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BY THE COMPTROLLER GENERAL

# Report To The Congress

OF THE UNITED STATES

## Fictitious Tax Deposit Claims Plague IRS

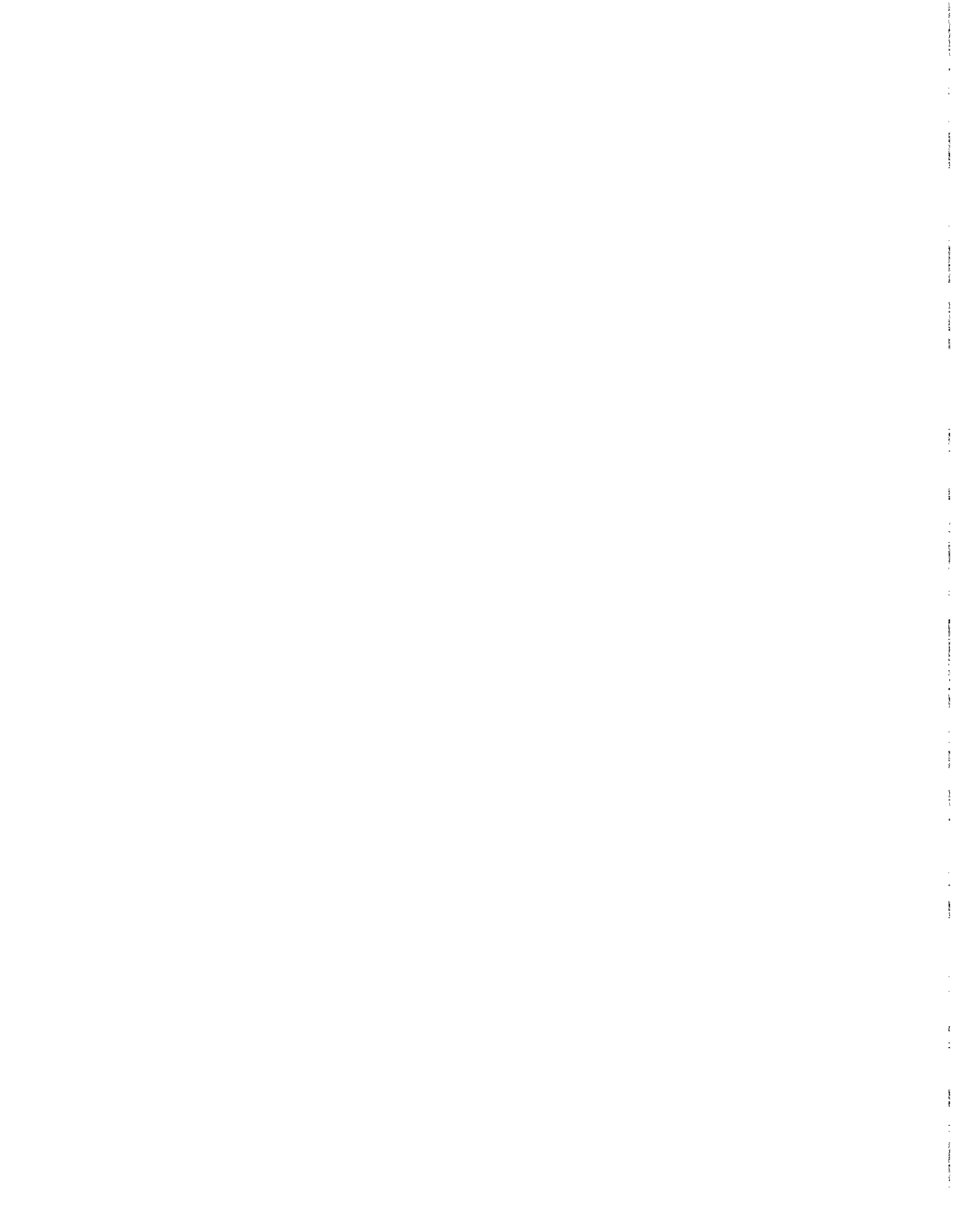
GAO estimates that 31 percent of the delinquent employers' accounts it reviewed involved fictitious tax deposit claims. Present and proposed IRS administrative procedures are not adequate to resolve this problem. Therefore, a civil penalty, which is severe enough to be a meaningful deterrent, is needed.



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APRIL 28, 1981





COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON D.C. 20548

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To the President of the Senate and the  
Speaker of the House of Representatives

The current interest in cash management and the timely collection of tax revenues prompted us to review the procedures used by the Internal Revenue Service to collect withheld taxes from employers who do not deposit the taxes and subsequently claim on their tax return that they made the deposits. Because of the large percentage of employers we found who claim such fictitious deposits, this report points out the need for a civil penalty to be used against these employers.

Copies of the report are being sent to the Director, Office of Management and Budget; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

*Milton J. Aroslan*

Acting Comptroller General  
of the United States



D I G E S T

Employers' failure to pay employment taxes-- income tax withheld and social security tax--is one of the most serious delinquency problems facing the Internal Revenue Service (IRS). Employers can delay IRS collection efforts by falsely claiming on their quarterly tax returns that the taxes were deposited to a Federal bank account. The Internal Revenue Code contains no specific provision for a civil penalty for claiming fictitious deposits of these taxes.

Withheld income and social security taxes, called employment trust fund taxes, accounted for \$298 billion of the \$460 billion IRS collected in fiscal year 1979. During fiscal year 1976, the latest year for which data is available, IRS began collection action against employers who held back \$2.4 billion of these trust fund taxes.

Employers who claim fictitious tax deposits are flagrantly abusing the concept of voluntary tax law compliance. First, they have converted to their own use the income tax and social security payments that they withheld from their employees' wages. Then, to compound the abuse, they have prepared their employment tax returns to show deposit payments they never made, thereby delaying IRS collection actions.

GAO'S PREVIOUS REPORT ON FICTITIOUS  
DEPOSIT CLAIMS

GAO previously reported <sup>1</sup>/ that among delinquent employers whose accounts were closed during a 1-week period at one IRS district office, 20 percent had claimed fictitious deposits on their tax returns. Sample statistics showed that IRS collection actions were delayed an average of 84 days because of the fictitious deposit claims. (See p. 7.)

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<sup>1</sup>/"IRS Can Improve Its Program To Collect Taxes Withheld By Employers," GGD-78-14, February 21, 1978.

GAO recommended that the Congress enact legislation for a civil penalty to deter employers from claiming fictitious deposits. IRS agreed with the need for such legislation but reserved comment on the particular type of penalty which should be imposed. To date, IRS has not recommended that legislation for a penalty for this purpose be enacted.

#### GAO'S RECENT WORK ON FICTITIOUS DEPOSIT CLAIMS

Following up on this work recently at five IRS district offices, GAO found that employers claiming fictitious deposits continued to be a problem.

On the basis of an analysis of delinquent tax accounts in the five districts, GAO estimated that 31 percent of the employers' accounts involved fictitious deposit claims. These fictitious deposit claims delayed IRS collection action an average of 64 days. (See p. 8.)

#### PAST, PRESENT, AND PROPOSED IRS PROCEDURES TO COMBAT FICTITIOUS DEPOSIT CLAIMS

IRS has tried to prosecute employers who fictitiously claimed deposits for filing fraudulent tax returns under section 7206 of the Internal Revenue Code. However, it was necessary to prove criminal willfulness. As this proved too difficult, IRS abandoned the prosecution program in 1976.

Currently, IRS tries to identify employers who repeatedly claim fictitious deposits. If IRS identifies such a repeater, it notes on the employer's tax file that speedier collection action should be taken on subsequent returns when the claimed deposits do not match those posted at the bank. The identification procedure lacks definitive criteria, however, so there is no assurance that all such employers are identified. (See p. 9.)

Further, IRS Collection Division officials said the procedure is not regularly followed in all of the service centers. They also said it has not been effective, and they plan to recommend dropping it altogether.

In July 1981 IRS plans to eliminate a computer check reconciliation process that delays collection action on fictitious deposit cases up to 8 weeks to allow time for deposits to be recorded. (See p. 10.)

This change could speed collection, but 2 to 5 weeks would still be needed for IRS to manually search its records for deposits misrecorded in another account before beginning collection action.

IRS has drafted a legislative proposal for a civil penalty for claiming fictitious deposits on employment tax returns. Further, an IRS study group has recently recommended that this proposal be enacted. However, no action has been taken on this legislative proposal. (See p. 10.)

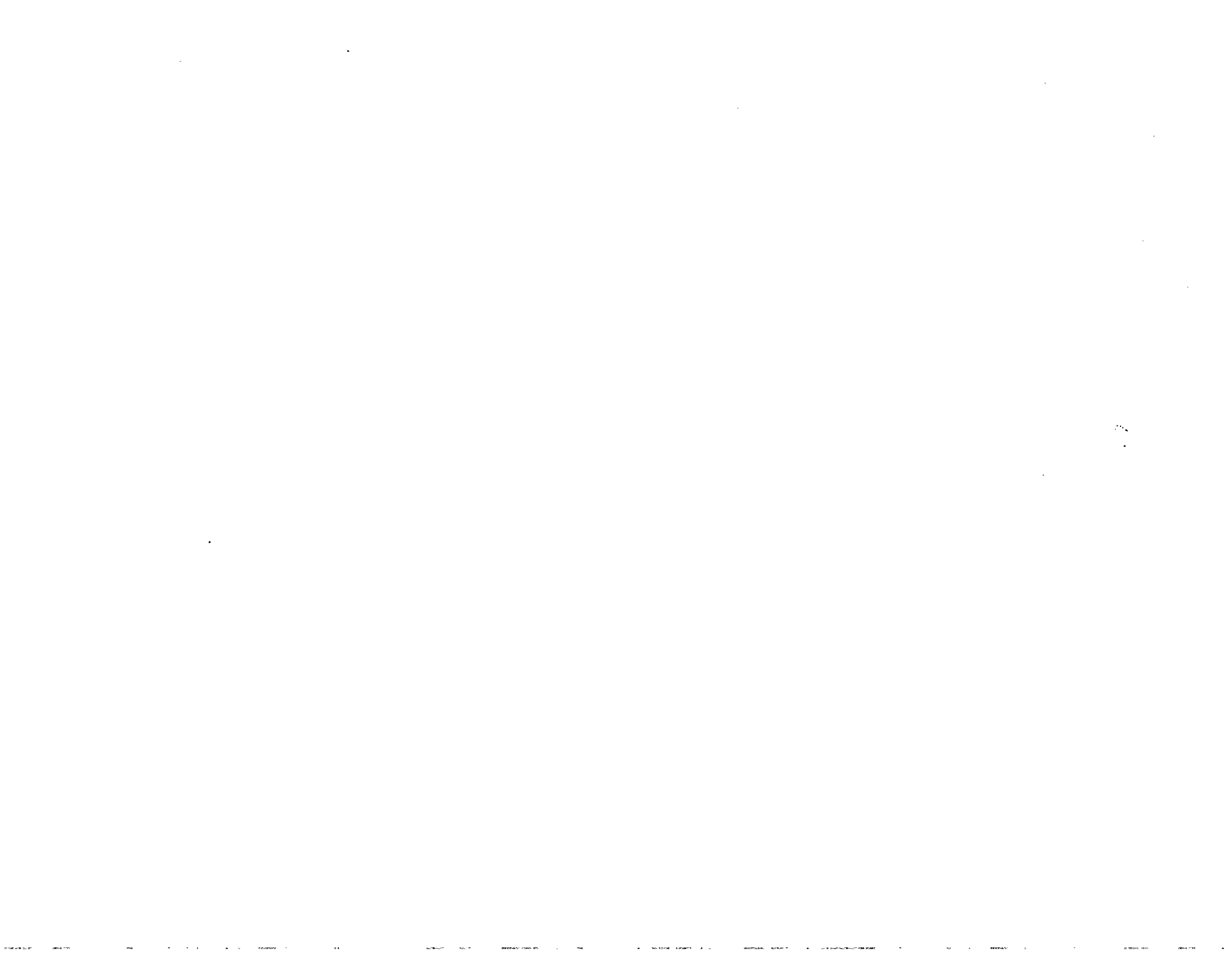
#### CONCLUSIONS

Fictitious deposit claims, which delay IRS collection of withheld taxes that were not paid over to the Government, continue to be a serious problem. Present and proposed procedures are insufficient to resolve the problem.

#### RECOMMENDATION TO THE COMMISSIONER OF INTERNAL REVENUE

The Commissioner, IRS, should pursue the enactment of legislation to provide a civil penalty--possibly as much as 25 percent of the fictitious deposits--on employers who claim fictitious deposits on their employment tax returns. (See p. 12 and app. IV.)

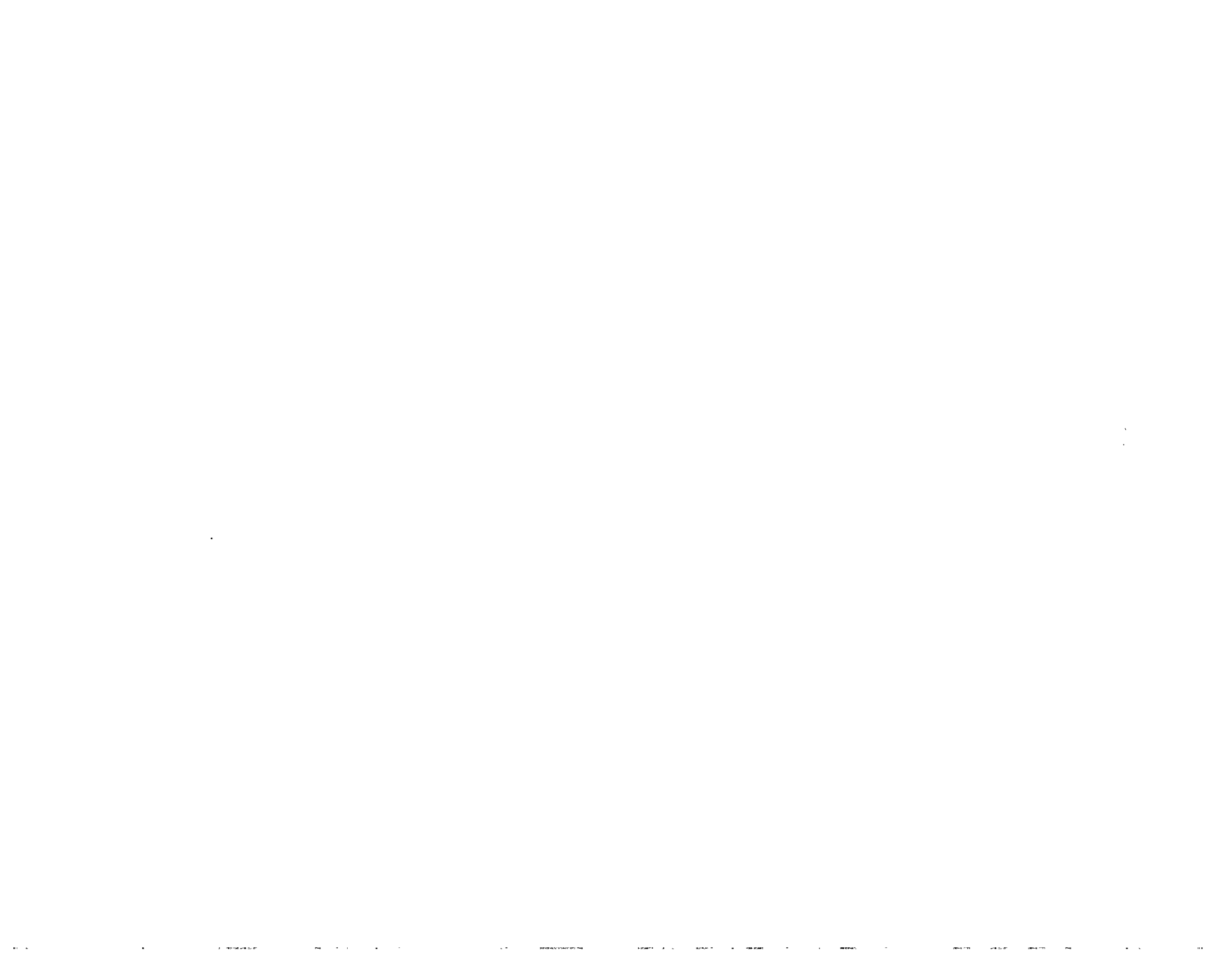
The Commissioner agrees with the GAO recommendation and will recommend to the Department of the Treasury legislation for the enactment of a related civil penalty.





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GAO	General Accounting Office	
IRS	Internal Revenue Service	



## CHAPTER 1

### INTRODUCTION

Employers who claim fictitious deposits of employment trust fund taxes--income tax withheld and social security tax--can significantly delay IRS collection efforts but are penalized no more than an employer who admits underpayment. The Internal Revenue Code contains no provision for an additional civil penalty for claiming fictitious deposits.

In fiscal year 1979, employment trust fund taxes accounted for \$298 billion (65 percent) of \$460 billion in internal revenue collections. In IRS' 1979 annual report the Commissioner noted that nonpayment of taxes withheld from employees' wages is one of the most serious delinquency problems. IRS initiated collection action against employers for nonpayment of \$2.4 billion in trust fund taxes during fiscal year 1976, the latest year for which data is available.

Employers became involved in withholding social security taxes from their employees' wages as a result of the passage of the Social Security Act in 1935. In 1943 employers became responsible for withholding income tax from their employees' wages. Employers are required to deposit these taxes periodically into the Federal Tax Deposit System.

Requiring employers to withhold taxes and periodically deposit them to a Federal bank account facilitates tax collection. In addition, it avoids the hardships to individual taxpayers of making lump-sum payments at the end of a year and minimizes the potential for individuals to avoid tax payment. One problem, however, is that it gives employers the opportunity to use the withheld taxes for their own benefit if they do not pay them to the Government. Testifying in 1976 before the Oversight Subcommittee of the House Ways and Means Committee, IRS officials expressed concern that employers use the withheld taxes as low interest loans from the Federal Government.

Employers who keep withheld taxes are subject to penalty and interest assessments. For example, assuming an employer filed his quarterly employment tax return on time but failed to pay the entire liability, the following assessments could be made:

--Failure-to-deposit penalty--5 percent of the amount not deposited on time.

--Failure-to-pay penalty--0.5 percent per month of the amount not paid by the date the return was due.

--Interest--12 percent per year on the amount due.

However, an employer who claims fictitious deposits can significantly delay IRS collection efforts but is penalized no more

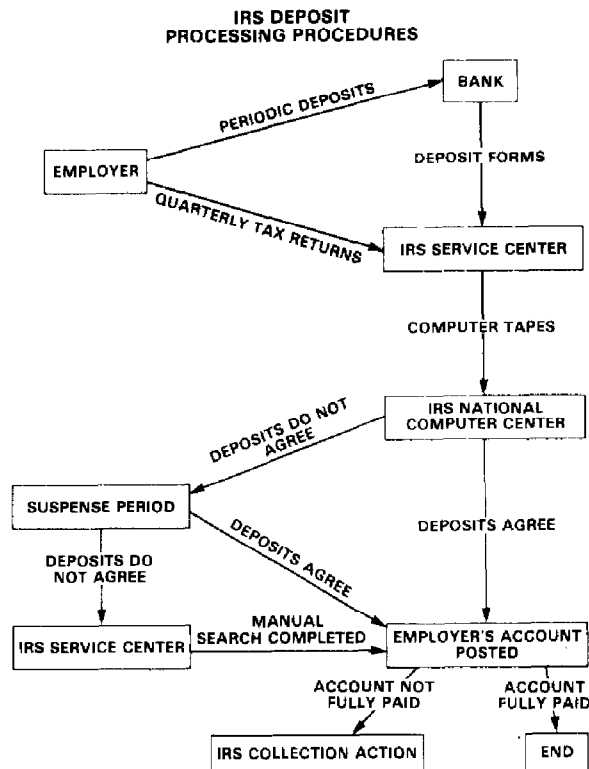
than an employer who admits on his return that the taxes were not paid.

THE FEDERAL TAX DEPOSIT SYSTEM  
AND IRS PROCESSING OF DEPOSITS

Employers generally must deposit employment trust fund taxes with a Federal Reserve or approved commercial bank and must file quarterly employment tax returns with IRS by the end of the month after the quarter ends.

IRS service centers prepare computer tapes of the actual deposits and the deposits claimed on the tax returns for processing in IRS' National Computer Center. If the amounts do not agree, the return is held in suspense for up to 8 weeks to allow for posting delays. If the amounts still do not agree, the returns are referred to the service centers for manual search to determine if the deposits were misapplied. IRS begins its normal collection process if it cannot locate a claimed deposit. Although the time necessary to manually resolve these cases varies, IRS service center officials estimate that it normally takes from 2 to 5 weeks.

Below is a diagram of these procedures. A more detailed description is included as appendix II.



## TAXPAYER DELINQUENT ACCOUNTS

When IRS determines that an employer has not paid all withheld taxes, the service center sends up to three tax due notices. If the taxes remain unpaid, the service center refers the delinquent account to a district office for more intensive collection action. In some cases IRS expedites referral of delinquent accounts to district offices after only one tax due notice. Referrals are expedited for several reasons, such as a large balance, payment with a bad check, or a history of delinquency.

## OBJECTIVES, SCOPE, AND METHODOLOGY

We previously addressed the problem of employers claiming fictitious deposits on employment tax returns in a report entitled "IRS Can Improve Its Programs To Collect Taxes Withheld By Employers" (GGD-78-14, Feb. 21, 1978). Because the legislation for a civil penalty that we recommended was not enacted, we followed up to determine if fictitious deposit claims continue to delay IRS collection actions.

Our previous review covered one IRS district office. Our followup review was expanded to five districts. The five IRS district offices selected for review and the reasons for this selection follow.

- The Chicago district was the location of our prior review.
- The Manhattan district has the highest employment tax collections.
- The Jacksonville; Los Angeles; and Aberdeen, South Dakota, district offices were statistically selected, at random, from the remaining district offices.

For the five districts selected, we asked IRS to save for our review all employment tax delinquent accounts closed during one week in 1980. The Chicago district office saved the accounts for the week beginning April 14, 1980. Due to delays in having IRS' national office request the accounts for the other four districts, those accounts were saved for the week beginning May 5, 1980.

We reviewed the accounts closed as uncollectible in the Chicago district and could find no significant difference in the processing procedures and time between them and accounts closed as fully paid. That being the case, to restrict the sample we omitted uncollectible accounts in the other large districts.

Since we wanted to determine the extent of delays in IRS processing time caused by employers claiming fictitious deposits, we excluded certain types of accounts where the nature of the action would distort the figures. The majority of the accounts we excluded are classified as:

- Accounts where the amount due consisted of interest and penalties only. For these, the employment taxes were fully paid, and claims of fictitious deposits would not be a factor in the processing time.
- Accounts that had been closed and reopened or were otherwise being referred for district office collection action for a second time. For these, the processing time would be longer because of actions other than the fictitious deposit claims.
- Accounts resulting from IRS audits or adjustments. For these, the major delay in processing would not be a fictitious deposit claim, but the audit or adjustment activity.
- Accounts resulting from IRS analysis of multiple delinquencies. For these, the processing time would be longer because of the waiting period for accumulating multiple delinquencies, and not a fictitious deposit claim.

After these exclusions the remaining accounts were essentially those being processed by IRS for the first time and having some portion of the employment taxes unpaid. We reviewed all remaining accounts in two districts but further narrowed our selection by a random sampling in three districts as shown in the following table.

<u>IRS district office</u>	<u>Total accounts</u>	<u>Accounts excluded</u>	<u>Accounts remaining</u>	<u>Accounts reviewed</u>
Aberdeen	53	38	15	15
Chicago	583	214	369	a/241
Jacksonville	777	394	383	230
Los Angeles (note b)	503	306	197	197
Manhattan	<u>965</u>	<u>561</u>	<u>404</u>	<u>237</u>
Total	<u>2,881</u>	<u>1,513</u>	<u>1,368</u>	<u>920</u>

a/The accounts reviewed in Chicago include 44 accounts closed as uncollectible. As mentioned on page 3 of this report, uncollectible accounts were not reviewed in the other three large district offices.

b/Includes three of four Los Angeles district locations.

We scheduled information from the accounts, including the deposits claimed and made, the delinquency amount, the approximate IRS receipt date, and the delinquent account issuance date. We determined processing times on the basis of the time period from the IRS receipt date to the delinquent account issuance date. We then compared the average processing times for different categories to determine the delay caused by claiming

fictitious deposits. The categories were (1) routine collection action for returns with fictitious deposit claims and no deposit claims, and (2) accelerated collection action for returns with fictitious deposit claims and no deposit claims.

We interviewed IRS headquarters personnel regarding action taken as a result of our prior report and the processing of returns and delinquent accounts. We also interviewed officials at the Kansas City service center regarding the Federal Tax Deposit System and officials at the five IRS district offices regarding specific problems they had with employers claiming fictitious deposits of withheld taxes. In addition, we contacted the Brookhaven, Atlanta, Ogden, and Fresno service centers regarding resolution of accounts when claimed deposits do not agree with posted deposits.

## CHAPTER 2

### PENALTY STILL NEEDED TO DETER

### EMPLOYERS' CLAIMS OF FICTITIOUS

### TRUST FUND TAX DEPOSITS

Employers who fail to pay taxes withheld from employees' wages can also delay IRS collection action by claiming fictitious deposits on their employment tax returns. These fictitious claims delay collection action because IRS checks to see if the discrepancy stems from a lag or error in its recording of the deposits received. GAO previously reported this problem in 1978 <sup>1/</sup> and recommended that the Congress enact legislation to provide a civil penalty to be used as a deterrent. No legislation was enacted. Therefore, in 1980 we followed up on this work and determined that fictitious deposit claims continue to plague IRS.

IRS has attempted to use the criminal provision of the Internal Revenue Code in order to help resolve this problem. These attempts were unsuccessful because of the difficulty of proving criminal willfulness. IRS has also taken and proposed some administrative actions to reduce the collection delays, but these actions have not and will not totally resolve this problem. Therefore, more needs to be done to achieve better compliance.

A penalty is needed because these employers flagrantly abuse the concept of voluntary tax law compliance. First, they have converted to their own use the income tax and social security payments that they withheld from their employees' wages. Then, to compound the abuse, they have prepared their employment tax returns claiming employment trust fund tax deposits that were never made, thereby delaying IRS collection actions.

IRS collection of unpaid trust fund taxes is delayed when the employer claims fictitious deposits sufficient to make the return appear to be fully paid or have a liability below a certain dollar amount. Tax returns showing a liability above that dollar amount would immediately be processed as delinquent accounts, regardless of any fictitious deposits claimed on the return.

### RESULTS OF GAO'S PRIOR REVIEW

We reported in 1978 that in the IRS Chicago district office, 20 percent of a sample of 335 employers paying taxes whose delinquent employment tax accounts were closed during one week

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<sup>1/</sup>"IRS Can Improve Its Programs To Collect Taxes Withheld By Employers," GGD-78-14, February 21, 1978.



in February 1977 had claimed fictitious deposits on their returns. These fictitious deposit claims delayed collection action an average of 84 days over normal processing time.

We recommended that the Congress enact legislation to provide a civil penalty to act as an incentive to deter employers from claiming fictitious deposits on their tax returns. In August 1977 and January 1978 IRS agreed that an effective penalty was needed but reserved comment on the particular type of penalty which should be imposed, pending further study. To date, IRS has not formally recommended that legislation for a penalty for this purpose be enacted although it has given additional consideration to the matter.

RESULTS OF GAO'S FOLLOWUP REVIEW

Five IRS district offices were selected for a followup review of delinquent accounts closed during one week in April or May 1980. We reviewed 920 accounts with the following results:

IRS district office	Delinquent accounts reviewed	GAO estimate of employers who claimed fictitious deposits making tax return appear fully paid (note a)	
		Number	Percent
Aberdeen	15	2	13
Chicago	241	62	26
Jacksonville	230	62	27
Los Angeles	197	67	34
Manhattan	<u>237</u>	<u>94</u>	40
Total	<u>920</u>	<u>287</u>	31

a/The computation of the estimate is described in appendix III.

Overall, we estimate that in 31 percent of the delinquent accounts reviewed, the employers had claimed fictitious deposits which made the tax returns appear to be fully paid. The estimated percentages of employers claiming fictitious deposits were consistently high in the four large IRS districts. Aberdeen district's percentage was considerably smaller, however, as was the number of closed cases reviewed. Officials of the four large districts believed fictitious deposit claims were a serious problem warranting remedial action. Aberdeen officials did not consider them to be a serious problem in their district.

Although it appears that the percentage of employers claiming fictitious deposits increased from 20 to 31 percent between 1977 and 1980, this is not necessarily the case. The populations included in the two reviews were not identical since in the second review we eliminated accounts with no opportunity for a fictitious deposit, as explained in chapter 1. However, on the basis of the 31 percent fictitious deposit claim rate we

found at the four large districts we visited and our discussions with IRS personnel having an overall prospective of the fictitious deposit claim problem, such claims are a continuing problem for IRS' larger districts.

We also analyzed the IRS processing time--the time period from the IRS receipt date to the delinquent account issuance date--to determine the effect of fictitious deposit claims.

	<u>Average processing time</u> <u>when delinquent employer:</u>		
	<u>Shows a</u>	<u>Claims tax</u>	<u>Difference in</u>
	<u>balance due</u>	<u>is fully paid</u>	<u>processing time</u>
	<u>(days)</u>		<u>(days)</u>

Account is accelerated (note a)	50	108	58
Account is not accelerated (note b)	86	153	67

a/Referred to district after one tax due notice.

b/Referred to district after three tax due notices.

As shown, claiming fictitious deposits delays the collection of withheld taxes. The weighted average delay to begin the collection process in the above cases was 64 days.

Thus, IRS is still plagued with the problem of employers claiming fictitious deposits on their employment tax returns. These fictitious claims delay IRS' actions to collect the withheld taxes an average of about 2 months.

IRS ACTIONS TO COMBAT EMPLOYERS'  
FICTITIOUS DEPOSIT CLAIMS NOT EFFECTIVE

IRS has long recognized the problem of fictitious deposit claims, but its actions to date have not been successful because of

- the difficulties in prosecuting employers who file fictitious deposit claims and
- the problems encountered in identifying employers who repeatedly claim fictitious deposits.

Unsuccessful criminal prosecution of  
employers claiming fictitious deposits

Under section 7206 of the Internal Revenue Code, IRS attempted to prosecute employers claiming fictitious deposits. The

section provides a criminal penalty of up to a \$5,000 fine and/or a maximum of 3 years imprisonment for filing fraudulent returns. IRS began a program in June 1975 to identify and prosecute the most flagrant cases (large dollar amounts and three or more returns with fictitious deposits). In September 1976 IRS discontinued the program because of the difficulty of proving criminal willful intent.

IRS' procedure for identifying problem employers not fully effective

IRS tries to identify employers who repeatedly claim fictitious deposits. If IRS identifies such a repeater, it notes on the employer's tax file that speedier collection action should be taken on subsequent returns when the claimed deposits do not match those posted at the bank. The identification procedure lacks definitive criteria, however, so there is no assurance that all such employers are identified.

The procedure calls for service centers to identify on the IRS master file those employers who meet the following criteria:

- The amount of fictitious deposits claimed must exceed a prescribed dollar amount.
- The employer must have been delinquent for at least two prior quarters or during the last four quarters must have paid his employment tax liability late.
- The employer must have claimed fictitious deposits in at least two prior quarters.

If the employer meets the above criteria, the tax examiner must still subjectively judge whether the employer's claiming of fictitious deposits is repetitious before noting this fact in the employer's record. The criteria also cautions that if a reasonable doubt exists, the tax examiner should not enter the indicator in the employer's record.

When an employer has been identified in the file, his future tax returns with deposit discrepancies bypass IRS' internal checking, and the delinquent accounts are immediately referred to a district office for collection action.

According to IRS Collection Division officials, the service centers do not always make the analysis because it is a very time consuming manual process. Further, in their opinion, the procedure is too loose and subject to judgment to be fully effective. They plan to recommend that this procedure be eliminated when IRS implements a new procedure described below.

NEW IRS PROCEDURE WOULD  
REDUCE COLLECTION DELAYS

In 1978 IRS studied business tax returns which contained deposit claims that did not agree with posted deposits. On the

basis of this study, IRS estimated that each year 600,000 of the 2 million returns containing such claims were cases where deposits claimed by employers were either never made or were misclaimed.

At that time, IRS considered eliminating the up to 8-week suspense period when an employer's claimed and posted deposits did not agree. (See p. 2.) The suspense period, which IRS instituted to allow for deposit posting delays, was no longer needed because deposits were being posted promptly. IRS decided against the change, however, because it would have resulted in a significant number of erroneous actions in cases where the deposits had been misapplied.

IRS is now planning a modified form of that procedural change which would be implemented July 1, 1981. This change would (1) eliminate the suspense period, (2) provide for a computer search for misapplied credits, and (3) retain the manual search process for the cases the computer could not resolve. This change should substantially reduce delays in collection actions when employers claim fictitious deposits. The service centers will still have to manually search for the claimed fictitious deposits, however, so a residual delay will remain. Accordingly, by claiming fictitious deposits employers will still be able to delay IRS collection action for 2 to 5 weeks.

WHAT PENALTY AMOUNT  
WOULD BE APPROPRIATE?

Our previous report recommended that the Congress enact legislation to provide a civil penalty to deter employers who claim fictitious deposits on their employment tax returns. In a letter dated January 4, 1978, the Commissioner agreed with the need for an effective penalty but reserved comment on the type of penalty pending further study. Since that time IRS' Legislative Analysis Division has drafted a proposal that would provide a civil penalty equal to 25 percent of the amount of fictitious deposits claimed on employment tax returns. Further, IRS' Accounts Receivable Study Group reviewed proposals for improving IRS collections and recommended in its October 1980 report that the proposed fictitious deposit penalty be enacted.

The proposal recognized that employers who falsely report tax deposits on their quarterly employment tax returns present a significant administration problem and that IRS has been unable to deter this practice because willful intent is difficult to prove under both the felony and civil fraud provisions of the Internal Revenue Code. The proposal concluded that to remedy this problem "a penalty of a lesser amount than the civil fraud penalty (50 percent of the underpayment) is needed." The proposed 25-percent penalty was recommended

"to encourage taxpayers to correctly report deposits on their quarterly returns and to take

away any financial advantage to be gained by not timely depositing taxes due."

The 25-percent rate appears to be in line with current IRS thinking. The Commissioner established a Civil Penalty Study Group to review the existing civil penalties and recommend changes needed to improve tax administration and assure compliance with the law. The study group's report dated September 10, 1979, recommended a number of changes, including an increase in the negligence penalty.

The negligence penalty, Section 6653(a) of the Internal Revenue Code, applies only to income and gift taxes and calls for an addition to the tax of 5 percent of the underpayment if any part is due to negligence or intentional disregard of rules and regulations. The addition to the tax for negligence is designed to discourage willful noncompliance with the tax laws and to deter misbehavior which goes beyond mere delinquency.

The study group concluded that the existing penalty of 5 percent is too small to be a meaningful deterrent. Accordingly, it recommended that the penalty for negligence be increased to 25 percent of the underpayment. To date, the study group's recommendation has remained internal to IRS.

We have no basis to confirm or deny the propriety of the proposed 25-percent penalty rate, but it is obvious that a significant penalty is needed if it is to serve as a meaningful deterrent to noncompliance which goes beyond mere delinquency. Claiming fictitious deposits falls into this category.

#### CONCLUSIONS

Employers continue to claim fictitious deposits on their employment tax returns and thereby delay IRS collection actions, just as they did at the time of our previous review. An estimated 31 percent of the delinquent accounts we reviewed had claimed fictitious deposits, which delayed collection actions an average of 64 days. IRS' own study in 1978 estimated that 600,000 returns each year claim deposits that were either never made or were misclaimed.

IRS' criminal prosecution and administrative actions to combat this practice have not been effective. The criminal prosecution attempts were dropped because they were not successful. Administrative actions to identify fictitious deposit claims are time consuming and provide far too much discretion and, therefore, do not assure that flagrant violators are identified for special attention. A new procedure, if implemented, would reduce processing time delays but would not directly deter employers from claiming fictitious deposits.

A severe civil penalty--possibly as much as 25 percent of the claimed fictitious deposits, as proposed by IRS' Legislative Analysis Division--should be imposed on employers who claim

fictitious deposits. The employers in question have converted to their own use the employment trust fund taxes withheld from their employees' wages and have prepared their employment tax returns to show that the funds were properly deposited to the Government's account. It is not enough to devise administrative procedures to reduce the delay in payment from such actions. A clear disincentive should be established to stop this action.

RECOMMENDATION TO THE COMMISSIONER  
OF INTERNAL REVENUE

We recommend that the Commissioner of Internal Revenue pursue the enactment of a civil penalty--possibly as much as 25 percent of the fictitious deposits--on employers who claim fictitious deposits on their employment tax returns. (See app. IV.)

IRS COMMENTS

IRS agreed with the need for a new civil penalty to deter taxpayers from claiming fictitious tax deposits. The Commissioner of Internal Revenue pointed out in his comments that IRS believes that its new procedure, as discussed on page 10, would significantly reduce the delay in billing employers who underpaid their employment trust fund taxes, and this would remove much of the incentive for employers to claim fictitious tax deposits. The Commissioner also stated that IRS will recommend to the Department of the Treasury legislation for enactment of a civil penalty similar to that suggested in appendix IV.

## COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

March 3 1981

Mr. William Anderson  
Director, General Government Division  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "Employers Claiming Fictitious Deposits of Withheld Taxes Continue to Plague IRS." The Internal Revenue Service agrees with the need for a new civil penalty to deter taxpayers from claiming fictitious tax deposits. While we believe significantly reducing the delay in billing underpaid employment trust fund taxes will remove much of the incentive for employers to claim fictitious tax deposits, we still endorse enactment of a civil penalty. We will recommend to Treasury, Office of Tax Policy, legislation very similar to that suggested in Appendix IV.

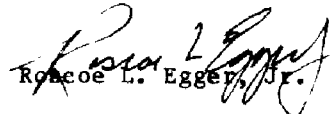
The following comments address specific points in the report:

The last sentence of the first paragraph under "Conclusions," page 11 of the report is in error. The Service's study identified the estimated 600,000 returns as underpaid but did not indicate that all 600,000 involved fictitious deposit claims. While a majority of the underpaid returns resulted in the issuance of balance due notices, the 1978 study did not identify a specific volume of returns that were underpaid due to fictitious FTD's. An earlier reference to the 600,000 underpaid returns on page 10 of the report is more accurate.

The explanation of the Federal Tax Deposit System in Appendix II, page 14, does not reflect the current deposit rules that are effective beginning January 1, 1981.

With kind regards,

Sincerely,

  
Roscoe L. Egger, Jr.

Department of the Treasury Internal Revenue Service

FEDERAL TAX DEPOSIT SYSTEM  
AND IRS PROCESSING OF DEPOSITS

THE FEDERAL TAX DEPOSIT SYSTEM

IRS requires employers to periodically deposit employment trust fund taxes at a Federal Reserve or approved commercial bank. The frequency of deposits is determined by the amount of taxes withheld. Generally, employers must deposit taxes when the accumulated amount withheld during the month reaches \$3,000, or at least once a month if the withheld taxes are over \$500. If the quarterly withheld taxes are less than \$500, they may be paid with the quarterly employment tax return.

Employers deposit the withheld taxes using a Federal tax deposit form. IRS furnishes these computer card forms to employers and prepunches the employers' tax identification information, type of tax, and tax period. Federal Reserve and commercial banks send the deposit forms to the IRS service centers daily. The service centers prepare a computer tape of all deposits for input to the master file at the IRS National Computer Center. The National Computer Center then posts the deposits to the appropriate employer's account. IRS estimates that most deposits are posted within 10 days of the deposit date.

RECONCILING CLAIMED  
AND ACTUAL DEPOSITS

Employers must generally file quarterly employment tax returns with an appropriate IRS service center by the end of the month after the quarter ends. The service center converts various information, including the total amount of deposits claimed, to computer tape for input to the National Computer Center.

The National Computer Center attempts to enter the return information on the appropriate employer's account. Several computer checks are made before the information can be posted. For example, names and identification numbers must agree. Also, the total deposits posted to the account must agree with the amount claimed on the return. If the deposit amounts do not agree, the return is held in suspense for up to 8 weeks to allow for posting delays. At the end of this period if the claimed deposits still do not agree with the posted deposits, the return is referred back to the service center for manual problem resolution.

Each year the National Computer Center refers back approximately 2 million returns with claimed deposits not matching posted deposits. The service centers try to resolve the problem by researching other accounts and files to determine if the deposits were misapplied. If a claimed deposit cannot be located, IRS begins its normal collection process on the account. Although the time necessary to manually resolve these cases varies depending on the volume received each week, IRS service center officials estimate that it normally takes from 2 to 5 weeks.



GAO COMPUTATION OF EMPLOYERS  
WHO CLAIMED FICTITIOUS DEPOSITS  
MAKING TAX RETURN APPEAR FULLY PAID

In some cases an employment tax delinquent account can outwardly appear to have a fictitious deposit claim where the employer is innocent of that offense. This can occur when the account is settled by some means other than payment or a determination that the account is uncollectible. For example, there may be a late determination that the deposit was made but was misapplied in the accounts. To fully resolve an individual case can require review of numerous records and can be very time consuming.

In our review of 920 delinquent accounts we initially identified 362 which outwardly appeared to have claimed fictitious deposits. We then took a sample of those accounts and, with IRS' assistance, jointly reviewed additional records to determine the number of valid fictitious deposit cases. We then applied the sample percentage to the universe of 362 cases to estimate the number that truly claimed fictitious deposits. Our estimate is conservative since cases where the joint GAO/IRS review could not clearly determine whether or not the employer had claimed fictitious deposits from readily available information were not considered to be fictitious filer cases.

We selected random samples of 30 accounts in each of the four large IRS districts. Aberdeen had only two cases, and we reviewed both.

The results of our sample were as follows:

<u>IRS district</u>	<u>Universe</u>	<u>Jointly determined valid cases in sample</u>	<u>Estimate of employers who claimed fictitious deposits (note a)</u>			
			<u>Estimated number</u>	<u>Sampling error</u>	<u>Range</u> <u>Low High</u>	
Aberdeen	2	2	2	+ 0	2	2
Chicago	74	25	62	+ 9	53	71
Jacksonville	85	22	62	+ 12	50	75
Los Angeles	100	20	67	+ 16	51	83
Manhattan	<u>101</u>	<u>28</u>	<u>94</u>	+ 9	<u>85</u>	<u>104</u>
Stratified results	<u>362</u>	<u>97</u>	<u>287</u>	+ 47	<u>240</u>	<u>334</u>

a/Differences in the table are attributable to rounding.

Thus we are 95 percent confident that the number of taxpayers reviewed who claimed fictitious deposits is between 240 and 334.

UNITED STATES GENERAL ACCOUNTING OFFICESUGGESTED AMENDMENT TO THE INTERNAL REVENUE CODE  
TO ASSESS A PENALTY ON EMPLOYERS WHO CLAIM  
FICTITIOUS DEPOSITS OF TAXES

We suggest the following amendment to the Internal Revenue Code:

## FAILURE TO ACCURATELY REPORT DEPOSIT OF TAXES

(a) Penalty - Any person required to deposit any amount of tax imposed by this title in such Government depository as is authorized under section 6302(c) to receive such deposits, who fails to accurately report whether such deposit has been made and the amount of such deposit shall be subject to a penalty of \_\_\_ percent of the amount of the underpayment, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. For purposes of this section, the term "underpayment" means the excess of the amount of the tax reported as deposited over the amount actually deposited.

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