unintentional mistakes is often a grey one, particularly in areas such as basis reporting, where a taxpayer may know that his or her reporting is inaccurate but does not have ready access to accurate information. This is an area where additional research is needed to improve understanding.

## MEASURING THE TAX GAP

Historically, estimates of federal tax compliance were based on special studies, including the Taxpayer Compliance Measurement Program (TCMP), which covered income and self-employment taxes and groups of taxpayers, and consisted of line-by-line audits of random samples of returns. These studies provided the IRS with information on compliance trends and allowed the IRS to update audit selection formulas regularly. However, this method of data gathering was extremely burdensome on the taxpayers whose returns were selected. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

The IRS conducted several much narrower compliance studies between 1988 and 2001, but nothing that would provide a comprehensive perspective on the overall tax gap. Until recently, all of these subsequent estimates of the tax gap have been rough projections that basically assume no change in compliance rates among the major tax gap components even though the magnitude of these projections reflects growth in tax receipts in these major tax gap categories.

The NRP, which the IRS has used to estimate the most recent tax gap updates, arose out of a desire to find a less intrusive means of measuring tax compliance. The IRS used a focused statistical selection process that resulted in the selection of approximately 46,000 individual income tax returns for Tax Year (TY) 2001 – somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow the IRS to meet certain objectives – to estimate the overall extent of reporting compliance among individual income tax filers and to update the audit-selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the “case building” data included third-party information returns from payers of income (e.g., Form W-2 and Form 1099) and prior-year returns filed by taxpayers. Also, for the first time, the IRS added data on dependents obtained from various government sources, as well as data obtained from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the amount of information requested from taxpayers, with some of the selected taxpayers not requiring any contact from the IRS. In effect, these data allowed the IRS to focus its efforts on return information that could not otherwise be verified. This pioneering approach was so successful it is being expanded in regular operational audit programs.

A second major NRP innovation was to introduce a “classification” process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors (referred to as classifiers) who identified not only which issues needed to be examined, but also the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (although, sometimes, minor adjustments were noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditor was required to evaluate, although the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return.

#### TAX GAP ESTIMATES

As noted above, for the 2001 tax year, the overall gross tax gap was estimated to be approximately \$345 billion, corresponding to a noncompliance rate of 16.3 percent. After accounting for enforcement efforts and late payments, the amount was reduced to \$290 billion, corresponding to a net noncompliance rate of 13.7 percent.

Noncompliance takes three forms:

- not filing required returns on time (nonfiling);
- not reporting one's full tax liability on a timely filed return (underreporting); and
- not timely paying the full amount of tax reported on a timely return (underpayment).

The IRS has separate tax gap estimates for each of these three types of noncompliance. Underreporting (in the form of unreported receipts and overstated expenses) constitutes over 82 percent of the gross tax gap, up slightly from earlier estimates. Underpayment constitutes nearly 10 percent and nonfiling almost 8 percent of the gross tax gap.

#### Nonfiling

The nonfiling gap is defined as the amount of true tax liability that is not paid on time by taxpayers who do not file a required return on time (or at all). It is reduced by amounts paid on time, such as through withholding, estimated payments, and other credits. The nonfiler population does not include *legitimate* nonfilers (i.e., those who have no obligation to file).

#### Underreporting

The underreporting gap is defined as the amount of tax liability not voluntarily reported by taxpayers who file required returns on time. For income taxes, the underreporting gap arises from three errors: underreporting taxable income, overstating offsets to income or to tax, and net math errors. Taxable income includes such items as wages and salaries, rents and royalties, and net business income. Offsets to income include income exclusions, exemptions, statutory adjustments, and deductions. Offsets to tax are tax credits. Net math errors involve arithmetic mistakes or transcription errors made by taxpayers that are corrected at the time the return is processed. In addition to developing an estimate of the aggregate underreporting gap, it is possible to break aspects of this estimate down into measures of the underreporting gap attributable to specific line items on the tax return.

### Underpayment

The underpayment gap is the portion of the total tax liability that taxpayers report on their timely filed returns but do not pay on time. This arises primarily from insufficient remittances from taxpayers themselves. However, it also includes employer under-deposits of withheld income tax. In the case of withheld income tax, it is the responsibility of the employees to report the corresponding tax liability on timely filed returns, and it is the responsibility of their employers to deposit those withholdings with the government on time.

### THE TAX GAP MAP

Figure 1 summarizes the key components of the tax gap and how they relate to one another. It has come to be known as the "Tax Gap Map." As the Tax Gap Map indicates, the IRS estimates that, for 2001, approximately \$55 billion of the gross tax gap will eventually be paid through enforcement or other late payments, leaving a net tax gap of about \$290 billion. This projection of what will eventually be paid is based on fiscal year tabulations of past enforcement revenue and on prior studies of amounts that are paid late without enforcement efforts. Obviously, this projection depends directly on actions that both the IRS and taxpayers will take in the future, and the past is not likely to be a perfect predictor of that. Moreover, the IRS does not have good data on the amounts that are paid late without enforcement efforts. Consequently, this estimate of enforcement revenues and other late payments is necessarily subject to some uncertainty.

The Tax Gap Map distinguishes between "good" and "weak" estimates. For example, the corporation income tax estimates are acknowledged as weak because compliance behavior may have changed since the mid-1980s, which is the last time the IRS collected data on corporate compliance. Moreover, the underreporting tax gap is estimated as the difference between true tax liability and reported amounts. Determining true tax liability for large multinational corporations can be difficult, given the complexity of the tax law, economic activities undertaken by these taxpayers, and the difficulty of making any kind of statistically valid assumptions based on a limited population of taxpayers. Weaknesses in general arise from two causes: using old data and using data and methods that do not adequately reflect the full extent of noncompliance.

Figure 2 organizes these estimates by type of tax and by type of noncompliance. As with tax gap estimates for prior tax years, the overall tax gap is dominated by the underreporting of individual income tax, which results in part from the dominant role that the individual income tax plays in overall federal tax receipts.

The individual income tax accounted for about half of all tax receipts in 2001. Individual income tax underreporting, however, was approximately \$197 billion, or about 57 percent of the overall tax gap. While a comparison with 1988 data would suggest a slight decrease in individual income tax reporting compliance, it is important to remember that the data tell nothing about the years just before or just after TY 2001 and, as such, cannot show whether compliance trends today are improving or getting worse. Moreover, many aspects of the data and estimating methodologies used now are not comparable to earlier studies. In addition, broader changes in the economy over the past 20 years have made comparisons between the data difficult.

Figure 1

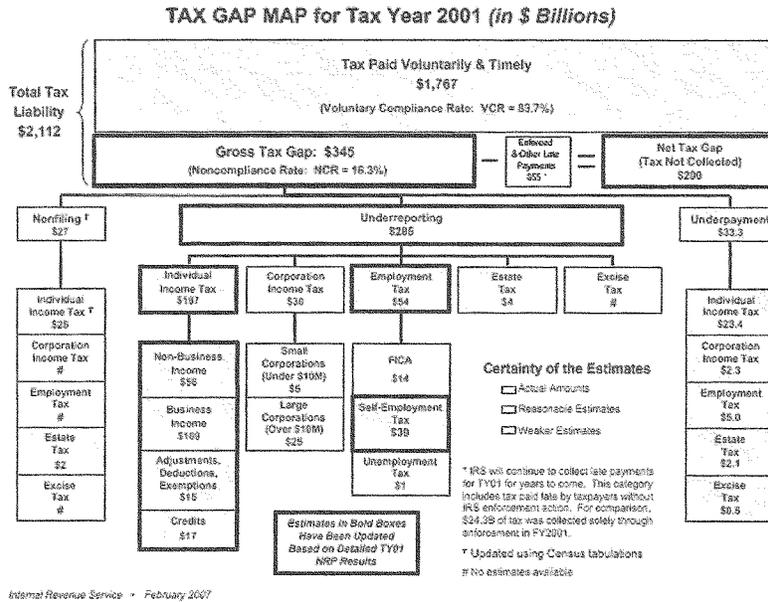


Figure 2

Tax Year 2001 Gross Tax Gap by Type of Tax and Type of Noncompliance (in \$ billions)

Type of Tax	Type of Noncompliance			TOTAL	
	Nonfiling Gap	Underreporting Gap	Underpayment Gap*	Amount	Percent Distribution
Individual Income Tax	25	197	23.4	245	71.1%
Corporation Income Tax	#	30	2.3	32	9.3%
Employment Tax	#	54	5.0	59	17.0%
Estate & Gift Tax	2	4	2.1	8	2.4%
Excise Tax	#	#	0.5	1	0.1%
<b>TOTAL</b>	<b>27</b>	<b>285</b>	<b>33.3</b>	<b>345</b>	<b>100.0%</b>
Percent Distribution	7.8%	82.5%	9.7%		

\* Since the underpayment gap figures are generally actual amounts rather than estimates, they are presented here to the closest \$0.1 billion.

# No estimates are available for these components.

Amounts may not add to totals due to rounding. See Figure 1 regarding the reliability of estimates.

The estimate of the self-employment tax underreporting gap is \$39 billion, which accounts for about 11 percent of the overall tax gap. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self-employment tax together, then, it can be seen that individual underreporting contributes approximately 68 percent of the overall tax gap.

Figure 3 presents the same information, broken out by type of taxpayer (as defined by the IRS operating divisions that serve the taxpayer) rather than by type of noncompliance. This indicates that most of the underreporting of individual income tax is associated with individuals who have business income. The underreporting of self-employment tax is closely associated with the underreporting of business income by individuals; sole proprietors who understate their business income for income tax purposes are not likely to report the unreported income for employment tax purposes either.

Figure 3

## Tax Year 2001 Gross Tax Gap by Type of Tax and IRS Operating Division (in \$ billions)

Type of Tax	IRS Operating Division						TOTAL	
	Wage & Investment	Small Business / Self-Employed			Large & Mid-Size Business	Tax-Exempt & Gov't Entities	Tax Gap	Non-Compliance Rate
		Individuals	Corporations	Total				
Individual Income Tax	50	195	N/A	195	N/A	N/A	245	20.9%
Corporation Income Tax *	N/A	N/A	6	6	25	1	32	18.5%
Employment Tax	0	40	7	47	8	4	59	8.1%
Self-Employment	N/A	39	N/A	39	N/A	N/A	39	51.9%
FICA and FUTA	0	1	7	8	8	4	20	3.0%
Estate & Gift Tax	#	8	N/A	8	N/A	N/A	8	22.9%
Excise Tax †	0	0	0	0	0	0	1	
TOTAL Gap	50	243	14	257	34	4	345	
Percent of Total	14.5%	70.5%	4.0%	74.5%	9.8%	1.2%	100.0%	
Noncompliance Rate	12.1%	27.1%	5.3%	22.3%	8.0%	3.4%		16.3%

\* Unrelated Business Income Tax is shown as corporation income tax.

† Includes underpayment gap only.

# No estimate is available for this component.

Amounts may not add to totals due to rounding. Zeros indicate amounts less than \$0.5 billion. See Figure 1 regarding reliability of estimates.

Individual income tax accounts for over 71 percent of the overall tax gap estimate of \$345 billion. This is due, in part, to the fact that individual income tax is the largest single source of federal receipts.

The individual income tax underreporting gap can be broken out by the various line items on a typical return – income sources, offsets to income (i.e., exemptions, adjustments, and deductions), and offsets to tax (i.e., credits). Figure 4 provides updated estimates of both the tax gap arising from misreporting on each line item and the corresponding Net Misreporting Percentage (NMP).<sup>1</sup> These estimates are based on thorough audits of a representative sample of returns, but they also account for underreporting that is not detected in those audits.

As in previous compliance studies, the NRP data suggest that well over half (\$109 billion) of the individual underreporting gap came from understated net business income (e.g., unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated subtractions from income (i.e., statutory adjustments, deductions, and exemptions) and from overstated tax credits.

An obvious conclusion from Figure 4 is that the accuracy of reporting the various line items on the average income tax return varies widely, depending on the type of income or offset being reported. Figure 5 presents the same line items grouped by the degree to which the items are “visible” to the IRS – that is, the extent to which they are subject to information reporting and withholding. The conclusion is striking: reporting compliance is strongest in the presence of substantial information reporting and withholding. This is illustrated graphically in Figure 6. Although the contribution to the underreporting gap depends on the dollars of income or offset at stake, the NMP is clearly inversely related to the degree of visibility.

It appears that compliance rates for sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study for TY 1988. The amounts least likely to be misreported on tax returns are subject to both third-party information reporting and withholding and are, therefore, the most visible (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (e.g., interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4.5 net misreporting percentage rate for items subject to substantial information reporting, such as interest, dividends, pensions, and social security benefits.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher net misreporting percentage rate of 8.6 percent. As expected, amounts not subject to withholding or third-party information reporting (e.g., sole proprietor income and the “other income” line on Form 1040) are the least visible and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

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<sup>1</sup> The net amount of income misreported divided by the sum of the absolute values of the amounts that should have been reported. The NMP measures provide insight into the extent of noncompliance for any given provision. However, caution should be applied when comparing NMPs across tax provisions. First, a provision may have a large NMP but contribute only slightly to the tax gap (e.g., the total true tax liability for a particular item is relatively small). Second, the NMP contains an adjustment for income amounts that were underreported but does not have a corresponding adjustment for offset amounts that were not claimed.

Figure 4

Tax Year 2001 Individual Income Tax Underreporting Gap and Net Misreporting Percentage (NMP) Associated with Income and Offset Line Items

Type of Income or Offset	Underreporting Gap (\$B)	Net Misreporting Percentage <sup>†</sup>
<b>Total Underreporting Gap</b>	<b>197</b>	<b>18%</b>
<b>Underreported Income</b>	<b>166</b>	<b>11%</b>
<i><b>Non-Business Income</b></i>	<b>56</b>	<b>4%</b>
Wages, salaries, tips	10	1%
Interest income	2	4%
Dividend income	1	4%
State income tax refunds	1	12%
Alimony income	*	7%
Pensions & annuities	4	4%
Unemployment compensation	*	11%
Social Security benefits	1	6%
Capital gains	11	12%
Form 4797 income	3	64%
Other income	23	64%
<i><b>Business Income</b></i>	<b>109</b>	<b>43%</b>
Non-farm proprietor income	68	57%
Farm income	6	72%
Rents & royalties	13	51%
Partnership, S-Corp, Estate & Trust, etc.	22	18%
<b>Overreported Offsets to Income</b>	<b>15</b>	<b>4%</b>
Adjustments	-3	-21%
SE Tax deduction <sup>§</sup>	-4	-51%
All other adjustments	1	6%
Deductions	14	5%
Exemptions	4	5%
Credits	17	26%
<b>Net Math Errors (non-EITC)</b>	<b>*</b>	

† The amount of income or offset misreported divided by the amount that should have been reported. The NRP contains an adjustment for income amounts that were underreported, but does not have a corresponding adjustment for offset amounts that were not claimed.

\* Less than \$0.5 billion.

§ Taxpayers *understate* this adjustment because they understate their self-employment income and, thereby, their self-employment tax. Therefore, the gap associated with this item is negative.

Figure 5

Tax Year 2001 Individual Income Tax Underreporting Gap and Net Misreporting Percentage (NMP) Associated with Income and Offset Line Items, By Visibility Groups

Visibility Group Type of Income or Offset	Underreporting Gap (\$B)	Net Misreporting Percentage <sup>†</sup>
<b>Total Underreporting Gap</b>	<b>197</b>	<b>18%</b>
<b>Items Subject to Substantial Information Reporting and Withholding</b>	<b>10</b>	<b>1%</b>
Wages, salaries, tips	10	1%
<b>Items Subject to Substantial Information Reporting</b>	<b>9</b>	<b>5%</b>
Interest income	2	4%
Dividend income	1	4%
State income tax refunds	1	12%
Pensions & annuities	4	4%
Unemployment compensation	*	11%
Social Security benefits	1	6%
<b>Items Subject to Some Information Reporting</b>	<b>51</b>	<b>9%</b>
Partnership, S-Corp, Estate & Trust, etc.	22	18%
Alimony income	*	7%
Capital gains	11	12%
Deductions	14	5%
Exemptions	4	5%
<b>Items Subject to Little or No Information Reporting</b>	<b>110</b>	<b>54%</b>
Non-farm proprietor income	68	57%
Farm income	6	72%
Rents & royalties	13	51%
Form 4797 income	3	64%
Other income	23	64%
Total statutory adjustments	-3	-21%
<b>Not Shown on Figure 6<sup>§</sup></b>	<b>17</b>	<b>26%</b>
Credits	17	26%

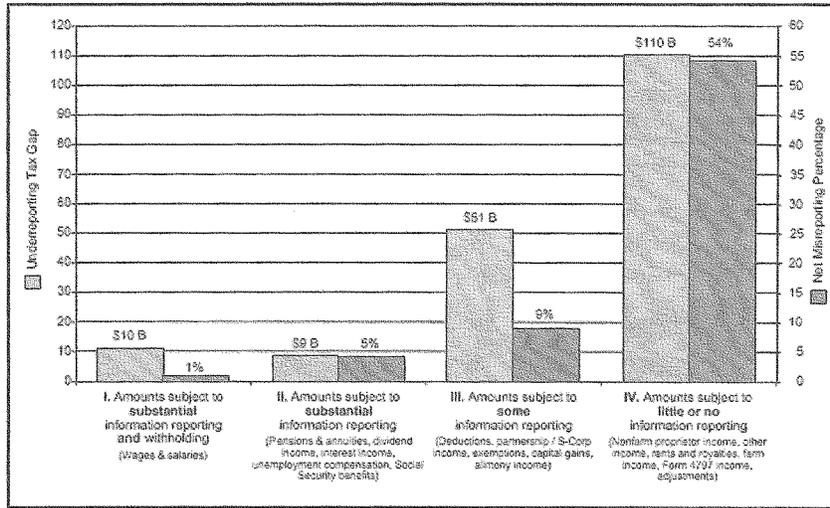
† The aggregate amount of income or offset misreported divided by the sum of the absolute values of the amount that should have been reported. The estimates of the amounts that should have been reported account for underreported income that was not detected by the audits, but do not have a corresponding adjustment for unclaimed offsets (e.g., deductions, exemptions, statutory adjustments, and credits) that were not detected.

\* Less than \$0.5 billion.

§ Since credits are offsets to tax, it is difficult to combine them with income and income offset items when calculating a combined NMP.

Figure 6

**Tax Year 2001 Individual Income Tax Underreporting Gap  
Misreporting of Income and Offsets by "Visibility" Categories**



Based on updated estimates derived from the TY01 National Research Program study of individual income tax reporting compliance.

With transactions that are less visible to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may fail to comply fully because they are overwhelmed by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reasons, there is a serious problem with underreporting for those items not subject to information reporting.

The underpayment gap is the simplest component of the tax gap to measure since, for the most part, it is observed in full. The underpayment gap is the difference between the tax that taxpayers report on their timely filed returns and the amount that is actually paid by the payment due date. The first amount is tabulated from the Individual Master File. With the exception of employer under-deposit of withheld income tax, the amount paid is also tabulated from the Individual Master File.

Figure 7 summarizes the underpayment gap and rates for TY 2001 arrayed by taxpayer type (rather than tax type as in Figure 1). Almost all of what is voluntarily reported is also paid on time, and more than two-thirds of the balance is paid within two years. Individual income tax contributes almost two-thirds of the total underpayment gap, and over three-quarters of the individual income tax underpayment gap is associated with taxpayers who have business income.

Since sole proprietors report their self-employment tax on their individual income tax returns (Form 1040), the TY 2001 NRP study provided new compliance data with which to estimate this component of the tax gap. Self-employment tax is sometimes not reported correctly (or at all) in connection with reported self-employment income that is reported. However, most of this component of the tax gap is associated with unreported self-employment income. The NRP auditors detected some of this unreported income, but not all of it. The IRS estimate of the self-employment tax underreporting gap accounts for this undetected income. Estimates also account for the fact that some of this unreported income would not be subject to full self-employment tax, given the annual cap on Social Security taxes. Accounting for all of these factors, the updated estimate of the self-employment tax gap for TY 2001 is \$39 billion.

The remaining tax gap estimates shown on the Tax Gap Map (Figure 1) are based on data older than TY 2001. In order to develop estimates based on the latest data, but for a common tax year, the IRS projected the most recent previous estimates to TY 2001 using a simple approach. Lacking information to the contrary, the IRS assumed that the compliance rate for each major component remained constant. The tax gap in a given component was projected to grow at the same rate as tax receipts in that component. The IRS plans to update these estimates as newer compliance data become available.

The main lesson from the Tax Gap Map is that noncompliance is worst where the barriers to voluntary compliance or the opportunities for noncompliance are greatest. This is seen even more vividly in Figure 6, which shows the importance of third-party information reporting.

Figure 7

Tax Year 2001 Underpayment Gap By Type of Taxpayer

Type of Taxpayer	Gross Underpayment Gap (\$ Billions)	Voluntary Payment Compliance Rate†	Net Underpayment Gap (\$ Billions)		Cumulative Payment Compliance Rate‡	
			After 1 Year	After 2 Years	After 1 Year	After 2 Years
All Taxes *	31.7	98.6%				
Wage & Investment	4.3	98.9%	2.1	1.8	99.4%	99.6%
Small Business / Self-Employed	23.7	97.6%	7.3	6.5	99.2%	99.3%
Large & Mid-Size Business	3.3	99.6%	2.0	2.0	99.7%	99.7%
Tax Exempt / Government Entities	0.4	99.87%	0.2	0.1	99.95%	99.97%

† The Voluntary Payment Compliance Rate is the portion of tax reported on timely filed returns that is paid on time. The Cumulative Payment Compliance Rate is the portion of tax reported on timely filed returns that is paid as of a certain date.

\* The \$31.7 billion total for all taxes excludes \$1.6 billion of individual income taxes withheld by employers but neither reported on timely filed employment tax returns nor paid by employers.

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## VOLUNTARY COMPLIANCE

A wide range of factors influence voluntary compliance, although there is little empirical confirmation as to the most important of these factors or their magnitudes. However, it is generally agreed that IRS actions are not the sole – or perhaps even the primary – determinants of voluntary compliance. In addition to whether information reporting and withholding requirements exist as mentioned previously, other important factors include the following:

- Tax law changes, including:
  - opening or closing opportunities for noncompliance
  - tax law complexity may confuse taxpayers or make noncompliance more difficult to observe
  - tax rates may affect incentives to report income
- The economy, including:
  - income and unemployment levels
  - the mix of industries
- Demographics, including:
  - the aging of the population
  - changing household arrangements
  - growth in the number of non-English-speaking taxpayers
- Socio-political factors, including:
  - swings in patriotic sentiments
  - taxpayer perceptions of whether they are getting their money's worth from their taxes

Additionally, there are both direct and indirect effects of enforcement activities. Direct effects refer to the collection of additional revenue from taxpayers who are subject to enforcement actions. Indirect effects refer to "spillover" effects when enforcement activity on one set of taxpayers has positive effects on the compliance behavior of the rest of the taxpayer population in response to heightened enforcement activity.

### MEASURING VOLUNTARY COMPLIANCE

It is very difficult to determine the impact that any IRS activity has on voluntary compliance. While the direct effect of IRS enforcement activities is identifiable through the impact on collections, the IRS cannot easily estimate the indirect effects. That is partly because the IRS cannot observe taxpayers' true tax liabilities (they must be estimated), and partly because so many factors may influence the extent to which they pay their tax voluntarily and timely – including many factors outside of IRS control. The challenge is to estimate the impact of each IRS activity on observable behaviors – returns filed, tax reported, and tax paid – controlling for other influences as much as possible. Only then will the IRS know the best mix of activities that will foster the greatest degree of voluntary compliance.

### Long-Term Goal for Voluntary Compliance

The Voluntary Compliance Rate (VCR) is the amount of tax for a given tax year that is paid voluntarily and timely, expressed as a percentage of the corresponding amount of tax that the IRS estimates should have been paid. It reflects taxpayers' compliance with their filing, reporting, and payment obligations. The latest estimate of VCR is 83.7 percent for all taxes and all taxpayers for TY 2001.

In the Administration's budget request for FY 2007, the IRS established a long-term goal of an 85 percent voluntary compliance by TY 2009. In February of 2007, the IRS Oversight Board, as part of establishing a strategic direction for the IRS, established a long-term goal of an 86 percent voluntary compliance rate by TY 2009. Senator Baucus, Chairman of the Senate Finance Committee, has asked for a 90 percent voluntary compliance goal by TY 2017.

An increase in the VCR to 86 percent by TY 2009 may not seem large, but the available evidence suggests that the VCR has not changed dramatically over the last 20 to 30 years. For example, based on TCMP data from the 1960s through the 1980s, the IRS estimates that the VCR has moved within a range of two percentage points and was virtually the same in TY 2001 as it had been in TY 1985.

Much of the estimated fluctuation during this time likely was due to the inherently imprecise nature of these estimates, the impact of the Tax Reform Act of 1986, and the changing relative sizes of revenues from different taxes. Since the IRS has estimated the overall VCR for just a few selected years in that period, it is possible that compliance may have fluctuated in the intervening years. However, the evidence from individual income tax underreporting – by far the largest portion of the tax gap, and the component most frequently measured – indicates that there was no consistent trend over this time period.

The IRS and the public must have realistic expectations about the magnitude and timing of the impact of any reasonable actions to reduce the tax gap, particularly if it is not accompanied by broader simplification and reform of the tax code, or significant advances in compliance technology. Implementing efforts to reduce the tax gap will take time; changing taxpayer behavior significantly will also take time. Accordingly, results from these efforts will be realized incrementally over a number of years. As part of the actions outlined in this report, the IRS will, for example, acquire and analyze new data, improve document-matching programs, refine examination selection criteria, purchase and test new technology, and train employees to handle new enforcement and customer service responsibilities.

Moreover, while it may be possible to take action to *reduce* the tax gap, it is not possible to implement a policy that *eliminates* the tax gap without an unacceptable change in the fundamental nature of the current tax compliance system. The IRS is, however, committed to addressing all levels of noncompliance. Therefore, the efforts to reduce the tax gap will continue to be developed and refined to achieve the highest level of compliance possible.

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# COMPONENTS

With an estimated net tax gap of \$290 billion for TY 2001, no single approach will be successful at substantially reducing noncompliance. Accordingly, the Treasury Strategy set out a comprehensive, integrated, multi-year strategy that must be implemented within the context of the annual budget process. This report builds on the work of the Treasury Strategy to provide a comprehensive framework that will be institutionalized by the IRS as part of sound tax administration.

This report includes seven components, detailed below:

1. Reduce Opportunities for Evasion (pages 20-25)
2. Make a Multi-Year Commitment to Research (pages 26-27)
3. Continue Improvements in Information Technology (pages 28-32)
4. Improve Compliance Activities (pages 33-41)
5. Enhance Taxpayer Service (pages 42-49)
6. Reform and Simplify the Tax Law (page 50-52)
7. Coordinate with Partners and Stakeholders (page 53-56)

## Component 1 Reduce Opportunities for Evasion

Legislative changes and published guidance will reduce opportunities for evasion.

### Legislative Proposals

The Administration's FY 2007 Budget contained five legislative proposals that would reduce evasion opportunities by focusing on employment taxes, information reporting, streamlining collection procedures, and problem return preparers. The Administration's FY 2008 Budget expands on those five and contains several additional proposals that would further reduce opportunities for evasion without unduly burdening honest taxpayers. Collectively, the Department of Treasury estimates that these 16 legislative proposals would generate \$29.5 billion over the next 10 years. The IRS is encouraged to see that three of the proposals have already become law (in modified form) and that Congress is taking action on a number of the remaining proposals.

Public Law 110-28, Title VIII, the Small Business and Work Opportunity Tax Act of 2007, enacted proposals on amending the collection due process procedures for employment tax liabilities, expanding preparer penalties, and creating an erroneous refund claim penalty. These proposals, along with others contained in the FY 2008 Budget, are described below in more detail:

***Expanding Information Reporting:*** Third-party reporting is critical for ensuring voluntary compliance. Without reliable third-party data, the IRS cannot easily detect errors in the absence of expensive and intrusive audits. The IRS receives over 1.5 billion information returns a year, reporting income from employers, financial institutions, third-party payers, and state and federal governments. However, the IRS still lacks reliable information on certain types of income, most notably income earned by small businesses and the self-employed. Information reporting proposals in the Administration's FY 2008 Budget would:

- ***Require information reporting on payments to corporations.*** This proposal would require a business to file an information return for payments aggregating to \$600 or more in a calendar year to a corporation (except a tax-exempt corporation). This proposal is estimated to generate \$7.7 billion over the next ten years.
- ***Require basis reporting on security sales.*** This proposal would require certain brokers to report information regarding adjusted basis in connection with the sale of certain publicly traded securities. Brokers would also be required to report acquisition or disposition dates to help determine gain or loss for taxpayers. This proposal is estimated to generate \$6.7 billion over the next ten years.
- ***Expand broker information reporting.*** This proposal would require a broker who is an auctioneer or operates a consignment business (electronic or other) to file an information return showing customer information and gross proceeds from the sale of tangible personal property. The requirement would apply only for customers with 100 or more separate transactions generating at least \$5,000 in gross proceeds in a year. This proposal is estimated to generate \$2.0 billion over the next ten years.

- *Require information reporting on merchant payment card reimbursements.* This proposal would provide the IRS with authority to put into effect regulations requiring merchant acquiring banks (organizations that process card payments for merchants) to report to the IRS annually the gross reimbursement payments made to merchants in a calendar year. This proposal is estimated to generate \$10.7 billion over the next ten years.
- *Require a certified Taxpayer Identification Number from contractors.* This proposal requires a contractor receiving payments of \$600 or more in a calendar year from a particular business to furnish to the business its certified Taxpayer Identification Number (TIN). This proposal would require a business to verify the TIN with the IRS, which would be authorized to disclose whether the TIN-name combination matches IRS records. If a contractor fails to furnish an accurate certified TIN, the business would then be required to withhold a flat rate. This proposal is estimated to raise \$749 million over the next ten years.
- *Require increased information reporting for certain government payments for property and services.* This proposal would authorize the IRS and Treasury Department to issue regulations requiring information reporting on all non-wage payments by federal, state and local governments to procure property and services. This proposal is estimated to generate \$390 million over the next ten years.
- *Increase information return penalties.* This proposal would increase the \$50 and \$100 penalty amounts to \$100 and \$250, respectively, and would increase the \$250,000 and \$100,000 penalty caps to \$1,500,000 and \$500,000, respectively. This proposal is estimated to generate \$546 million over the next ten years.

*Improving Compliance by Businesses:* More efficient filing mechanisms, clearer rules on who is liable for employment taxes, and streamlined collection due process will contribute to improved business tax compliance.

- *Require e-filing by certain large organizations.* This proposal would require all corporations and partnerships required to file Schedule M-3 to file their income tax returns electronically. In the case of large taxpayers not required to file Schedule M-3, such as exempt organizations, the regulatory authority to require electronic filing would be expanded beyond the current 250-return minimum.
- *Implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes.* This proposal would set standards for holding employee leasing companies jointly and severally liable with their clients for federal employment taxes. This proposal would provide standards for holding employee leasing companies solely liable if they meet specified requirements. This proposal is estimated to generate \$57 million over the next ten years.
- *Amend collection due process procedures for employment tax liabilities.* Legislation was signed May 25, 2007, implementing a modified version of this proposal. It expands the exception to the requirement for pre-levy Collection Due Process proceedings to include certain levies issued to collect federal employment taxes. The change will generate an estimated \$364 million over the next ten years.

*Strengthening Tax Administration:* Tax administration will be strengthened through disclosure revisions and stronger penalties for nonfiling.

- *Expand IRS access to information in the National Directory of New Hires (NDNH) for tax administration purposes.* This proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncompliant taxpayers, and identification of levy sources.
- *Permit disclosure of prison tax scams.* This proposal would authorize the IRS to disclose certain limited return information about tax violations by inmates so prison officials could punish and deter such conduct through administrative sanctions. This is expected to generate \$5 million over the next ten years.
- *Make repeated willful failure to file a tax return a felony.* This proposal would subject any person who willfully fails to file tax returns in any three years within any five year period, if the aggregated tax liability for such period is at least \$50,000, to a new aggravated failure to file criminal penalty. This proposal is estimated to generate \$12 million over the next ten years.

*Strengthening Penalties:* Enhanced penalties will help to deter noncompliance.

- *Expand preparer penalties.* Legislation was signed May 25, 2007, implementing a modified version of this proposal. It expands the scope of the existing preparer penalties to include non-income tax returns and related documents. The proposal also increases related penalty amounts. The change will generate an estimated \$80 million over the next ten years.
- *Impose penalty on failure to comply with electronic filing requirement.* This proposal would establish a penalty for failure to comply with e-file requirements. The amount of the penalty would be \$25,000 for a corporation or \$5,000 for a tax-exempt organization.
- *Create an erroneous refund claim penalty.* Legislation was signed May 25, 2007, implementing a version of this proposal. It imposes a penalty of up to 20 percent of a disallowed portion of a claim for refund or credit for which there is no reasonable basis for the claimed tax treatment, or for which the taxpayer did not have reasonable cause. The change will generate an estimated \$98 million over the next ten years.

The Treasury Department and the IRS will continue to explore additional possibilities for legislative proposals, as well as improved methods for using external data and data from information reports.

#### Published Guidance

Published guidance in the form of regulations, revenue rulings, revenue procedures, notices, and announcements is a critical element in the IRS' efforts to reduce tax avoidance, improve taxpayer compliance, and close the tax gap.

Published guidance:

- Enhances compliance by providing detailed substantive and procedural rules;
- Helps compliant taxpayers better understand how to determine and pay their tax liability;
- Reduces disputes between the IRS and taxpayers regarding the proper interpretation of the tax law and the procedures necessary to comply with it; and
- Makes it more difficult for noncompliant taxpayers to avoid detection or incorrectly claim that their behavior is permitted under the tax law.

Some tax statutes specifically direct the Treasury Department and the IRS to issue regulations or other guidance. Certain statutory provisions have little or no effect until implemented by regulations or other administrative guidance, and some provide only general direction and broadly delegate authority to publish regulations. Published guidance interprets the tax law and articulates how it applies in different circumstances, thus helping taxpayers determine how to comply with their tax obligations.

The Treasury Department and the IRS continue to resolve many difficult issues and remove impediments to voluntary compliance through published guidance. The ever-increasing complexity of, continuing changes in, and temporary nature of the tax law also present significant challenges to addressing long-standing compliance problems through guidance. The published guidance program also aids in identification of issues that guidance cannot address and serves a significant role in developing suggestions for legislative solutions.

Each year, the Treasury Department and the IRS issue a Priority Guidance Plan (PGP) that sets forth the guidance projects targeted for completion over the course of the following 12 months. The PGP typically includes more than 250 separate guidance projects.

Examples of published guidance designed to improve compliance recently issued by the Treasury Department and the IRS include:

- Regulations clarifying the tax rules and information reporting requirements for widely held fixed investment trusts;
- Regulations implementing and explaining new tax shelter disclosure rules and penalties;
- Regulations and other guidance on reporting and inclusion in income of deferred compensation from nonqualified deferred compensation plans;
- Regulations and other guidance clarifying and explaining the new deduction for domestic production activities;
- Guidance explaining the rules governing charitable contributions of vehicles;

- Guidance on transfer pricing issues related to cross-border services and cost-sharing agreements;
- Proposed regulations addressing the tax treatment of private annuities;
- Guidance designating a loss importation strategy as a listed transaction;
- Guidance implementing a new excise tax on tax-exempt entities and their managers in connection with participation in certain potentially abusive transactions;
- Guidance improving information reporting for certain wagering activities;
- Proposed regulations addressing when expenditures for tangible property may be deducted or must be capitalized; and
- Rulings addressing the consequences, including potential penalties, of filing returns (or failing to file returns) based on frivolous tax positions.

Issuing published guidance is an important tool for the IRS in closing the tax gap. Notwithstanding the inherent challenges, the Treasury Department and the IRS will continue to provide published guidance to improve compliance by addressing abusive tax avoidance transactions, providing clarifications and explanations of the tax laws, ensuring consistency of treatment of similarly situated taxpayers, and where possible, reducing burden on compliant taxpayers.

Some projects currently underway include development of guidance in these areas:

- Transfer pricing (Internal Revenue Code (IRC) section 482)
- Foreign tax credits (IRC section 901)
- Patent cross licensing
- International restructurings (IRC section 367)

#### Initiatives

- Work with Congress to enact remaining legislative proposals included in Administration's FY 2008 Budget:
  - Require information reporting on payments to corporations;
  - Require basis reporting on security sales;
  - Expand broker information reporting;

- Require information reporting on merchant payment card reimbursements;
- Require a certified Taxpayer Identification Number from contractors;
- Require increased information reporting for certain government payments for property and services;
- Increase information return penalties;
- Require e-filing by certain large organizations;
- Implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes;
- Expand IRS access to information in the NDNH for tax administration purposes;
- Permit disclosure of prison tax scams;
- Make repeated willful failure to file a tax return a felony; and
- Impose penalty on failure to comply with electronic filing requirement.
- Develop new legislative proposals for consideration in the Administration's FY 2009 Budget. Approaches under consideration include:
  - Improvements in coordination with State governments, including coordination concerning licensing activities; and
  - Further expansions of information reporting requirements, including reporting of financial activity that currently may not be subject to information reporting.
- Develop regulations and other published guidance clarifying ambiguous areas of the law, targeting specific areas of noncompliance, and preventing abusive behavior.

## Component 2

**Make a Multi-Year Commitment to Research**

Research is critical in helping the IRS understand behavior, develop strategies, and measure progress.

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, allocate resources more effectively, and reduce the tax gap. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, because this reduces the burden of unnecessary taxpayer contacts and because it enables the IRS to collect more with a given level of resources. Research is also critical in helping the IRS establish benchmarks against which to measure progress in improving compliance.

The NRP demonstrates the importance of comprehensive compliance data. In addition, accurate NRP data provides a critical benchmark for determining the sources of noncompliance and for measuring changes in compliance over time. Data from the NRP reporting compliance study have allowed the IRS to:

- Target examinations and other compliance activities better, thus increasing the dollar-per-case yield and reducing “no change” audits of compliant taxpayers; and
- Improve operational audits by using innovations pioneered during the 2001 NRP to reduce taxpayer burden.

Continued compliance research is a vital component of a sound tax gap strategy. An NRP reporting compliance study of 5,000 S corporation tax returns filed in 2003 and 2004 is currently in process. Since 1985, S corporation return filings have increased dramatically. In that year, there were 722,444 Forms 1120S filed. In 2004, that number had grown by nearly five times to over 3.6 million, while other corporate returns declined by approximately 500,000 for the same period.

By 1997, S corporations had become the most common corporate entity. In 2004, tax returns filed by S corporations accounted for over 63 percent of all corporate returns filed. The last time the IRS conducted an S corporation study was 1984. As a result, the IRS does not have reliable reporting compliance data for these entities. The current S corporation study represents the first time that the IRS has conducted a reporting compliance study across tax years, and it will require that the data be knitted together to provide a comprehensive picture. The study will continue through 2007.

Without new reporting compliance studies, the IRS must rely on studies conducted over 20 years ago to estimate compliance for areas other than individual income tax or S corporations. Moreover, with each passing year, the data from the 2001 study on individual income tax compliance becomes more outdated. Without up-to-date studies in all areas, the IRS is hampered in its ability to respond rapidly to trends and emerging vulnerabilities in the tax system. A multi-year commitment to research ensures that the IRS can efficiently target resources and effectively respond to new sources of noncompliance as they emerge.

The Administration's FY 2008 Budget request for the IRS funds for three significant research initiatives. These include:

- *Increasing compliance studies.* The IRS will conduct reporting compliance studies for additional segments of taxpayers for which the IRS now relies on very old data (e.g., corporation income tax, employment tax, and partnerships), or for which the IRS has never conducted any compliance studies at all (e.g., excise tax).
- *Updating existing data from the 2001 NRP study.* The IRS will conduct an annual study of compliance among Form 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance data each year and, by combining samples over several years, will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.
- *Researching the effect of service on taxpayer compliance.* This project will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:
  1. Meeting taxpayer needs by providing the right channel of communication;
  2. Better understanding taxpayer burden;
  3. Understanding taxpayer needs through the errors they make; and
  4. Researching the impact of service on overall levels of voluntary compliance.

#### Initiatives

- Undertake additional compliance studies, including S corporations and individuals.
- Update tax gap estimates using new and existing data.
- Research the effect of service on taxpayer compliance.
- Research the relationship between complexity, burden, and compliance.

### Component 3 Continue Improvements in Information Technology

A combination of new systems and enhancements to existing systems is critical to a productive use of resources.

Information technology (IT) modernization is critical to ensuring the most productive use of both taxpayer service and compliance resources. It provides the necessary infrastructure that allows the most efficient utilization of resources, which in turn allows the IRS to target key components of the tax gap better. Because IT modernization is a cornerstone to efficient and effective tax administration, the IRS is committed to strong oversight and accountability of IT projects.

The IRS information technology vision includes systems that:

- Allow for better identification of the cases to be worked;
- Route those cases to the most appropriate workstream; and
- Employ cost effective technology analytics to best manage cases once they reach the correct workstream.

The IRS' current investment in technology infrastructure includes a combination of new systems and enhancements to existing systems, with emphasis on improving both effectiveness and efficiency. Included in this infrastructure are tools to increase taxpayer compliance through early detection, improved case selection, more efficient case delivery, and better case management:

- **Case Selection.** The NRP provides significant data for improving case selection criteria. NRP data facilitates selection of the most productive returns to examine. This not only reduces the tax gap, but also allows the IRS to update tax gap estimates. The case selection process is further enhanced through automated classification processes. The IRS also uses current audit information from "issue management" systems to provide for immediate identification of emerging issues. For Collection programs, the IRS will use improved decision analytics to select cases and route them to the most appropriate workstream.
- **Case Delivery.** Delivery systems also are being modified to move audit work into the system more effectively and efficiently. Both return classification and delivery will move toward digital rather than paper-based returns, eliminating the time consuming and expensive process of ordering returns and sending examiners out to IRS campus locations for classification details. Additionally, the IRS will replace manual processes with electronic case building and instant access to multi-year tax return information.
- **Case Management.** Automated systems are being deployed to allow more batched processing of high volume types of examinations. Technology enhancements will allow

employees to work cases in an online environment, where returns and case-related data can be downloaded, and actions can be tracked electronically. The IRS will continue to link multiple internal and external databases to enhance overall effectiveness, allowing better identification, management, and performance monitoring for compliance workload. The IRS also has several projects that will enhance criminal enforcement, with spillover effects to civil cases.

The Administration's FY 2008 Budget request includes an additional \$81 million in funding to improve the IRS' information technology infrastructure, which is vital to improving IRS' enforcement and services capabilities. The investments proposed in the Budget will allow the IRS to:

- *Upgrade critical IT infrastructure.* This will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers, automated call distributor hardware, and Wide Area Network/Local Area Network routers and switches.
- *Enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security.* This will allow the CSIRC to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur.
- *Enhance the IRS' network infrastructure security.* This will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The FY 2008 Budget request also includes a total of \$282 million to continue the development and deployment of the IRS' Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

- *Continue development of CADE and AMS.* The development of CADE and AMS systems is the heart of IRS' IT modernization. These two systems, working together, will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. The objective is for the IRS to operate similarly to a bank, where account transactions occurring during the business day are posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all current information regarding that taxpayer, including electronic access to tax return data and electronic copies of correspondence. Armed with such comprehensive and up-to-date information, IRS representatives will be in a much better position to help taxpayers resolve their issues, which benefits both the IRS and taxpayers while promoting voluntary compliance.

The development of CADE and AMS also includes a comprehensive re-working of the notice system to streamline the process and enhance its efficiency. In July 2008, CADE is scheduled to post and settle tax returns with a balance due condition and amended tax returns, Form 1040X. The daily settlement of these accounts through CADE and the linkage with AMS will enable the balance due notices to be sent on a daily basis and delivered to the taxpayer as much as eight days faster than current time lines.

- *Continue development of MeF.* MeF is the future of electronic filing. It provides a standard data format for all electronically filed tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker filing acknowledgement to the taxpayer or their representative. In FY 2007, the IRS is beginning the development and implementation of the Form 1040 on the MeF platform. The MeF system will enable the IRS to better analyze tax compliance issues and address noncompliance among taxpayers by removing the impediments caused by lack of data availability and completeness, access, and data accuracy. MeF will allow the re-engineering of much of the current manual and time consuming compliance processes including the following:
  - *Completeness of Data.* The MeF system provides 100 percent of the data contained within the returns, their schedules and attachments, third-party documents, and amended returns in an electronic form. All documentation will be available completely and electronically, which is equivalent to a paper copy of the entire return file, but in a more usable and transportable form. The current e-filing system only provides returns and does not have the ability to provide supplemental documentation, including attachments, electronically. Paper submissions provide only limited transcriptions of return data or an image of the return. All other documentation is recalled and analyzed using time consuming manual processes.
  - *Data Availability and Access.* Currently, IRS electronic systems capture an average of 20 percent of the data contained within tax and information returns. To gather additional information for compliance needs, the IRS must conduct manual transcriptions, which are costly and time consuming. For each form, the amount of information retained or transcribed varies by form type, complexity, and size. For those returns submitted through MeF, 100 percent of the data will be available to the IRS in electronic format, including associated schedules and attachments, regardless of the form type and without additional expense.
  - *Data Accuracy.* The IRS currently expends time and resources ensuring the data received from tax and information filers and transcriptions are accurate and reliable. The MeF system and its processes increase data accuracy by reducing the incidence of errors and by minimizing the need for manual transcriptions. This is made possible by validating the information prior to submission. The use of business rules also ensures that the returns are free of computation errors.

- **Cost Effective Data Capture & Storage.** The manual processing of return data, attachments, and schedules is time consuming and costly. E-filing is the most effective means of capturing, storing, and recalling data. Savings include a reduction in submission processing and storage costs. Additional savings will be achieved from reduced cost for retrieving and re-filing returns for examinations and transcription for identification of compliance trends or research.
- **Fed/State Electronic Federal Tax Payment System.** The IRS and the Treasury Department's Financial Management Service are developing a pilot in conjunction with South Carolina and Illinois. The pilot will enable Illinois taxpayers (South Carolina will participate in a later phase) to pay all their federal and certain state taxes online via the Treasury's Electronic Federal Tax Payment System (EFTPS). This initiative will provide one stop for taxpayers to make their federal and state tax payments.
- **Compliance Monitoring Process.** Compliance monitoring is premised on the notion that the IRS should make use of every available tool and public data source in trying to bring corporations into compliance. The Large and Mid-Size Business (LMSB) division has designed a Compliance Monitoring Process (CMP). LMSB developed and will be implementing an enhanced compliance initiative dependent on information technology that leverages the increases in transparency mandated by Sarbanes-Oxley and other laws. This program also leverages the increased transparency of public companies' financial statements that will result from implementation of Financial Accounting Standards Board Interpretation No. 48 (FIN 48).

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, and the business community, but also contribute to operational improvements and efficiencies within the IRS.

#### Initiatives

- Improve high income and non-EITC exam workload selection and method of delivery and assess the effectiveness of the exam treatment stream on selected nonfiler cases. (Also supports Component 4)
- Expand Automated Underreporter (AUR) Auto Notice Generation to include additional income types and all Form 1040 family returns. (Also supports Component 4)
- Develop system requirements for expanding the AUR Soft Notice Test, which involves asking taxpayers to voluntarily self-correct for future years. (Also supports Component 4)
- Evaluate the AUR matching process, and implement an improved case scoring and selection concept to select the most productive cases. (Also supports Component 4)
- Develop enhancements to the Compliance Data Warehouse to improve workload identification and prioritization algorithms, allowing better evaluation of alternative treatment streams and ensuring Collection cases receive the most efficient and effective treatments. (Also supports Component 4)

- Update the Collection inventory management system to improve functionality navigation, performance, and efficiency. (Also supports Component 4)
- Automate lien delivery, recording, and release processes with state and local jurisdictions to improve the timeliness of lien filings and the payment of fees. (Also supports Component 4)
- Test the use of statistical modeling techniques within the Tax Exempt and Government Entities Division (TEGE) to detect high-risk compliance patterns in order to use data to expand and improve examination case selection. (Also supports Component 4)
- Develop and implement a set of compliance decision analytical tools that will support analysis of TEGE returns and other data to detect compliance trends and improve case and issue selection. (Also supports Component 4)
- Implement a new TEGE electronic examination system (TREES) that will consolidate agent tools to increase the accuracy and efficiency of the examination process.
- Build and implement MeF receipt of electronic transmissions for additional tax forms.

#### Component 4 Improve Compliance Activities

Obtaining maximum coverage and yield from available resources is necessary for the greatest impact on compliance.

The IRS has made significant progress in reducing the tax gap through improvements in enforcement efforts. The following examples demonstrate this progress:

- Enforcement revenues have grown by nearly \$15 billion since FY 2001, totaling \$48.7 billion in FY 2006.
- Examinations of individual taxpayer returns increased by 77 percent between FY 2001 and FY 2006, when the IRS conducted nearly 1.3 million examinations. Similarly, the coverage rate rose from 0.58 percent to 0.98 percent during that period.
- The IRS has focused more resources on examinations of individuals with income over \$1 million. The number of examinations in this category rose by almost 80,000 in FY 2006 as compared to FY 2004, the first year the IRS began tracking them separately. The coverage rate has similarly risen from 5.03 percent to 6.30 percent in that period.
- Audits of business returns increased by 29 percent between FY 2001 and FY 2006. The coverage rate over the same period rose from 0.55 percent to 0.60 percent.
- Audits of corporations with assets over \$10 million grew from 8,718 in FY 2001 to 10,578 in FY 2006, and the coverage rate increased from 15.1 percent to 18.6 percent.
- Examinations of the very largest corporations, those with assets over \$250 million, increased by nearly 30 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.
- For audits of taxpayers with assets greater than \$10 million, the cycle time per audit has been reduced by 22.6 percent from 23 months in FY 2001 to 17.8 months in FY 2006. This allows IRS to use its resources more efficiently and increase the number of corporate audits conducted.
- The IRS has placed more emphasis on tax-exempt organizations by increasing the number of examinations by nearly 33 percent from 5,342 in FY 2001 to 7,079 in FY 2006.
- The IRS achieved a 91.4 percent conviction rate on criminal investigation cases from FY 2001 through December 31, 2006.
- The IRS established the position of Deputy Commissioner, International to improve oversight of and focus on global taxation issues.

These results reflect the direct impact of IRS enforcement initiatives. Though difficult to quantify, there is also a significant indirect effect of IRS enforcement, which some research suggests could be at least three times the direct effect of enforcement efforts. This indirect effect is seen when an

individual thinks twice about failing to report income or overstate a deduction if he or she knows a neighbor or friend has been audited. Similarly, if taxpayers are aware that the IRS is more active, voluntary compliance increases.

The IRS' compliance strategy attacks the tax gap by balancing three critical enforcement principles.

- **Coverage.** Balanced audit coverage is important from an IRS presence and noncompliance deterrence perspective.
- **Yield.** It is important that IRS resources address those noncompliant returns that will yield the greatest revenue impact for the Treasury Department.
- **Intentional Noncompliant Behavior.** The larger components of the tax gap involve more complex issues and/or unreported income that usually require more in-depth audits or in flagrant cases of tax evasion, criminal investigation.

Where possible, the IRS will use low-cost, highly automated systems and resources to maintain or increase compliance coverage levels. Many of these systems will not involve face-to-face interactions with taxpayers. This includes programs such as Automated Underreporter, Automated Collection System, Automated Substitute for Return, correspondence exam, and "soft notices."

The IRS will use a combination of low-cost, highly automated systems and face-to-face interactions with taxpayers to address high yield and complex compliance issues. These include field audits, field collection contacts, and large corporate audits. Resources will be devoted to addressing major and persistent areas of noncompliance through face-to-face interactions with taxpayers.

To ensure coordination of IRS efforts to address all aspects of the tax gap, the Deputy Commissioner for Services and Enforcement has formed an executive level tax gap committee. This committee analyzes compliance data and makes recommendations on the proper allocation of compliance resources so that the IRS can maximize its ability to address the tax gap components. This group is currently quantifying:

- Coverage rates;
- Resource utilization;
- Return on investment (ROI); and
- Effectiveness of compliance programs.

Though it is not feasible to eliminate the tax gap completely, it is possible to maximize the use of existing resources to address coverage, yield, and noncompliant behavior better. As resources are made available due to shifts in return filing patterns, or from efficiencies achieved from systemic changes (both technology and process), resources will be redirected to address significant components of the tax gap, keeping the factors mentioned above in the proper balance. For example, the IRS cannot simply allocate resources to the highest yielding activities and thereby sacrifice balanced coverage across all elements of noncompliance. Audit coverage rates and return on investment information is provided in Figures 8 and 9.

Figure 8

## FY 2006 Coverage Rates for Key Taxpayer Categories

	Enforcement Area	Coverage Rate
Corporations	Corporations with Assets > \$250M	35.3%
	Corporations with Assets \$10M - \$50M	14.2%
	1120S Corporations	0.38%
Individual Income Tax	Individuals > \$1M	5.23%
	Individuals > \$100,000	1.67%
	Individuals < \$100,000	0.89%
	All Individuals	0.98%
Employment Tax	Employment Tax Returns	0.11%
Estate Tax	Estate Tax with Gross Estate > \$5M	28.12%

Figure 9

## Estimated Program Marginal Direct Return on Investment (ROI) for FY 2008 Hiring Initiatives\*

IRS Program	ROI
Large Corporate Exam Program	3:1
Small Business Exam and Collection Program	3:1
Individual Document Matching	9:1
Automated NonFiling Program	14:1

\* Marginal ROIs are computed by applying an assumed "marginality" factor to the observed average return on investment.

Some specific examples of IRS efforts to allocate resources to target specific noncompliance attributed to the tax gap include addressing:

- *Promoters of abusive tax avoidance transactions.* While these cases are time consuming to investigate, civil injunction actions often lead to the identification of scheme participants, including many small corporate and individual taxpayers. The IRS then allocates resources to examine and correct the abusive transactions. The IRS also assesses civil penalties as appropriate against abusive promoters and preparers.
- *High income nonfilers.* The IRS has campus Taxpayer Delinquency Investigation (TDI) and Automated Substitute for Return (ASFR) programs that address nonfilers. Some high-income cases are not typical and require complex skills to examine. The IRS allocates field resources to investigate and resolve these cases.
- *Offshore activity.* Taxpayers who engage in offshore activity for the purposes of underreporting income or participating in a tax haven taxation regime must be addressed. The IRS is improving its ability to identify these cases and the specialized skills of the examiners who handle them.

- *Unscrupulous return preparers.* Most return preparers are professional, provide valuable service to their clients, and are effective advocates for good tax administration. Unfortunately, a few unscrupulous preparers can have a significant negative effect on compliance. The IRS allocates resources to conduct visits to Electronic Return Originators (EROs), pursue preparer examinations with the goal of penalizing improper behavior, and seek civil injunctions and/or criminal indictments against the most egregious behavior.
- *Small businesses.* Because research indicates there is a greater likelihood of misreporting and underreporting by small businesses, the IRS plans to increase the level of Form 1040, Schedule C examinations.

Improving audit currency and identifying issues for examination are key elements of the IRS' effort to target noncompliance. These efforts often involve finding ways to streamline examinations of compliant taxpayers, so that examination resources can be focused on more problematic areas. Efforts to improve currency and transparency include:

- *Schedule M-3.* To improve transparency of corporate taxpayers, the IRS mandated a new Schedule M-3 for large business taxpayers. The Schedule M-3 provides more detail on book-tax differences, enabling the IRS to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk.
- *Compliance Assurance Program.* The IRS is also expanding the Compliance Assurance Program (CAP), to improve both currency and transparency. The CAP program is a real-time approach to compliance review that allows the IRS, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. CAP is more efficient than a post-filing examination – as it provides corporations certainty about their tax liability for a given year within months, rather than years, of filing a tax return. This provides compliant taxpayers with greater certainty as to their tax and financial reporting positions, and allows the IRS to focus its examination resources on more problematic areas.
- *Pre-Filing Agreement.* The Pre-Filing Agreement (PFA) program provides taxpayers an opportunity to request that revenue agents examine and resolve potential issues before tax returns are filed. The IRS continues to explore other ways to work with LMSB taxpayers on a pre-filing basis to address their federal tax liability compliance.
- *Leverage Corporate E-file.* The IRS is improving issue identification and the selection for examination of high-risk returns through new mandatory e-filing. Many corporations are now required to file their tax returns electronically and this mandate will expand in future tax years. E-filing will provide more consistent treatment and data analysis for efficient, near real time identification of high-risk issues and taxpayers. E-filing and Schedule M-3 together also allow the IRS to identify and exclude more efficiently lower-risk taxpayers from full examinations.

Additional compliance initiatives in process on IRS campuses include:

- *International support.* The IRS is expanding investigations of individuals who report income to Puerto Rico but fail to file a Form 1040PR to report social security, begin or end bona fide residence in a U.S. possession, and request to limit partnership withholding from foreign sources.
- *Form 941 nonfilers.* The IRS is expanding employment tax compliance efforts through matching information returns filed with the Social Security Administration to the filing of related employment tax returns.
- *Form 1120-S compliance.* The IRS is increasing reviews of invalid S corporation returns and their shareholders. Entities that do not have valid elections, and their shareholders' returns, will be adjusted to reflect the proper tax effect.
- *Fed/State referrals.* The IRS actively pursues leads obtained through information sharing with the states, as well as initiates examinations based on outcomes of state audits.

IRS employees play a critical role in the effort to improve compliance in terms of both taxpayer service and enforcement. In addition to implementing elements of any strategy to improve compliance, IRS employees also serve as a source for developing these elements in the first place. In order to ensure that the IRS' workforce is responsive to the need to improve compliance, the IRS recently published regulations that remove limitations on the use of quantity measures in evaluating the performance of, or imposing or suggesting goals for, IRS organizational units. These regulations will improve accountability while not changing current provisions that bar the use of performance measures based on quantity measures when evaluating employees' performance.

There are six specific initiatives in the FY 2008 Budget request that are aimed at significantly improving compliance activities. Collectively these initiatives should generate an additional \$699 million in revenue when all of the new hires reach full potential in FY 2010. These initiatives will:

- *Improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance.* This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes, and investigating for possible criminal referral persons who have evaded taxes.
- *Increase examination coverage for large, complex business returns, foreign residents, and smaller corporations with significant international activity.* Using information from Form 1120, Schedule M-3 and enhanced data resulting from mandatory e-filing, this initiative will address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multinational transactions where the potential for noncompliance is significant. Improved business processes along with this funding will allow IRS to maintain its attention to the very largest businesses while expanding the overall coverage rate for large corporate and flow-through returns from 7.9 percent to 8.2 percent in FY 2008.

- *Expand document matching in existing sites and the inclusion of document matching at a new site.* This enforcement initiative will increase coverage within the Automated Underreporter (AUR) document matching program, resulting in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. In addition, a new document matching program will be established at the IRS' Kansas City campus. The establishment of this new AUR site is estimated to result in over \$183 million in additional enforcement revenue per year beginning in FY 2010.
- *Increase individual filing compliance through the Automated Substitute for Return Refund Hold Program.* This will minimize revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. It is estimated that this initiative will result in securing more than 90,000 delinquent returns in FY 2008.
- *Improve tax-exempt entity compliance by preventing the misuse of such entities by third parties for tax avoidance or other unintended purposes.* This funding will aid in increasing the number of TEGE compliance contacts by 1,700 (6 percent) and employee plan/exempt organization determinations closures by over 9,000 (8 percent) annually by FY 2010.
- *Increase criminal tax investigations, which will aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud.* These investigations will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program.

In addition to these initiatives, the IRS is beginning to realize benefits from the Private Debt Collection program. Pursuant to Congressional authorization, taxpayers receive the same treatment from private collection agencies (PCAs) that they would from the IRS, including access to the Taxpayer Advocate Service. The PCAs only work cases where the taxpayer does not dispute the liability and collect money the IRS could not collect otherwise. Ninety-seven percent of the taxpayers who responded to the IRS customer satisfaction survey regarding contact by a PCA were satisfied with the service received.

Improving compliance in the cash economy is also a focus. A joint IRS/Taxpayer Advocate team is exploring alternatives for improving compliance in this portion of the tax gap. The team has reviewed data from multiple existing studies and is surveying both internal and external sources for potential recommendations.

Another focus is to ensure that attorneys, accountants, and other tax practitioners adhere to high professional standards. The Office of Professional Responsibility (OPR) recently obtained a wholesale review of practitioner tax filing patterns. In addition to providing a statistical analysis of practitioner tax noncompliance, this review identified practitioners whose personal filing patterns were problematic. Circular 230 enforcement action in this area has had the collateral effect of prompting well over 75 percent of the delinquent practitioner returns to be filed after contact by OPR. This enforcement effort reinforces the message that OPR considers tax compliance to be an important matter and expects tax professionals to remain compliant.

OPR is also a participant and lead facilitator of a new return preparer strategy designed to maximize resources and coverage in the noncompliant tax preparer arena. The Servicewide Enforcement Preparer Strategy is comprised of a team representing all functions involved with the return preparer/parallel investigation workload. In addition to an annual planning meeting that has taken place, monthly conference calls are conducted among all members to coordinate between functions to ensure issues and enforcement actions such as injunctions and penalties are consistent, timely, and effective.

Criminal Investigation (CI) supports compliance initiatives and sends a strong public message by investigating egregious tax evaders, chronic noncompliance, promoters and participants in abusive schemes, employment tax evasion, high-income nonfilers, and unscrupulous return preparers. IRS CI has one of the highest conviction rates in federal law enforcement. Over 79 percent of convicted offenders are sentenced to prison terms averaging 22 months.

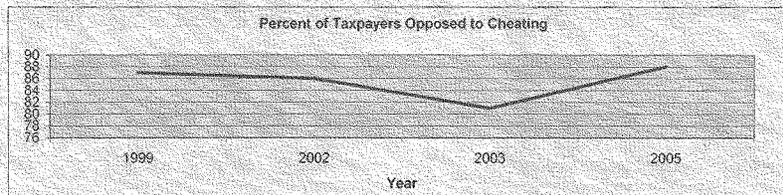
To address offshore and cross-border compliance risks (through enforcement and by issuing guidance), the IRS has formed Issue Management Teams in the following areas:

- Cost sharing;
- Abusive foreign tax credit generators;
- Section 936 exit strategies;
- Foreign earnings repatriation;
- Hybrid instruments; and
- Transfer pricing.

Tax Treaties and Tax Information Exchange Agreements (TIEAs) are two additional important tools in addressing and enhancing international compliance through the exchange of information with other national tax authorities. Through TIEAs and the Exchange of Information Article of Tax Treaties, the IRS is able to develop cross-border information to identify and address abusive transactions for civil and criminal purposes.

Americans seem less tolerant of tax cheating than they did only a few years ago and are generally supportive of IRS compliance activities against tax scofflaws. According to a 2003 Roper poll conducted for the IRS Oversight Board, 81 percent of Americans said it is unacceptable to cheat on income taxes. A 2005 survey for the IRS Oversight Board shows that the number is now 88 percent, as demonstrated in Figure 10.

Figure 10



Source: IRS Oversight Board Taxpayer Attitude Surveys

In addition, attitudinal support for compliance remains high as illustrated by the following statistics:

- Nearly three out of four taxpayers agree that it is everyone's civic duty to pay their fair share of taxes.
- Nearly one in every three Americans (30 percent) agree that it is everyone's personal responsibility to report anyone who cheats on their taxes, a six point increase from 2004 and 11 point increase from 2003.
- Although the public continues to feel strongly that the IRS should target large corporations and those at high-income levels who do not comply, increasing numbers feel that it is important to ensure compliance from small businesses (73 percent) and lower-income taxpayers (66 percent), as well.
- An increasing number of taxpayers cite third-party reporting as a deterrent to noncompliance (41 percent).
- Over 82 percent of Americans say that their own personal integrity has the greatest influence on whether they report and pay their taxes honestly. This is double the number citing any other factor.

According to the Pew Research Center study "A Barometer of Modern Morals," 79 percent of Americans consider not reporting all income on one's tax return to be morally wrong, while just 5 percent consider it morally acceptable and 14 percent say it is not a moral issue. Of those who said this behavior is morally wrong, cheating on one's taxes ranked second only to cheating on one's spouse.

### Initiatives

- Increase audit coverage and better target returns for examination.
- Enhance the ability to identify and address tax schemes of business and individuals involving offshore activity, address illegitimate use of tax havens to shelter income, and increase information matching and examination activity for individuals living abroad.
- Enhance collection programs and increase the Federal Payment Levy Program using third-party data.
- Work with other federal agencies regarding the Federal Payment Levy Program. (Also supports Component 7)
- Improve compliance by tax preparers through implementation of the Service Wide Enforcement Preparers Strategy. (Also supports Components 3 and 7)
- Improve collection selection criteria and filters for balance due and nonfiler cases, including identifying and addressing potential high-income nonfilers. (Also supports Component 3)
- Litigate cases, work settlements, and design large scale resolution initiatives for tax shelter transactions to deter noncompliance. (Also supports Component 1)
- Initiate a project using Combined Annual Wage Reporting (CAWR) data to identify tax-exempt organizations that may not be properly reporting and paying employment taxes. (Also supports Component 3)
- Increase criminal enforcement on abusive schemes, corporate fraud, employment tax, egregious nonfilers, and on Bank Secrecy Act violations.
- Improve the alignment and allocation of service-wide resources to identify, develop, and resolve challenges better in the global taxation arena.
- Improve tax administration to deal more effectively with increased emphasis on globalization by all corporate and individual taxpayers.
- Increase industry and global issue focus by aligning resources to cases and issues with the highest compliance risk.
- Leverage the efforts of examiners as well as external partnerships with foreign tax administrators to identify and address emerging issues of significant compliance risk. (Also supports Component 7)
- Address offshore and cross-border compliance risks through enforcement and by issuing guidance in the following areas:
  - Cost sharing;
  - Abusive foreign tax credit generators;
  - Section 936 exit strategies;
  - Foreign earnings repatriation;
  - Hybrid instruments; and
  - Transfer pricing.

## Component 5 Enhance Taxpayer Service

### Effective taxpayer service has a significant effect on voluntary compliance.

Taxpayer service is especially important for helping taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, regulations and other published guidance, toll-free call centers, the Internet, and Taxpayer Assistance Centers (TACs). In addition, during the filing season, IRS-supported Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites provide free return preparation services for low-income, elderly, and limited-English-proficiency taxpayers.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS and reduces overall inadvertent noncompliance and the need for downstream enforcement.

According to a survey commissioned by the IRS Oversight Board in 2006, taxpayers increasingly recognize that the IRS provides good quality service through a variety of channels, such as its website, toll-free telephone lines, and TACs. This is supported by the metrics used to measure the effectiveness of the IRS' taxpayer service efforts. In category after category, there is improvement in the levels of telephone services, electronic filing, and access to IRS.gov. This is demonstrated by the following statistics:

- E-filing by individuals has continued to increase, up three percentage points in TY 2005, from 51 percent to 54 percent of all individual returns.
- The level of service for toll-free assistance was 82 percent, about the same level as in 2005 and up substantially from 2001. (Level of service is a measure that reflects the percentage of calls answered through the IRS' toll-free taxpayer assistance program compared to total call attempts, including calls answered, busy, disconnected, and abandoned.)
- The level of customer satisfaction with the toll-free line remains 94 percent, the same as in 2005.
- The tax law accuracy of toll-free response edged up to 91 percent from 89 percent in 2005.
- Taxpayers continued to find IRS.gov a useful source of information for complying with their tax obligations. Visits to the IRS website jumped nearly 10 percent in 2006 to more than 197 million visits.
- More taxpayers used the online refund status tool "Where's My Refund." In 2006, there were 24.7 million status checks, up nearly 12 percent from 2005.

Expanded outreach activities to individuals currently underway include:

- *Military Initiative.* During FY 2008 the IRS will analyze and determine the results of prior year targeted outreach to retired and soon-to-be retired military on the taxability of military pensions.

Using a control group approach, the comparison of post-outreach delinquency rates with pre-outreach rates will assist the IRS in determining the effectiveness and impact of its efforts. Once results are analyzed, strategic direction will be determined for future years for the entire federal employee and retiree population.

- *Disability Initiative.* The IRS is partnering with national and local organizations that serve taxpayers with disabilities in an effort to provide education on available tax credits and tax preparation assistance. Initially 30 cities participated and in 2007 it has been expanded to 54 cities.
- *Limited English Proficiency Hispanic Initiative.* The IRS is supporting an aggressive multimedia and grassroots outreach campaign targeting communities with a significant number of Hispanic individuals to disseminate tax information and distribute Spanish products.
- *Native American Initiative.* Partnering with national and local volunteer organizations to reach hard-to-serve areas, such as Indian Reservations, the focus of this initiative is to develop new and enhance existing relationships to increase distribution of educational products and information, expand tax preparation assistance and provide access to a broader array of resources for implementing strategies that include the Earned Income Tax Credit (EITC).
- *Rural Initiative.* Building alliances with groups that have extensive pre-existing rural infrastructures and knowledge to reach rural populations, the IRS will partner with the W.K. Kellogg Foundation to bring the Rural Strategy to a national scale. In FY 2007, the Kellogg Foundation agreed to fund rural initiatives in seven states. The IRS will also partner with the U.S. Department of Health and Human Services Welfare Peer Technical Assistance to develop state-wide rural strategies in two states.

#### The Taxpayer Assistance Blueprint

In July 2005, the Senate Committee on Appropriations issued report language requesting that the IRS conduct a comprehensive review of its current portfolio of services and develop a five-year plan for taxpayer services. This review, conducted jointly with the National Taxpayer Advocate and the IRS Oversight Board, was designed to achieve the following objectives:

- Establish a credible taxpayer/partner baseline of needs, preferences, and behaviors;
- Implement a transparent process for making service-related resource and operational decisions;
- Develop a framework for institutionalizing key research, operational, and assessment activities to plan and manage improved service delivery; and
- Utilize both short-term performance and long-term business outcome goals and metrics to assess service value.

In April 2006, the Taxpayer Assistance Blueprint (TAB) Phase 1 report was completed and the results presented to Congress. Phase 1 identified and reported five strategic service improvement themes for enhancing taxpayer and practitioner service needs and preferences:

- Improve and expand education and awareness activities. This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- Optimize the use of partner services. This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- Elevate self-service options to meet the expectations of taxpayers. This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options.
- Improve and expand training and support tools to enhance assisted services. This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- Develop short-term performance and long-term outcome goals and metrics. This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

TAB Phase 2 focused on developing refined data around taxpayer and partner needs, preferences, and behaviors. Phase 2 also identified current planning documents, decision processes, and existing commitments affecting IRS service strategy. The TAB Phase 2 Report, delivered to Congress in April 2007, includes analysis of research results as well as details of a five-year strategic plan for taxpayer service. The TAB Strategic Plan outlines a multi-year commitment to research, including conducting research on the impact of taxpayer service on compliance. This will help the IRS better target taxpayer services and develop programs that can improve voluntary compliance and contribute to reducing the tax gap. The TAB Strategic Plan includes performance measures, service improvement initiatives, and a decision-making and governance process to prioritize service and research initiatives and funding proposals. Continued stakeholder, partner, and employee engagement is incorporated into all aspects of the TAB Strategic Plan.

The IRS does not know what percent of the tax gap is due to inadvertent, unintentional non-compliance that arises from the complexity and confusion surrounding our tax laws, having very little research currently available that addresses this issue. Several research studies are currently underway as part of the TAB Phase 2 to measure the impact of service on reducing inadvertent errors. Additional studies will be included in the proposed five-year research plan. Current research includes:

*Benchmark Survey of Taxpayers.* This survey will ask 40,000 taxpayers if they have used IRS taxpayer services to help prepare and file their tax returns – and which services and channels (e.g., phone, walk-in, Internet, publications) they used to get this help. The IRS will test to see if there are differences in average values for measures of filing, reporting, and payment compliance for respondents who did or did not use various IRS taxpayer services.

- *NRP Study*. The IRS is working to add survey questions to the next set of NRP audits to (1) find out whether taxpayers who used customer service programs had fewer reporting errors on their returns and (2) try to collect useful data on the root causes of inadvertent errors and possible treatments. The IRS is exploring the possibility of incorporating these types of questions into field examination audits on a pilot basis.
- *The Compliance Impact of Preparer, IRS and Self-Prepared Returns*. This analysis will divide all returns processed into groups based on who prepared the return: self-prepared, practitioner prepared, IRS prepared, software prepared and other options. The IRS will test to see if measures of filing, reporting, and payment compliance among these groups are significantly different.
- *The Impact of Taxpayer Advocate Service (TAS) Programs on Compliance*. This analysis will use Master File transaction codes to determine which taxpayers used TAS services in a particular fiscal year. This group will serve as a test group, and their subsequent filing, payment, and reporting compliance will be tracked. A control group comprised of a random sample of taxpayers who did not use TAS services or IRS services during the same fiscal year will be tracked to determine whether there are significant differences in compliance rates between the two groups.
- *Behavior Testing Lab*. This initiative will measure the accuracy of sample tax returns prepared by several focus groups of taxpayers, with and without access to IRS taxpayer services. This is another methodology for measuring the impact of service on compliance.

Analysis of the wealth of taxpayer data compiled as part of TAB Phase 2 revealed certain recurring findings about taxpayer needs, preferences, and behavior. The findings, combined with ongoing policy considerations and priorities, led to the development of TAB Guiding Principles that provide the groundwork for the development of the TAB Strategic Plan for taxpayer service. The TAB Guiding Principles are:

1. The primary goal of service for individual taxpayers is to facilitate compliance with federal tax obligations.
2. A portion of the tax gap is attributable to errors by individual taxpayers. IRS service programs should be designed to prevent, minimize, and correct such errors with due consideration of taxpayer burden.
3. IRS service investments will focus on preventing, minimizing, and correcting taxpayer noncompliance.
4. Enhance the IRS website so that it becomes the first choice of more taxpayers for obtaining the information and services needed to comply with tax obligations.
5. The IRS recognizes the significant role that partners play in tax administration. As such, the IRS will look for opportunities to assist these third parties in helping taxpayers understand and meet their tax obligations.

Based on these principles and extensive research analysis, the TAB Strategic Plan was designed to outline the vision for taxpayer service delivery over the next five years. Key components of the TAB Strategic Plan include the Performance Measures Portfolio, the Service Improvement Portfolio, and the Implementation Strategy. The IRS' ability to conduct research and to improve the delivery of services, and consequently improve compliance, is dependent on a number of variables that contribute to the constant evolution of the TAB Strategic Plan, including tax legislation, the IRS budget, technology, and the public marketplace. Therefore, the implementation strategy must be institutionalized before specific elements of the plan can be realized.

Based on recommendations in the TAB Strategic Plan, consideration is being given to the funding necessary to enhance IRS.gov so that becomes the first choice of individual taxpayers and their preparers when they need to contact the IRS for help. Consideration is also being given to other program initiatives that will address inadvertent, unintentional errors caused by:

- Language barriers. Pursuing strategies that focus on providing tax information in languages other than English.
- Educational barriers. Pursuing strategies that focus on expanding and improving the quality of voluntary assistance through VITA/TCE and similar partnership efforts.
- Misunderstanding of tax law. Pursuing strategies that focus on clarifying and improving forms, instructions and publications to reduce the burden that taxpayers experience in attempting to comply.
- Communication barriers. Pursuing strategies that focus on improving the quality, ease of use, and access to printed, electronic, and telephonic assistance channels; as well as placement of face-to-face assistance resources to effectively serve taxpayers unlikely to use other service channels.
- Practitioners' lack of knowledge/understanding of tax law. Pursuing strategies designed to enhance the quality and accessibility of practitioner assistance through education, tailored assistance channels, and effective monitoring of practitioner behavior and return preparation quality.

The Administration's FY 2008 Budget request includes the funding necessary to implement many of the telephone service and website enhancements recommended by the TAB Strategic Plan, as well as funding for research to understand better individual taxpayer noncompliance and the effect of service on compliance. Specific taxpayer service initiatives in the request include:

- *Expand Volunteer Income Tax Assistance (VITA) programs.* This will help expand IRS volunteer return preparation, outreach and education, and asset-building services to low income, elderly, Limited English Proficiency (LEP), and disabled taxpayers. It will increase the ability to recruit, train, and support partners for outreach and tax assistance, and to identify those partners best suited to reach special populations.

- *Begin initial implementation of TAB Strategic Plan recommendations.* Based on the findings of the TAB, the funding for this initiative will implement telephone service and website electronic interaction enhancements, including the following:
  - *Contact Analytics.* This will provide tools for evaluating contact center experiences by recording, storing, and analyzing every element of a taxpayer's service call. It will provide the capability to drill down to individual recordings, improving the ability to measure call accuracy, timeliness, and professionalism – leading to process improvements and cost savings. It also will improve the ability to identify and respond to problems – leading to more accurate, clearer responses to taxpayers. Employee satisfaction will increase through improved work processes that allow assistants to handle more complex calls with fewer transfers.
  - *Estimated Wait Time.* This will provide a real-time message on the telephone service channel that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call. This will reduce taxpayer burden and increase customer satisfaction.
  - *Expanded Portfolio of Tax Law Decision Support Tools.* This enhancement to IRS.gov will provide a common set of support tools to maximize use by taxpayers, partners, and IRS employees. It will enable users to conduct key word and natural language queries on a Frequently Asked Questions (FAQs) database and to receive answers to tax-law questions on an interactive basis. By monitoring taxpayer use, the IRS can continuously improve the information provided to taxpayers, thereby increasing customer satisfaction and operational savings.
  - *Spanish "Where's My Refund?"* This adds the refund status feature to the Spanish webpage on IRS.gov to provide the Spanish-speaking community with the same level of customer service available on the English webpage.
- *Conduct research on the effect of service on taxpayer compliance.* This will provide additional resources for a long-term, concerted research effort to identify ways to close the tax gap and to base the allocation of resources to both service and enforcement activities on a clearer understanding of how these activities affect voluntary compliance. This will require compiling more comprehensive data over a number of years, culminating in yearly analyses designed to quantify the effect of most IRS activities on the voluntary compliance of specific taxpayer populations. The research will focus on four areas:
  - Meeting taxpayer needs through the most effective and efficient service channels;
  - Developing a better understanding of taxpayer burden;
  - Understanding taxpayer needs through the errors they make; and
  - Examining the effect of service on overall levels of voluntary compliance.

### Electronic Tax Administration

There is perhaps no area with greater potential for reducing burden for both taxpayers and the IRS than Electronic Tax Administration (ETA). The benefits of electronic interaction with taxpayers are clear and compelling. Many taxpayers find it more convenient and beneficial to do business electronically than to send paper through the mail. In addition, taxpayers can get their questions answered and can download the form they need at their convenience, at any time of the day or night. For the IRS, handling taxpayer contacts electronically means that employees can be refocused to other high-benefit purposes.

Significant challenges remain in transitioning from a paper-based environment to an electronic-based environment. The IRS has developed an E-Strategy for Growth, which outlines the IRS' plans to reduce taxpayer burden. To achieve the strategic goals, the IRS will develop and implement e-file marketing strategies, continue to expand the use of electronic signatures, and enhance IRS website services for both practitioners and taxpayers. Ultimately, the goal of the IRS is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

A key component of ETA for the IRS is e-filing. This system has demonstrated measurable success with regard to individual taxpayer satisfaction. From its modest beginning as a pilot program in 1986 – when 25,000 returns were filed electronically – the number of e-filed returns has dramatically increased, with more than 71 million returns filed electronically in the last filing season. The benefits to these taxpayers include:

- Faster refunds;
- More accurate returns;
- Quick electronic confirmation;
- Free Internet filing;
- Easy payment options; and
- Federal/State e-filing.

An additional service that allows tax professionals and payers to do business with the IRS electronically is e-Services, a suite of Internet based products. These services include Preparer Taxpayer Identification Number (PTIN) applications with instant delivery, Taxpayer Identification Number (TIN) matching for third-party payers, on-line registration for electronic e-Services, and on-line initiation of the electronic return originator application. The e-Services' Incentives Products offered to increase e-filing are on-line Disclosure Authorization, Electronic Account Resolution, and Transcript Delivery System. Due to industry demand, the availability of incentives to those tax professionals and payers that e-file has been lowered from 100 to 5 individual returns filed.

Another electronic service success launched recently is the new Online Payment Agreement available on IRS.gov. Over 90 percent of taxpayers entering into payment agreements with the IRS can now request an agreement and receive confirmation of its approval through this application.

#### Initiatives

- Enable taxpayers with disabilities to understand available tax credits and receive tax preparation assistance through partnerships with national and local organizations that serve this unique group of taxpayers. (Also supports Component 7)
- Increase accuracy on toll-free telephone customer inquiries, processing functions, and paper adjustments.
- Improve the quality of volunteer-prepared returns through enhancements to the VITA program, including quality training and sample processing reviews.
- Enhance services to persons with limited English proficiency through: the Taxpayer Assistance Blueprint; development of a Multi-Lingual Strategic Plan; development of a Virtual Translation Office; and launch of a revised version of the Spanish IRS.gov webpage.
- Improve quality and timeliness of taxpayer contacts by maintaining an enhanced integrated quality assurance process with internal and external partners. (Also supports Component 4)
- Enhance IRS.gov.
- Improve services through programs at both the national and local level by expanding collaborations with organizations serving the disabled, Native American communities, and pre-existing rural infrastructures.
- Expand and enhance the Spanish website to increase electronic options, including options for Spanish language delivery of applications currently only available in English. (Also supports Component 3)
- Provide Reporting Agents with access to e-Services. (Also supports Component 3)
- Implement Taxpayer Assistance Blueprint Phase 2, which includes a five-year strategic plan for taxpayer service based on extensive research to understand taxpayer and stakeholder needs.
- Implement Internet-Customer Account Services (I-CAS) Release 1, which will enable taxpayers to view account information. (Also supports Component 3)
- Implement I-CAS Release 2, which will enable taxpayers to change their address, file an extension, submit a Power of Attorney, and calculate a payoff amount on balances due via a secure Internet link. (Also supports Component 3)
- Continue publicity efforts encouraging use of Online Payment Agreement.

## Component 6 Reform and Simplify the Tax Law

Current tax law complexity is a substantial barrier to compliance.

The complexity of the tax code makes it difficult for taxpayers to understand their tax obligations and for the IRS to administer the tax law. Special rules, subtle distinctions in the tax law and complicated computations add to this complexity and foster a sense of unfairness in our tax system, which ultimately discourages compliance. Notwithstanding an increasing awareness of the discrepancy in taxes due and taxes paid, the tax law continues to move in a direction of increasing complexity, which frustrates efforts to reduce the tax gap. In 2006 alone, Congress passed six items of legislation that affected the tax law. Within these bills, 223 provisions required over 1,200 actions by the IRS to implement the new requirements. These changes to the tax law further increased complexity and, therefore, lessened the IRS' ability to increase voluntary compliance. Simplification may require a paradigm shift.

Taxpayers who want to comply with the tax law often make unintentional errors on their returns as they struggle to understand complicated rules and forms. Complexity also provides opportunities for those who are willing to exploit the system. Furthermore, complexity makes it difficult for the IRS to detect noncompliance. Simplifying the tax code will reduce unintentional errors by well-meaning taxpayers and reduce opportunities for evasion. A simpler tax code will also be easier for the IRS to administer.

The Administration's FY 2008 Budget provides several proposals that would assist with simplification, reduce errors, and improve taxpayers' understanding of available tax benefits. These proposals would:

- Clarify the uniform definition of a child;
- Simplify Earned Income Tax Credit (EITC) eligibility requirements regarding filing status, presence of children, and work and immigrant status; and
- Reduce computational complexity of the refundable child tax credit.

The complexity of the tax law necessitates that limited IRS resources are increasingly committed to administering a wide array of targeted tax provisions created to meet social policy goals. These targeted provisions divert IRS resources from basic compliance efforts. The IRS has taken a number of steps to reduce taxpayer burden, including the establishment of the Office of Taxpayer Burden Reduction (TBR). Recent improvements in IRS forms, processes, and procedures include:

- Simplifying the filing requirements for Form 944 (Employer's Annual Federal Tax Return);
- Eliminating the need for filing Form 2688 (Application for Additional Extension of Time to File U.S. Individual Income Tax Return) by allowing taxpayers to get an automatic six month extension to file; and

- Creating the EITC Assistant, an on-line tool that helps taxpayers determine their eligibility for the earned income tax credit (EITC) and their estimated EITC amount.

Additional projects to simplify tax forms and processes are currently under review by TBR.

Another IRS resource commitment aimed at addressing the issue of helping taxpayers understand complex tax rules involves form and publication improvement efforts. The IRS originates and improves tax forms, instructions and publications to ensure they are technically accurate, timely, understandable, and as easy to use as possible in order for taxpayers to fulfill their tax filing and payment obligations. There are currently over 1,000 tax products, including forms, instructions, publications, and Spanish tax products. Each year the IRS reviews its products with the goal of simplifying, reducing burden, increasing understanding, eliminating redundancy, and fostering compliance. Based on taxpayer feedback, research, and tax law changes, existing products are revised and new products developed regularly. Recent examples include the Schedule M-3, Form 944, Employer's Annual Federal Tax Return, and the new draft Form 990, Return for Organization Exempt from Income Tax, which is now available for public comment. There are also compliance proposals under review for Forms 1120, U.S. Corporation Income Tax Return, and Form 1065, U.S. Return of Partnership Income. To address potential compliance issues for small businesses and individuals with limited English proficiency, chapters in Publication 17, Your Federal Income Tax, and Publication 334, Tax Guide for Businesses, are being translated into Spanish.

IRS.gov is used to disseminate tax product information and changes. It contains draft forms, final forms, and a What's Hot in Tax Forms, Publications, and Other Tax Products, which includes articles on tax product changes. In addition, there is an email address – [taxforms@irs.gov](mailto:taxforms@irs.gov) – for submitting comments on IRS tax products.

Focus groups are conducted regularly to obtain taxpayer information relative to product changes. Public interaction is also a focal point of the IRS Nationwide Tax Forums, an annual venue that provides another opportunity for feedback regarding tax forms and publications, and other interactions with stakeholder groups.

#### Initiatives

- Work with Congress to enact simplification legislative proposals in Administration's FY 2008 Budget to:
  - Clarify the uniform definition of a child;
  - Simplify EITC eligibility requirements regarding filing status, presence of children, and work and immigrant status; and
  - Reduce computational complexity of the refundable child tax credit.

- Continue Taxpayer Burden Reduction projects involving:
  - Simplifying the S-corporation election process;
  - Simplifying employment tax return amendments (Forms 941, 943, 944, and 945); and
  - Redesigning Form 8857, Request for Innocent Spouse Relief.
- Continue Tax Form and Publication improvements.

## Component 7 Coordinate with Partners and Stakeholders

Conducting outreach and leveraging external partnerships is a key component.

The IRS is partnering and leveraging resources with local, state, and federal agencies across the country. Examples of accomplishments resulting from these relationships include the following:

- Centralizing the process for IRS assessments based on state audit reports;
- Implementing a Questionable Employment Tax Practices (QETP) Initiative to develop a federal and state interagency approach to combat employment tax schemes and increase voluntary compliance. To date, 16 states have agreed to partner with the IRS on this initiative;
- Obtaining 88 agreements in 27 states with stakeholders such as state professional licensing agencies and local business licensing agencies to distribute educational information to small business applicants;
- Establishing the Leeds Castle Group with the tax administration agencies of China, India, South Korea, the United Kingdom, Japan, Australia, Canada, France, and Germany to meet regularly to consider and discuss issues related to global and national tax administration;
- Developing a Joint Operations Center (JOC) for National Fuel Tax Compliance in partnership with the Federal Highway Administration (FHWA) and participating states to act as one seamless organization leveraging resources at the state and federal level to develop fuel tax compliance strategies, including joint examinations and investigations based on JOC data analysis;
- Utilizing state/federal data for Combined Annual Wage Reporting (CAWR)/Federal Unemployment Tax (FUTA) matches; and
- Partnering with foreign tax agencies as part of the Organization for Economic Cooperation and Development's (OECD) Forum on Tax Administration.

The IRS, in connection with the OECD Working Party on Aggressive Tax Planning, is currently designing a database of various cross-border tax avoidance schemes in order to share knowledge and information among the OECD members. In addition, several Tax Information Exchange Agreements (TIEAs) recently became effective that will be useful in gathering valuable information (i.e., financial institution information) in the effort to reduce the tax gap.

The United States, Canada, Australia, and the United Kingdom continue their collaboration at the Joint International Tax Shelter Information Center (JITSIC) to supplement the ongoing work of each of the tax administrations in identifying and curbing abusive tax avoidance transactions, arrangements, and schemes. The objectives of JITSIC are to deter promotion and investment in abusive tax schemes, primarily through exchange of information. Exchange of information in JITSIC is done in accordance with the provisions of the bilateral treaties between each of the four countries involved.

Initiatives under development include the following:

- **Data Warehouse/Mining:** Conducting a test to evaluate the tax administration benefits of utilizing the state data warehouse concept.
- **State Reverse File Match Initiative (SRFMI):** Developing a system where states match IRS master file extracts against state master files to identify those who filed state but not federal returns, and those who reported different amounts on their state and federal returns.
- **Tax Education:** Entering into agreements with state education departments and federal immigration agencies to promote "Understanding Taxes" materials to educate younger citizens and foreign taxpayers going through naturalization about U.S. tax responsibilities.
- **Small Business Assistance:** Expansion of partnerships with the Small Business Administration (SBA) and its Service Corps of Retired Executives (SCORE) program and Small Business Development Centers (SBDCs), as well as other partners to deliver expanded educational messages directly to business owners.

The IRS also has a robust outreach and education program accomplished through relationships with national and local payroll, practitioner, small business, and industry stakeholder organizations. Examples of accomplishments include:

- Development of relationships with over 1,500 small business industry and tax professional organizations to deliver expeditiously key tax-related messages to small business audiences.
- Delivering information through Phone Forums to practitioners, industry representatives, and small business owners.
- Implementing Small Business Forums with industry representatives and small business owners.
- Offering multiple educational products, such as:
  - Electronic newsletters including "e-news for Tax Professionals" and "e-news for Small Businesses";
  - The Virtual Small Business Tax Workshop DVD, a 10-lesson interactive video;
  - The Small Business Resource Guide CD-Rom;
  - The Tax Calendar for Small Businesses and Self-Employed; and
  - "Tax Talk Today," a monthly web cast for tax professionals featuring IRS representatives discussing significant tax issues.
- Developing and widely distributing educational information on areas of high noncompliance, such as computation of business income, cost of goods sold, and various business expenses.

- Establishing a system to track resolution of problem issues identified by stakeholders (Issue Management Resolution System);
- Delivering an outreach campaign to industries that includes Audit Technique Guides and Tax Tips, which provide specific information for small businesses; and
- Providing Ethics Seminars for Practitioners addressing requirements from the Circular 230.

Initiatives include development of strategies to:

- Provide outreach and education to unaffiliated tax professionals – those who provide tax preparation services but do not align themselves with a professional organization; and
- Increase outreach and education regarding e-Commerce issues, including taxability of sales transactions on auction sites.

In addition, the IRS works with partners to disseminate tax information on subjects such as the EITC, child tax credit, e-file, life-cycle events, and compliance issues and to provide free income tax preparation to specific taxpayer populations (i.e., low income, elderly, limited English proficiency, disabled). Relationships exist with 60 national partners such as AARP, Armed Forces Tax Council, United Way, Health & Human Services, Annie E. Casey, and the Kellogg Foundation. In addition, the IRS supports more than 300 coalitions nationwide, comprised of thousands of community partners who educate or serve millions of taxpayers. This effort facilitated the opening of over 12,000 VITA and Tax Counseling for the Elderly sites with more than 68,000 volunteers during the 2006 filing season.

#### Initiatives

- Further enhance the centralized process to maximize the utilization of State Audit Reports (SARs) by IRS for federal assessments. (Also supports Component 4)
- Implement a Questionable Employment Tax Practices (QETP) initiative in partnership with the Department of Labor, the National Association of State Workforce Agencies, the Federation of Tax Administrators, and state workforce agencies, to provide a collaborative national approach to combat employment tax schemes. (Also supports Component 4)
- Further enhance the Fed/Fed program by facilitating and expanding partnerships with other federal agencies to improve tax administration. (Also supports Component 4)
- Engage all 50 states through the State Reverse File Match Initiative (SRFMI) - a process that matches IRS extracts received through the Governmental Liaison Data Exchange Program against state master files to identify individuals and businesses who filed a state return but not a federal return and to identify differences in federal and state income reporting. (Also supports Component 4)
- Determine tax administration benefits of utilizing state data warehouse concept. (Also supports Components 3 and 4)

- Develop an educational targeted outreach DVD for military personnel preparing for retirement. (Also supports Component 5)
- Enhance outreach efforts to industry audiences about available Audit Technique Guides and Tax Tips.
- Establish links to IRS.gov on industry, practitioner, educational, and governmental stakeholders' websites.
- Develop and widely distribute educational fact sheets on areas of high noncompliance.
- Develop a strategy to reach practitioners without affiliation to a professional organization.
- Leverage key partners such as the SBA and its SCORE program and SBDCs to deliver small business workshops to the new business community.
- Deliver educational messages through existing relationships with universities and colleges.
- Develop audio educational messages for toll-free wait times.
- Customize outreach to specific industries to encourage voluntary compliance.
- Request feedback from internal and external stakeholders on existing outreach and educational programs to identify best practices and enhancements.
- Develop strategies to educate first-time business filers.
- Expand relationships and collaboration with foreign tax administrations to increase the informal and formal communications on international tax administration matters.

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# SUMMARY

To implement the steps outlined in this report successfully, it is imperative for the IRS to have a highly trained and engaged workforce. While not addressed in detail in this report, the IRS is committed to employee engagement, ongoing training assessments and delivery, ongoing agency-wide communications, employee and managerial burden reduction, leadership empowerment, and succession planning. The IRS has extensive action plans and strategies in each of these areas. For example, in the area of succession planning, the IRS has established a Leadership Succession Planning office and is implementing a Leadership Succession Review (LSR) process in FY 2007. The LSR process involves leadership assessments of all senior managers, executive review of the assessments, and one-on-one feedback and discussion of executive potential.

The actions outlined in this report address improving compliance through a balanced approach. This report describes steps currently being taken, and those under development, by the IRS to reduce opportunities for tax evasion, details how the IRS will leverage technology, recognizes the critical need for a strong taxpayer service program, discusses development of taxpayer service initiatives, and describes legislative proposals that, when implemented, will improve compliance. At the same time, the initiatives maintain respect for taxpayer rights, limit burden on compliant taxpayers, and present an outreach approach to ensure all taxpayers understand their tax obligations. This report also details the importance of having a multi-year research program that will assist both in understanding the scope and reasons for noncompliance.

It is important to take all reasonable steps to improve voluntary compliance. As more is learned about the causes of noncompliance and ways to improve voluntary compliance, strategies will be modified to reflect the latest information.

It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the level of service that the taxpaying public deserves, and to maintain a strong and well-targeted enforcement presence are necessary to improve compliance rates. The IRS is committed to applying its resources where they are of most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply.

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# APPENDIX

## Timetrames for Initiative Implementation

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Work with Congress to enact remaining legislative proposals included in the Administration's FY 2008 Budget.	<b>1, 6</b>	Ongoing IRS will continue to identify legislative proposals in partnership with Treasury	2/09 IRS will continue to identify legislative proposals in partnership with Treasury	√

<sup>†</sup> 1. Reduce Opportunities for Evasion; 2. Make a Multi-Year Commitment to Research; 3. Continue Improvements in Information Technology; 4. Improve Compliance Activities; 5. Enhance Taxpayer Service; 6. Reform and Simplify the Tax Law; and 7. Coordinate with Partners and Stakeholders.

\* Check indicates initiative will continue beyond FY09 depending on budget availability.

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Develop regulations and other published guidance clarifying ambiguous areas of the law, targeting specific areas of noncompliance and preventing abusive behavior.</p>	<p><b>1</b></p>	<p><u>6/30/08</u> Request recommendations from stakeholders for topics on which guidance should be a priority</p> <p><u>7/30/08</u> Identify approximately 250 items for which guidance is a priority</p> <p><u>8/30/08</u> Release the 2008-2009 Priority Guidance Plan (PGP)</p> <p><u>9/30/08</u> Release at least 80% of the items appearing on the 2007-2008 PGP</p>	<p><u>6/30/09</u> Request recommendations from stakeholders for topics on which guidance should be a priority</p> <p><u>7/30/09</u> Identify approximately 250 items for which guidance is a priority</p> <p><u>8/30/09</u> Release the 2009-2010 PGP</p> <p><u>9/30/09</u> Release at least 85% of the items appearing on the 2008-2009 PGP</p>	<p>√</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Undertake additional compliance studies, including S corporations and individuals.	<b>2</b>	<u>10/1/07</u> Begin reporting compliance study for TY 2006 individual income tax returns  <u>6/30/08</u> Complete S corporation compliance study	<u>10/1/08</u> Begin reporting compliance study for TY 2007 individual income tax returns	✓
Update tax gap estimates using new and existing data.	<b>2</b>	<u>6/30/08</u> Release S corporation reporting compliance study tabulations  <u>6/30/08</u> Update payment compliance estimates	<u>6/30/09</u> Update payment and filing compliance estimates	✓
Research the effect of service on taxpayer compliance.	<b>2</b>	<u>9/30/08</u> Undertake at least three significant research projects linking service to compliance (e.g., study relationship between taxpayer attitudes and compliance)	<u>9/30/09</u> Undertake at least three significant research projects linking service to compliance (e.g., study how particular types of service delivery affect individual compliance)	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Research the relationship between complexity, burden, and compliance.</p>	<p><b>2</b></p>		<p><u>9/30/09</u> Undertake survey of individual taxpayers to improve burden estimates (e.g., conduct a new survey of individual taxpayer burden)</p> <p><u>9/30/09</u> Begin at least three research projects focusing on the relationships between complexity, burden, and compliance</p>	<p>√</p>
<p>Improve high income and non-EITC exam workload selection and method of delivery and assess the effectiveness of the exam treatment stream on selected nonfiler cases.</p>	<p><b>3, 4</b></p>	<p><u>10/1/07</u> Begin selecting, classifying, and auditing individual returns based on updated selection scores derived from NRP TY 2001 results</p> <p><u>1/30/08</u> Implement initial phase of an automated case screening and selection process</p>	<p><u>10/1/08</u> Begin evaluating the productivity of high-income taxpayer cases identified using the revised scores and activity codes</p> <p><u>9/30/09</u> Complete implementation of the automated case screening and selection process</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> <small>(Bold = Primary)</small>	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Expand AUR Auto Notice Generation to include additional income types and all Form 1040 family returns.</p>	<p><b>3, 4</b></p>	<p><u>9/30/08</u> Expand the volume of auto notices bypassing the screening phase on 1040 series returns</p>	<p><u>9/30/09</u> Expand the volume of auto notices bypassing the screening phase by including the entire ELF Form 1040 series and add cases from SB/SE inventories</p> <p>Add withholding to the auto notice income issues in an effort to work the most productive cases</p>	<p>✓</p>
<p>Evaluate the AUR matching process, and implement an improved case scoring and selection concept to select the most productive cases.</p>	<p><b>3, 4</b></p>	<p><u>12/31/07</u> Reengineer the AUR matching process to improve coverage and maximize resource utilization resulting in increased AUR closures</p> <p><u>9/30/08</u> Streamline overhead costs by reducing manual screening</p> <p><u>9/30/08</u> Complete studies and implement an enhanced workload selection system</p>	<p><u>9/30/09</u> Implement additional improvements to workload selection tools (e.g., incorporating results as feedback to validate rules/score, and adding the capability to select cases for different treatments)</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Develop system requirements for expanding the AUR Soft Notice Test, which involves asking taxpayers to voluntarily self-correct for future years.</p>	<p><b>3, 4</b></p>	<p><b>9/30/08</b> Develop and complete programming requirements</p>	<p><b>9/30/09</b> Implement initiative for approximately 250,000 taxpayers</p>	<p>✓</p>
<p>Develop enhancements to the Compliance Data Warehouse to improve workload identification and prioritization algorithms, allowing better evaluation of alternative treatment streams and ensuring Collection cases receive the most efficient and effective treatments.</p>	<p><b>3, 4</b></p>	<p><b>1/1/08</b> Release Phase 1</p>	<p><b>1/1/09</b> Release Phase 2</p>	

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
<p>Update the Collection inventory management system to improve functionality and navigation and provide capability to interface with other modernized systems.</p>	<p><b>3, 4</b></p>	<p><u>9/30/08</u> Completion of coding and integration testing</p>	<p><u>11/1/08</u> Begin piloting of the updated system   <u>1/1/09</u> Begin nationwide deployment of updated system   <u>6/30/09</u> Nationwide deployment completed</p>	
<p>Automate lien delivery, recording, and release processes with state and local jurisdictions to improve the timeliness of lien filings, lien releases, and the payment of fees.</p>	<p><b>3, 4</b></p>	<p><u>9/30/08</u> Complete cost analysis, design specifications, and establish enterprise standards</p>	<p><u>8/31/09</u> Establish and fully test prototype   <u>9/30/09</u> Full deployment</p>	

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
<p>Test the use of statistical modeling techniques within TEGE to detect high-risk compliance patterns in order to use data to expand and improve examination case selection.</p>	<p><b>3, 4</b></p>	<p><u>1/31/08</u> All test examinations completed</p> <p><u>4/30/08</u> Final report completed</p>		
<p>Develop and implement a set of compliance decision analytic tools that will support analysis of TEGE returns and other data to detect compliance trends and improve case and issue selection.</p>	<p><b>3, 4</b></p>	<p><u>1/15/08</u> Complete logical and physical design phase</p> <p><u>5/31/08</u> Complete system development</p> <p><u>7/31/08</u> Deploy system to all users</p>		

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
Implement a new TEGE electronic examination system (TREES) that will consolidate agent tools to increase the accuracy and efficiency of the examination process.	<b>3</b>	Deployment began in May 2007  11/30/07 Complete roll-out of TREES to all TEGE examination revenue agents		
Build and implement MeF receipt of electronic transmissions for additional tax forms.	<b>3</b>	1/08 Deploy Form 1120F on the MeF platform  1/08 Deploy Form 990N (ePostcard) on the MeF platform	9/09 Deploy first phase of Form 1040 on the MeF platform	
Increase audit coverage and better target returns for examination.	<b>4</b>	10/1/07 Begin selecting, classifying, and auditing individual returns based on updated selection scores (DIF) derived from NRP TY 2001 results  (cont'd)	10/1/08 Begin evaluating the effectiveness of the updated DIF scores  9/30/09 Increase number of Schedule C audits by an additional 5% to (cont'd)	√

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>‡</sup>
(cont'd)		<p><b>9/30/08</b> Increase number of Schedule C audits by 7% to address the individual business income tax underreporting gap</p> <p><b>9/30/08</b> Migrate correspondence exam telephone customers to the enterprise call routing platform, which will expedite case closures</p>	<p>address the individual business income tax underreporting gap</p> <p><b>9/30/09</b> Utilize information obtained from the Subchapter S Corporation National Research Project to enhance return selection and examinations</p> <p><b>9/30/09</b> Begin screening amended returns through the Dependent Database</p> <p><b>9/30/09</b> Improve the number of correspondence audits that are closed by enhancing the case selection methodology with real-time information</p> <p><b>1/31/09</b> Improve correspondence case selection methodologies based on real-time information</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>1</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Enhance the ability to identify and address tax schemes of business and individuals involving offshore activity, address illegitimate use of tax havens to shelter income, and increase information matching and examination activity for individuals living abroad.</p>	<p><b>4</b></p>	<p><u>9/30/08</u> Complete the examination of cases in the pilot phase of the Broker Compliance Initiative Project. Make IRC section 6700 promoter investigation referrals for those individuals and large businesses identified as facilitating abusive offshore transactions as a result of this project</p> <p><u>9/30/08</u> Develop compliance initiative projects in the areas of private banking and offshore merchant accounts to address offshore noncompliance</p>	<p><u>9/30/09</u> Analyze results of cases in the Broker Compliance Initiative Pilot phase and update selection criteria for future cases. Make IRC section 6700 promoter investigation referrals for those individuals and large businesses identified as facilitating abusive offshore transactions</p> <p><u>9/30/09</u> Implement pilot phase for any approved compliance initiative projects</p>	<p>√</p>
<p>Enhance collection programs and increase the Federal Payment Levy Program using third-party data.</p>	<p><b>4</b></p>	<p><u>9/31/08</u> Work with Centers for Medical Services (CMS) to modify levy processing and improve offsets of Medicare reimbursements for tax debts</p>	<p><u>3/31/09</u> Work with Financial Management Service (FMS) to determine feasibility of including CMS Medicare payments in the Treasury Offset Program/FPLP</p>	<p>√</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> ( <b>Bold = Primary</b> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Work with other federal agencies regarding the Federal Payment Levy Program (FPLP).</p>	<p><b>4, 7</b></p>	<p><u>6/30/08</u> Increase dollars collected by expanding FPLP to:  <ul style="list-style-type: none"> <li>• Defense Finance and Accounting Service salary payment files</li> <li>• Department of Defense Civilian Employees</li> <li>• Department of Health and Human Services</li> <li>• Environmental Protection Agency</li> <li>• Department of Energy</li> </ul> </p>	<p><u>3/31/09</u> Increase dollars collected by pursuing agreements with the Department of Defense to add additional Federal wage and other payments</p>	
<p>Improve compliance by tax preparers through implementation of the Servicewide Enforcement Preparers Strategy.</p>	<p><b>3, 4, 7</b></p>	<p><u>10/1/07</u> Convene servicewide preparer strategy summit   <u>3/30/08</u> Finalize and begin implementation of service-wide preparer strategy   <u>1/1/08</u> Initiate research study of preparer compliance</p>	<p><u>10/1/08</u> Update, as necessary, service-wide preparer strategy based on research study findings</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>f</sup> ( <b>Bold = Primary</b> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>f</sup>
<p>Improve collection selection criteria and filters for balance due and nonfiler cases, including identifying and addressing potential high income nonfilers.</p>	<p><b>3, 4</b></p>	<p><u>12/31/07</u> Expand use of third-party information and research to enhance case selection</p> <p><u>12/31/07</u> Finalize Servicewide Nonfiler Strategy</p>	<p><u>12/31/08</u> Refine Decision Analytics rules to improve inventory delivery</p> <p><u>12/31/08</u> Develop a new model to enhance collection case selection criteria</p>	
<p>Litigate cases, work settlements, and design large scale resolution initiatives for tax shelter transactions to deter noncompliance.</p>	<p><b>1, 4</b></p>	<p><u>3/31/08</u> Complete examination of Global Settlement Initiative (GSI) participants</p> <p><u>9/30/08</u> Litigate unresolved Son of Boss cases, cases of GSI non-participants, and promoter penalty cases that opted not to take the resolution initiative</p>	<p><u>9/30/09</u> Complete audits of GSI non-participants</p> <p><u>9/30/09</u> Continue to litigate unresolved Son of Boss cases, cases of GSI non-participants, and promoter penalty cases that opted not to take the resolution initiative</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Initiate a project using Combined Annual Wage Reporting (CAWR) data to identify tax-exempt organizations that may not be properly reporting and paying employment taxes.</p>	<p><b>3, 4</b></p>	<p><b>11/30/07</b> Identify opportunities for other employment tax related projects</p> <p><b>2/28/08</b> Analyze results of FY 2007 CAWR examinations and document lessons learned for future CAWR projects</p>		
<p>Increase criminal enforcement on abusive schemes, corporate fraud, employment tax, egregious nonfilers, and on Bank Secrecy Act violations.</p>	<p><b>4</b></p>	<p><b>9/30/08</b> Achieve an average conviction rate of 92% for the combined component programs</p> <p><b>9/30/08</b> Achieve an average publicity rate of 80% for the combined component programs</p>	<p><b>9/30/09</b> Achieve an average conviction rate of 92% for the combined component programs</p> <p><b>9/30/09</b> Achieve an average publicity rate of 80% for the combined component programs</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> ( <b>Bold</b> = <b>Primary</b> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Improve the alignment and allocation of service-wide resources to identify, develop, and resolve challenges better in the global taxation arena.</p>	<p><b>4</b></p>	<p><u>12/31/07</u> Realign LMSB International Resources to Improve Integration/Leverage Expertise</p> <p><u>12/31/07</u> Utilize International Planning and Operations Council to identify opportunities to conduct cross-divisional examinations</p>	<p><u>3/31/09</u> Increase International Examiner hiring with emphasis upon high-risk geographic areas</p> <p><u>12/31/08</u> Enhance cross-divisional coordination to ensure coverage and development of significant issues while reducing burden</p> <p><u>6/30/09</u> Promote identification and assessment of emerging international/U.S. Possessions compliance issues through development of a process for referrals and a system for timely evaluation of those referrals</p>	<p>√</p>

Initiatives	Related Treasury Strategy Component(s) <sup>1</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>2</sup>
<p>Improve tax administration to deal more effectively with increased emphasis on globalization by all corporate and individual taxpayers.</p>	<p><b>4</b></p>	<p><u>3/31/08</u> Expand information-sharing through increased membership in the Joint International Tax Shelter Information Centre (JITSIC), by adding Japan and expanding JITSIC offices to London</p> <p><u>3/31/08</u> Introduce new M-3 for Form 1120F to gather information on foreign controlled corporations</p> <p>Ongoing Increase education and guidance to U.S. taxpayers of their withholding responsibilities on Fixed Determinable Annual Periodic (FDAP) payments to non-U.S. persons and expand similar activities with qualified intermediaries</p>	<p><u>9/30/09</u> Introduce revised Form 5471 for international transactions that have potential U.S. tax issues</p> <p><u>9/30/09</u> Pilot issue identification and workload selection using filings of the revised form 1120F with Schedule M-3</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>1</sup> ( <b>Bold = Primary</b> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>2</sup>
<p>Increase industry and global issue focus by aligning resources to cases and issues with the highest compliance risk.</p>	<p><b>4</b></p>	<p>9/30/08 Pilot the Shelter Data Management system and the automated international issue selection process</p> <p>9/30/08 Use Transactions of Interest under proposed regulation 6011 (when finalized) to identify emerging issues</p>	<p>6/30/09 Fully implement the Shelter Data Management System (SDM) and pilot the larger Selection and Workload Classification system, of which SDM is a part</p> <p>9/30/09 Integrate international issue identification into overall workload selection process</p> <p>9/30/09 Expand use of Transactions of Interest approach</p>	
<p>Leverage the efforts of examiners as well as external partnerships with foreign tax administrators to identify and address emerging issues of significant compliance risk.</p>	<p><b>4, 7</b></p>	<p>12/31/07 Expand the use of the Organization for Economic Co-operation and Development (OECD) Abusive Transaction Database to identify emerging abusive transactions/ issues</p> <p>9/30/08 Hire additional International Examiners in areas with high risk international issues</p>	<p>9/30/09 Complete Basic level International Training of LMSB Front-line and Senior Managers to improve Issue Identification and Familiarity</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Address offshore and cross-border compliance risks through enforcement and by issuing published guidance.</p>	<p><b>4</b></p>	<p><u>12/31/07</u> Initiate Project on Foreign Athletes &amp; Entertainers (FAE) to ensure appropriate reporting and sourcing of income</p> <p><u>12/31/07</u> Complete Voluntary Settlement Initiative for embassy/consular employees and begin enforcement activities on non-electors</p> <p><u>9/30/08</u> Issue regulations on transfer pricing, foreign tax credit, and foreign trusts</p>	<p><u>9/30/09</u> Issue additional regulations on transfer pricing guidance, foreign tax credit, and foreign trusts, and new regulations on cross border restructuring</p>	<p>√</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> ( <b>Bold</b> = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Enable taxpayers with disabilities to understand available tax credits and receive tax preparation assistance through partnerships with national and local organizations that serve this unique group of taxpayers.</p>	<p><b>5, 7</b></p>	<p><u>12/30/08</u> Partner at the local and national levels to expand efforts with organizations that serve people with disabilities, to increase return preparation assistance space</p> <p><u>3/31/09</u> Work with select government entities to increase the availability of free tax assistance programs</p>	<p><u>12/31/09</u> Partner at the local and national levels to expand efforts with organizations that serve people with disabilities and to increase return preparation</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> <small>(Bold = Primary)</small>	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Increase accuracy on toll-free telephone customer inquiries, processing functions, and paper adjustments.</p>	<p><b>5</b></p>	<p><u>1/31/08</u> Implement an Interactive Tax Law Assistant (ITLA) tool to assist employees in providing accurate, efficient, and complete responses to basic tax law telephone inquiries</p> <p><u>1/31/08</u> Continue to develop Accessory Manager Tools that provide standard research paths, consolidate account data, and automatically populate input fields</p> <p><u>9/30/08</u> Implement recommendations from the Correspondence Accuracy Improvement Study</p>	<p><u>1/31/09</u> Continue to develop and enhance the Interactive Tax Law Assistant (ITLA) tool to assist employees in providing accurate, efficient, and complete responses to a wider variety of more complex tax law telephone inquiries</p> <p><u>1/31/09</u> Review nationwide error trends to determine the areas where implementation of an Accessory Manager Tool would have the most significant impact, and develop tools based on this analysis</p> <p><u>1/31/09</u> Continue to utilize program review teams to conduct annual quality reviews to seek improvement opportunities and identify best practices</p>	<p>√</p>

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
<p>Improve the quality of volunteer-prepared returns through enhancements to the Volunteer Income Tax Assistance (VITA) Program, including quality training and sample processing reviews.</p>	<p><b>5</b></p>	<p><u>3/31/08</u> Conduct on-site workshops to address quality concerns identified while making visits during filing season</p>	<p><u>12/31/09</u> Replace current knowledge-based tax law preparation training with a process-based training approach</p>	<p>√</p>
<p>Enhance services to persons with limited English proficiency (LEP) through: the Taxpayer Assistance Blueprint (TAB); development of a Multi-Lingual Strategic Plan; development of a Virtual Translation Office; and launch of a revised version of the Spanish irs.gov webpage.</p>	<p><b>5</b></p>	<p><u>1/31/08</u> The internet application "Where's My Refund" allows taxpayers to access their refund information. This application will be offered on the Spanish IRS.gov</p> <p><u>9/30/08</u> The Multi-Lingual Project Office will work with Research to pinpoint isolated community locations and identify actions to customize assistance (cont'd)</p>	<p><u>Ongoing</u> Maintain the application and upgrade annually as needed</p> <p><u>Ongoing</u> Continue expansion efforts</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
(cont'd)		<p><b>9/30/08</b> Launch targeted outreach messages for LEP taxpayers in isolated communities</p> <p><b>9/30/08</b> Expand the Virtual Translation Office (VTO) to increase and enhance VTO translations. The VTO will:</p> <ul style="list-style-type: none"> <li>• translate glossaries of tax terms into multiple languages</li> <li>• produce the tax forms and publications currently published in Spanish</li> <li>• create additional forms and educational materials in Spanish</li> <li>• produce new educational materials in other languages</li> <li>• lay the foundation for translating products into other IRS-priority languages</li> </ul>		

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Improve quality and timeliness of taxpayer contacts by maintaining an enhanced integrated quality assurance process with internal and external partners.</p>	<p><b>4, 5</b></p>	<p><u>12/31/08</u> Develop and deliver Site Coordinator's Training</p> <p><u>12/31/08</u> Define volunteer training levels and focus on consistent use of intake and interview sheets and volunteers performing quality reviews</p> <p><u>9/30/08</u> Engage partners and employees in feedback solicitation through roundtable discussions and partner satisfaction surveys</p>	<p><u>6/30/09</u> Engage partners and employees in feedback solicitation through roundtable discussions and via partner satisfaction surveys</p>	
<p>Enhance IRS.gov.</p>	<p><b>5</b></p>	<p><u>9/30/08</u> Deploy an interactive tax law decision support tool as recommended in the Taxpayer Assistance Blueprint report and deliver improved Frequently Asked Questions (FAQs) support</p>	<p><u>9/30/09</u> Deploy enhancements to the interactive tax law decision support tool to deliver Probe and Response Capability</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> ( <b>Bold = Primary</b> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Improve services through programs at both the national and local level by expanding collaborations with organizations serving the disabled, Native American communities, and pre-existing rural infrastructures.</p>	<p><b>5</b></p>	<p><u>9/30/08</u> Increase availability of EITC education and financial education in hard to serve Native American communities through network of partnerships involving Native community financial institutions, community development corporations, financial education providers, and Native American advocates</p>	<p><u>3/31/09</u> Work with U.S. Department of Agriculture to increase the availability of free tax assistance programs</p> <p><u>12/31/09</u> Collaborate with Rural Funding Foundations to expand tax related services in rural areas</p>	
<p>Expand and enhance the Spanish Website to increase electronic options, including language delivery of applications currently only available in English.</p>	<p><b>3, 5</b></p>	<p><u>1/31/08</u> Launch Spanish version of the internet application "Where's My Refund," which allows taxpayers to access their refund information</p> <p><u>9/30/08</u> Expand and enhance the Spanish website to educate Spanish speaking taxpayers about tax responsibilities for determining various tax eligibility</p>	<p>Ongoing Maintain the application and upgrade annually as needed</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>1</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>t</sup>
Provide Reporting Agents with access to e-Services.	<b>3, 5</b>	Deployed access to Electronic Account Resolution (EAR) and Transcript Delivery System (TDS) for Reporting Agents in June 2007  10/1/07 Market availability of new services to all Reporting Agents  6/30/08 Monitor access and modify as necessary  9/30/08 Work with Reporting Agents to explore opportunities for electronic delivery of bulk notices	Ongoing Maintain the application and upgrade annually as needed	

Initiatives	Related Treasury Strategy Component(s) <sup>t</sup> ( <i>Bold = Primary</i> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>t</sup>
<p>Implement Taxpayer Assistance Blueprint Phase 2, which includes a five-year Strategic Plan for taxpayer service, based on extensive research to understand taxpayer and stakeholder needs.</p>	<p><b>5</b></p>	<p><u>9/30/08</u> Identify attributes of intentional versus unintentional taxpayer noncompliance</p>	<p><u>9/30/09</u> Pending success of model development, determine causes for taxpayer errors and begin to develop appropriate treatments</p>	<p>√</p>
<p>Implement Internet-Customer Account Services (I-CAS) Release 1, which will enable taxpayers to view account information.</p>	<p><b>3, 5</b></p>	<p><u>9/30/08</u> Implement I-CAS Release 1 to enable taxpayers filing Form 1040 to view account information via a secure Internet link. I-CAS will offer online tax account services that will emulate an online banking experience</p>		

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> <small>(Bold = Primary)</small>	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Implement I-CAS Release 2, which will enable taxpayers to change their address, file an extension, submit a Power of Attorney, and calculate a payoff amount on balances due via a secure Internet link.</p>	<p><b>3, 5</b></p>		<p>9/30/09 Implement I-CAS Release 2 to enable taxpayers to change their address, file an extension, submit a Power of Attorney, and calculate a payoff amount on balances due via a secure Internet Link</p>	
<p>Continue publicity efforts encouraging use of Online Payment Agreement.</p>	<p><b>5</b></p>	<p><u>Ongoing During Filing Season</u> Issue News Releases and other communications encouraging use of on-line application for tax year 2007 balance due returns  <u>Ongoing</u> Promote ease of using Online Payment Agreement via multifaceted stakeholder distribution networks</p>	<p><u>Ongoing During Filing Season</u> Issue News Releases and other communications encouraging use of on-line application for tax year 2008 balance due returns  <u>Ongoing</u> Promote ease of using Online Payment Agreement via multifaceted stakeholder distribution networks</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Work with Congress to enact simplification legislative provisions in Administration's FY 2008 Budget.	<b>1, 6</b>	Ongoing Treasury and IRS and will work with Congress to enact legislative proposals.	<u>2/09</u> Treasury and IRS and will recommend additional legislative initiatives to Congress	
Continue Taxpayer Burden Reduction projects.	<b>6</b>	<u>1/31/08</u> Release new Forms 1120S and 2553 <u>2/29/08</u> Complete regulations for new amended Forms 94X, (new forms under development to reduce employment tax reporting errors) <u>3/31/08</u> Verify customer acceptance of new Form 8857, Innocent Spouse Relief	<u>1/31/09</u> Release new amended Forms 94X	√

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> ( <i>Bold = Primary</i> )	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Continue Tax Form and Publication improvements.	<b>6</b>	<p><u>9/30/08</u> Develop a multi-year prioritized plan of burden reduction activities to include forms redesign and simplification</p> <p><u>9/30/08</u> Define the Modernized e-file (MeF) platform for the XML enabled PDF Form 1040, U.S. Individual Income Tax Return, for Tax Year 2009</p> <p><u>9/30/08</u> Launch a hyperlinked Publication 17, Your Federal Income Tax, on the irs.gov website. Hyperlinks will be incorporated, enabling taxpayers to link to relevant sections within Publication 17 to assist in tax preparation research</p>		√

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
<p>Further enhance the centralized process to maximize utilization of State Audit Reports (SARs) by IRS for federal assessments.</p>	<p><b>4, 7</b></p>	<p><u>5/31/08</u> Establish a system to baseline usability and productivity of incoming SARs</p>	<p><u>6/30/09</u> Partner with states to implement enhancements to improve the usability of SARs</p>	<p>Partner with states to automate receipt of SARs</p>
<p>Implement a Questionable Employment Tax Practices (QETP) Initiative in partnership with the U.S. Department of Labor, the National Association of State Workforce Agencies, the Federation of Tax state workforce agencies to provide a collaborative national approach to combat employment tax schemes.</p>	<p><b>4, 7</b></p>	<p><u>12/31/07</u> Launch QETP initiative by securing a minimum of 20 state participants</p> <p><u>6/30/08</u> Fully implement process to deliver data provided by the states for incorporation into employment tax audit work streams</p> <p><u>9/30/08</u> Increase number of states participating by 25%</p>	<p><u>9/30/09</u> Continue to increase state participation by an additional 25%</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>1</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>2</sup>
<p>Further enhance the Fed/Fed program by facilitating and expanding partnerships with other federal agencies to improve tax administration.</p>	<p><b>4, 7</b></p>	<p><b>6/30/08</b> Develop and launch a minimum of two new federal agency partnerships (e.g., SSA and SBA)</p>		

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
<p>Engage all 50 states through the State Reverse File Match Initiative (SRFMI) – a process that matches IRS extracts received through the Governmental Liaison Data Exchange Program against state master files to identify individuals and businesses who filed a state return but not a federal return and to identify differences in federal and state income reporting.</p>	<p><b>4, 7</b></p>	<p><b>7/31/08</b> Pilot use of systemic SRFMI data received from 14 states to identify nonfilers and underreporters</p>	<p><b>6/30/09</b> Launch Phase 2 of pilot by increasing state agency participation by 50% to 21 taxing agencies</p>	<p>Continue expansion of SRFMI participation to all appropriate state tax agencies</p>
<p>Determine tax administration benefits of utilizing state data warehouse concept.</p>	<p><b>3, 4, 7</b></p>	<p><b>7/31/08</b> Complete project analysis test and issue report of findings</p>	<p><b>9/30/09</b> Based on test outcomes, take steps to expand as appropriate</p>	<p>✓</p>

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Develop an educational targeted outreach DVD for military personnel preparing for retirement.</p>	<p><b>5, 7</b></p>	<p><b>12/31/08</b> Distribute and integrate DVD into all military pre-retirement seminars to reduce the percentage of military retirees entering the Federal Employee/Retiree Delinquency Initiative (FERDI) population</p>	<p><b>3/31/09</b> Obtain FY 2008 FERDI data for comparison to baseline data to measure DVD's effectiveness</p> <p><b>9/30/09</b> Conduct research to determine the need for military disability tax-related services</p> <p><b>12/31/09</b> Continue distributing DVD in all military pre-retirement seminars to reduce the percentage of military retirees entering the FERDI population</p>	
<p>Enhance outreach efforts to industry audiences about available Audit Technique Guides and Tax Tips.</p>	<p><b>7</b></p>	<p><b>6/30/08</b> Work with industry partners to determine enhancements needed to existing guides as well as input on development of new guides</p> <p>Ongoing Publicize Audit Technique Guide availability to industries through national/focal liaison activities</p>		

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Establish links to IRS.gov on industry, practitioner, educational, and governmental stakeholders websites.	<b>7</b>	<u>5/31/08</u> Promote Tax Centers (dedicated web space) and links to state and national organizations		
Develop and widely distribute educational fact sheets on areas of high non-compliance.	<b>7</b>	<u>9/30/08</u> Complete monthly distribution of 12 additional fact sheets	<u>9/30/09</u> Complete monthly distribution of 12 additional fact sheets	
Develop a strategy to reach practitioners without affiliation to a professional organization.	<b>7</b>	<u>3/30/08</u> Develop grass-roots delivery channel with national retail tax preparation firms  <u>9/30/08</u> Expand outreach to colleges and universities to include graduates entering tax preparation careers		

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Leverage key partners such as the SBA and its SCORE program and SBDCs to deliver small business workshops to the new business community.</p>	<p><b>7</b></p>	<p>Ongoing Continue contacts with traditional partners to maximize leveraged opportunities that provide education and outreach directly to business owners</p> <p><u>10/01/07</u> Establish a baseline of current leveraged small business tax workshops</p> <p><u>12/31/07</u> Partner with SCORE and SBDCs to enhance quality and consistency of leveraged Small Business Tax Workshops</p> <p><u>3/31/08</u> Partner with SBA to increase outreach through the National Women's Business Council</p> <p><u>3/31/08</u> Partner with SBA to promote voluntary compliance and share information customized information for new business owners</p> <p>(cont'd)</p>	<p><u>12/31/08</u> Incorporate information regarding common filing errors into current tax workshop curriculum</p>	

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
(cont'd)		<p><b>9/30/08</b> Increase the number of Small Business Tax Workshops</p>		
<p>Deliver educational messages through existing relationships with universities and colleges.</p>	<p><b>7</b></p>	<p><b>9/30/08</b> Incorporate key messages into professional curriculum taught via Tax Practitioner Institutes across the country</p>	<p><b>9/30/09</b> Determine a baseline and expand the participation of current Historically Black Colleges and Universities (HBCUs) in the VITA program</p> <p><b>12/31/09</b> Increase the participation of Beta Alpha Psi, a national scholastic and professional fraternity, in the VITA program by 10%</p> <p><b>12/31/09</b> Determine baseline and expand the Cooperative Extension Services Network tax prep and education programs in each of the four regions, HBCUs, tribal colleges and universities</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
Develop audio educational messages for toll-free wait times.	<b>7</b>	<p><u>1/31/08</u> Develop text and appropriate placement of specific educational messages. Submit Systems Change Request</p>	<p><u>1/31/09</u> Implement approved educational messages</p> <p><u>9/30/09</u> Work collaboratively with appropriate functions to create educational messages</p>	
Customize outreach to specific industries to encourage voluntary compliance.	<b>7</b>	<p><u>3/31/08</u> Begin launch of industry specific communication/outreach to small business/industry stakeholders and state licensing agencies based on data driven analysis of key issues</p> <p><u>9/30/08</u> Provide educational materials to new and existing business owners through partnerships with small business/industry stakeholders and state licensing agencies in all 50 states</p>	<p><u>9/30/09</u> Conduct outreach in all states to promote the use of the IRS' web-based Tax Centers designed to provide education and web resources for specific industries and professions</p>	

Initiatives	Related Treasury Strategy Component(s) <sup>†</sup> (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009 <sup>†</sup>
<p>Request feedback from internal and external stakeholders on existing outreach and educational programs to identify best practices and enhancements.</p>	<p><b>7</b></p>	<p><u>10/1/07</u> Convene Service-wide task force to collect and review stakeholder feedback</p> <p><u>10/31/07</u> Share recommendations with external stakeholders and obtain additional feedback</p> <p><u>12/31/07</u> Provide recommendations based on feedback</p> <p>Ongoing Implement appropriate recommendations</p>	<p>Ongoing Implement recommendations</p>	

Initiatives	Related Treasury Strategy Component(s)† (Bold = Primary)	FY 2008 Milestones	FY 2009 Milestones	Beyond FY 2009†
Develop strategies to educate first-time business filers.	<b>7</b>	<p><b>3/31/08</b> Collaborate with small business/industry partners to develop an outreach campaign to educate first time Schedule C filers, including common errors to avoid</p> <p><b>12/31/08</b> Implement outreach strategy to first-time business filers</p>		
Expand relationships and collaboration with foreign tax administrations to increase informal and formal communications on international tax administration matters.	<b>7</b>	<p><b>9/30/08</b> Complete OECD project dealing with international guidelines on attribution of profits to permanent establishments</p> <p><b>9/30/08</b> Participate in OECD monitoring of Transfer Pricing Guidelines including international business restructurings project</p>	<p><b>9/30/09</b> Participate in OECD work on monitoring Transfer Pricing Guidelines</p>	√

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# GLOSSARY

AARP - American Association of Retired Persons  
AMS - Account Management Services  
ASFR - Automated Substitute for Return  
AUR - Automated Underreporter  
BSA - Bank Secrecy Act  
BSM - Business Systems Modernization  
CADE - Customer Account Data Engine  
CAP - Compliance Assistance Program  
CAWR - Combined Annual Wage Reporting  
CI - Criminal Investigation  
CMP - Compliance Monitoring Process  
CSIRC - Computer Security Incident Response Center  
CSP - Common Services Projects  
CTC - Child Tax Credit  
EFTPS - Electronic Federal Tax Payment System  
EITC - Earned Income Tax Credit  
ERO - Electronic Return Originator  
ETA - Electronic Tax Administration  
FAQ - Frequently Asked Question  
FHWA - Federal Highway Administration  
FIN 48 - Financial Accounting Standards Board Interpretation No. 48  
FUTA - Federal Unemployment Tax  
FY - Fiscal Year  
IRC - Internal Revenue Code  
IRS - Internal Revenue Service  
I-CAS - Internet Customer Account Services  
IT - Information Technology  
JITSIC - Joint International Tax Shelter Information Center  
JOC - Joint Operations Center  
LEP - Limited English Proficiency  
LMSB - Large & Mid-Size Business Operating Division  
LSR - Leadership Succession Review

MeF - Modernized e-File  
NDNH - National Directory of New Hires  
NMT - Net Misreporting Percentage  
NRP - National Research Program  
NTA - National Taxpayer Advocate  
OECD - Organization for Economic Cooperation and Development  
OPR - Office of Professional Responsibility  
PCA - Private Collection Agency  
PFA- Pre-Filing Agreement  
PDC - Private Debt Collection  
PGP - Priority Guidance Plan  
PTIN - Practitioner Taxpayer Identification Number  
QETP - Questionable Employment Tax Practices  
ROI - Return on Investment  
SAR - State Audit Reports  
SBA - Small Business Administration  
SB/SE - Small Business/Self-Employed Operating Division  
SBDC - Small Business Development Center  
SCORE - Service Corps of Retired Executives  
SRFMI - State Reverse File Match Initiative  
TAB - Taxpayer Assistance Blueprint  
TAC - Taxpayer Assistance Center  
TAS - Taxpayer Advocate Service  
TBR - Taxpayer Burden Reduction  
TCE - Tax Counseling for the Elderly  
TCMP - Taxpayer Compliance Measurement Program  
TDI - Taxpayer Delinquency Investigation  
TEGE - Tax Exempt & Government Entities Operating Division  
TIEA - Tax Information Exchange Agreements  
TIN - Taxpayer Identification Number  
TREES - TEGE Electronic Examination System  
TY - Tax Year  
VCR - Voluntary Compliance Rate  
VITA - Volunteer Income Tax Assistance  
W&I - Wage & Investment Operating Division

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