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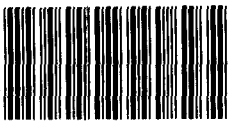
Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

August 1991

TAX ADMINISTRATION

Efforts to Prevent, Identify, and Collect Employment Tax Delinquencies



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The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report is one in a series that responds to your March 28, 1990, request for information on what the Internal Revenue Service (IRS) is doing to handle its accounts receivable inventory. This report addresses IRS' efforts to prevent, identify, and collect employment tax delinquencies. Federal employment taxes include social security and unemployment taxes owed by employers and employees' social security and income taxes withheld for the government by employers. At the end of fiscal year 1990, delinquent employment taxes accounted for about $29.7 billion, or 31 percent, of the $96.3 billion accounts receivable balance.

Over two-thirds of all federal tax revenue is collected through employment taxes. In fiscal year 1989, employment taxes accounted for $707 billion, or about 70 percent, of the $1 trillion in federal gross tax receipts. Each year, however, businesses fail to pay billions of dollars in employment taxes. Nonpayment of employment taxes poses significant problems for IRS and is costly to the government.

Failing businesses have used nonpayment of employment taxes as a means to avoid or delay going out of business. As a result, financially troubled businesses with large payrolls can quickly accumulate large delinquencies that are difficult, if not impossible, for IRS to collect. In addition, not only can the government lose the money it is owed, but it also provides full credit and benefits to the employees just as if the taxes had been paid. In some cases, money is refunded to employees for withheld income taxes that were never paid.

Results in Brief

Considering the significance of employment tax delinquencies and the quickness with which large employment tax delinquencies can accumulate, the prevention, early identification, and collection of these delinquencies are critical. At the time of our review, however, IRS did not have a centralized effort for preventing, identifying, or collecting delinquent employment taxes. Efforts were scattered throughout the various

functional areas of the agency with no central focus or assigned responsibility. Thus, IRS could not ensure that its resources were effectively allocated to address employment tax delinquencies.

Moreover, IRS had not developed all the information necessary to (1) target its efforts at employers most likely to be delinquent or (2) evaluate the effectiveness of its employment tax delinquency efforts. Our work indicates that, because of these conditions, IRS' efforts to prevent, identify, or collect employment tax delinquencies might not have been as effective as they could have been.

IRS had not done enough to prevent employment tax delinquencies. One reason is that IRS had insufficient information on the characteristics of delinquent taxpayers to determine the reasons for the delinquencies. Also, we found indications that one of IRS' two primary prevention programs—the Federal Tax Deposit (FTD) Alert Program—(1) was not targeted at those most likely to be delinquent, (2) produced numerous unproductive alerts, and (3) might not have had any significant effect on promoting employment tax compliance for the period the alert had been issued or subsequent periods.

Limited staff resources constrained the effectiveness of IRS' efforts to identify employment tax delinquencies through audit and information matching. This constraint also prevented IRS from investigating many of the leads and cases brought to its attention. In addition, the number of employment tax audits done by IRS' Examination function fell from 109,000 in 1979 to a low of about 24,000 in 1988 before rising to 42,000 in 1990.

Programs to collect employment tax delinquencies were not effective because they were generally untimely or used infrequently. For example, one collection program typically assessed taxpayers 2-1/2 years after the delinquency occurred, and another program was rarely used because, according to IRS officials, it was extremely labor-intensive and taxpayers who did not comply with the program's requirements were rarely prosecuted.

We believe IRS needs to develop a comprehensive plan to deal with employment tax delinquencies. This plan should designate an official to coordinate the activities of the various functional areas and develop the information needed to better target employment tax efforts and evaluate and improve effectiveness.

Background

Employers are generally required to file two types of employment tax returns. A quarterly return is required for the reporting of withheld income and social security taxes and the employer's share of social security taxes. An annual return is required for the reporting of the employer's unemployment taxes.

Employers are generally required to pay employment taxes periodically through the FTD system. The frequency of these deposits depends on the amount of taxes due and the frequency of the employer's payroll. Employment tax delinquencies occur when employers file returns but do not pay the required employment taxes, fail to file employment tax returns, or file incorrect employment tax returns showing taxes that are less than the amounts owed.

IRS has two primary employment tax delinquency prevention programs. These are the Small Business Tax Education and the FTD Alert programs. IRS identifies employment tax delinquencies through regular activities such as the processing of employment tax returns filed with a balance due the government but not paid. In addition to the regular processes, IRS has several other programs that identify employment tax delinquencies. These programs are the Employment Tax Adjustment Program (ETAP), which uses data from state audits; the Employment Tax Examination Program (ETEP), which uses leads from a variety of sources, including referrals from other IRS functions; and the Combined Annual Wage Reporting (CAWR) reconciliation program, which matches Social Security Administration (SSA) and IRS information.

Once IRS identifies a possible delinquency, it notifies the employer and specifies a period of time to pay the delinquent amount or explain why it is not owed. If the employer does not do this within the specified time period, IRS assesses the additional taxes and begins collection action.

IRS starts its collection process by sending employers a series of computerized balance due notices demanding payment. Delinquencies unresolved by the written notices are sent to IRS' Automated Collection System call sites for telephone contact with the taxpayer. If the telephone contact fails to resolve the delinquencies, they are sent to revenue officers in the field for personal contact. Enforced collection, through the seizure of a taxpayer's assets, can take place anytime after the written notices.

In addition to the normal collection process, IRS has several other procedures to collect delinquent employment taxes. These procedures are the

100-percent penalty, which allows IRS to assess the delinquency against both the business taxpayer and the individual officers responsible for not paying the taxes; monthly filing of tax returns; and special trust accounts for tax deposits. The latter two procedures allow IRS to take enforced collection actions faster and provide for criminal sanctions in the case of special trust accounts.

Objectives, Scope, and Methodology

The objectives of our review were to inventory and examine IRS' efforts to prevent, identify, and collect employment tax delinquencies and determine whether problems exist in IRS' overall strategy for addressing employment tax delinquencies. To inventory and examine IRS' programs, we reviewed IRS documents, including procedural manuals, studies, and policy statements and interviewed IRS officials. To determine whether problems existed in IRS' overall strategy, we (1) obtained available IRS information on each program, including the most recent statistical reports; (2) reviewed IRS internal audit reports and testimonies dealing with employment tax issues; (3) reviewed our prior reports and testimonies; and (4) interviewed officials from IRS.[1] We did not verify the accuracy of IRS statistical information or validate information in IRS studies and reports. Summaries of the programs we reviewed are included in appendixes I, II, and III.

Our work was done between October 1989 and November 1990 in accordance with generally accepted government auditing standards. We did our work at IRS' headquarters in Washington, D.C.; the IRS service center in Kansas City, Mo.; and IRS regional and district offices in Chicago. IRS officials generally agreed with the information presented, and their oral comments were incorporated in this report where appropriate.

Prevention Programs Are Not Effectively Targeted

At the time of our review, IRS had not done enough to develop and implement programs to prevent employment tax delinquencies. In addition, IRS had not developed the information necessary to (1) determine the reasons for employment tax delinquencies; (2) determine the specific characteristics of delinquent employers (e.g., size of business or length of time in operation); or (3) evaluate the effectiveness of its prevention efforts. Without this information, IRS could not effectively target its prevention programs.

[1]See the related GAO products section for a list of these reports.

We believe that some employers may be delinquent because they do not understand the deposit rules, and simplification would probably prevent some delinquencies. As we pointed out in our July 1990 report,[2] the complexity of the rules may be part of the reason that about one-third of the nation's employers are assessed at least one penalty annually for failure to comply with the deposit requirements. We made several recommendations that the Secretary of the Treasury simplify the rules. More recently, we testified on a proposed bill to simplify the payroll tax deposit system.[3] The proposed bill addressed many of the issues raised in our 1990 report. Despite the potentially large number of delinquencies caused by employers not understanding their employment tax responsibilities, IRS had made only limited efforts to educate employers.

At the time of our review, IRS had two primary prevention programs that addressed employment taxes—the FTD Alert and Small Business Tax Education programs. (See app. I for more details.)

FTD Alert Program

The FTD Alert Program, operated by IRS' Collection function, was designed to identify and prevent potential employment tax delinquencies by taxpayers who appear to have failed to make required deposits under the FTD system. Before the end of each quarter, IRS' computer identifies employers whose potential total tax liabilities meet a specified dollar criterion and who failed to deposit their taxes during the quarter. IRS then sends the employers computer-generated notices that request that they contact IRS to explain why the taxes have not been deposited. If an employer does not respond, an IRS revenue officer is expected to promptly contact the employer in an effort to prevent a delinquency from occurring.

On the basis of our examination and recent IRS studies, we believe this program has not had any significant effect on preventing employment tax delinquencies and does not efficiently utilize limited staff resources. The program (1) was not targeted at those most likely to be delinquent, (2) produced numerous nonproductive alerts, and (3) may have had no significant effect on promoting employment tax compliance for the period in which the alert was issued or subsequent periods.

[2]Tax Policy: Federal Tax Deposit Requirements Should be Simplified (GAO/GGD-90-102, July 31, 1990).

[3]Simplifying Payroll Tax Deposit Rules (GAO/T-GGD-91-59, July 24, 1991). This testimony was given before the Committee on Ways and Means, House of Representatives.

First, the program targeted only larger employers even though IRS data indicated that smaller employers account for the vast majority of businesses that owe employment taxes. For example, according to IRS data, approximately 96 percent of the 1.1 million employment tax delinquencies that occurred during fiscal year 1989 involved employers with liabilities less than the FTD Alert dollar criterion. Although it seems reasonable to pursue the larger dollar cases, selecting only the larger employers precluded the program from having an effect on the largest group of delinquents. In addition, our recent work on large dollar and federal agency accounts receivable showed that many of these accounts were in error and the taxpayers did not owe any taxes.[4]

IRS reviewed the effectiveness of the FTD Alert Program in 1982 and concluded that 60 percent of the alerts were nonproductive in that they did not identify delinquent taxpayers. According to IRS officials, many FTD alerts are still nonproductive. For example, Chicago district officials concluded, on the basis of the results of a limited study, that most alerts issued during the first quarter of 1990 did not identify businesses that had not made required deposits during the quarter.

Finally, IRS studies and our reports indicated that even when an alert had merit, it may not have had any significant effect in preventing delinquencies or promoting future compliance. The results of two studies conducted by IRS—a nationwide study completed in 1989 and another interim report on a regional study in 1990—showed that many employers subjected to a valid alert did not pay their taxes in the period of the alert. The national study also showed that the effect of the FTD Alert Program on subsequent taxpayer compliance behavior was not significant. The results from the regional study were inconclusive on future compliance. We reported similar results in our 1978 study of IRS' programs to collect taxes withheld by employers.[5]

Small Business Tax Education Program

The Small Business Tax Education Program, which is operated by the IRS Taxpayer Service function, attempts to prevent employment tax delinquencies through small business workshops and business tax courses that include discussions of employment taxes. In the early 1980s, IRS began conducting small business workshops, usually with the

[4]IRS Accounts Receivable Inventory (GAO/T-GGD-91-02, Oct. 18, 1990). This testimony was given before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives.

[5]IRS Can Improve Its Programs to Collect Taxes Withheld by Employers (GAO/GGD-78-14, Feb. 21, 1978).

Small Business Administration (SBA), for businesses that apply to IRS for employer identification numbers.[6] The voluntary workshops last about 4 hours and devote about 1 hour to SBA programs and the remaining time to business tax obligations, including employment tax responsibilities.

As of April 1990, IRS had about 1,300 partnerships with outside organizations nationwide to conduct the workshops. During fiscal year 1989, about 63,000 individuals attended the 2,200 sessions held. In contrast, there were over 5 million employers paying employment taxes in fiscal year 1989. IRS also began offering a business tax course cosponsored with educational institutions in 1988. The course was offered in nine parts, one of which covered employment taxes.

Finally, recognizing the limited efforts and the need to do more in educating employers, IRS' Research Division began several initiatives in 1990. These initiatives, although very limited in scope, include testing and measuring the effectiveness of (1) conducting monthly workshops to assist employers in preparing employment tax returns and (2) visiting new employers to explain and discuss their tax obligations.

Identification Programs Could Be More Effective

We found that programs designed to identify employment tax delinquencies suffered from limited staff resources, which prevented IRS from investigating many of the leads and cases brought to its attention. IRS had little management information to help measure the effectiveness of individual programs and prioritize identification efforts. Without such information, IRS could not ensure that its staff were allocated to the most productive programs. Programs designed to identify employment tax delinquencies included ETAP, ETEP, and CAWR. (See app. II for more details.)

ETAP

ETAP uses the results of state employment commission audits, in which agreements have been reached by the states with taxpayers for additional payments, to determine additional federal employment tax liabilities. ETAP was implemented in 1986. At the end of fiscal year 1990, 8 of the 10 IRS service centers and 31 of the 50 states were participating in the program. According to IRS, the remaining two service centers will join in fiscal year 1991.

[6]IRS uses employer identification numbers as a means of identifying business taxpayers. Each employer is required to obtain a number and use it on all business tax returns.

During fiscal year 1990, IRS expended about 7 of the 31 staff years budgeted for the program. Service center officials allocated the remaining 24 staff years to other programs. At that time, the program produced about $7.8 million in assessments and about $3 million in collections. These collections, however, represented only the amount collected within 6 months after assessment. Thereafter, IRS did not specifically identify cases as ETAP and, therefore, could not determine the effectiveness of ETAP in terms of total dollars collected versus staff years expended or dollars assessed.

Although complete information was not available to determine the cost effectiveness of ETAP compared to other programs, the program—unlike the CAWR and the FTD Alert programs—did not appear to be plagued with unproductive leads. Most leads were valid since they were based on the results of state audits that had already determined that the taxpayer owed employment taxes.

The ETAP coordinator in the Kansas City Service Center estimated that about 40 percent of the service center's ETAP cases involved employers that should have, but had not, filed employment tax returns with IRS. Identifying nonfilers could not only increase the collection of past delinquencies but might also result in enhanced voluntary compliance in succeeding years and, thereby, increase additional future revenue for IRS.

Although the Kansas City Service Center identified a number of nonfilers, others were probably not being detected because the service center did not determine whether the employer was a nonfiler for every case they received from the states. The service center discarded cases when the collection potential fell below a specified dollar criterion because staff resources were insufficient to work every ETAP case. Although this process may have been necessary, these cases were discarded without first determining whether the employer was a nonfiler. As a result, IRS lost the opportunity to get additional nonfilers into its system.

ETEP

ETEP is split between the two IRS functional areas of Collection and Examination. The Collection-based ETEP identifies small employers who misclassify employees as independent contractors. The Examination-based ETEP identifies larger employers who misclassify employees, employment tax return underreporters, and nonfilers of all sizes.

IRS has historically relied on Examination to do employment tax examinations, but over the years IRS has sharply reduced the staff resources applied even though the revenue yields per staff year for fiscal year 1990 were similar to those for income tax audits. The number of employment tax returns examined dropped from about 109,000 in 1979 to a low of about 24,000 in 1988 before rising to 42,000 in 1990.

According to IRS National Office officials, the decline occurred because of restrictions on IRS' authority to correct all misclassifications due to section 530 of the Revenue Act of 1978.[7] However, a national IRS study showed that only $146 million, or about 8 percent, of the estimated $1.9 billion in tax revenue lost due to misclassification for 1989 was directly attributable to section 530. In fiscal year 1990, IRS examined over 42,000 employment tax returns and proposed assessments of about $210 million. At the time of our review, IRS had no formula or criteria, other than dollar collection potential, to target employment tax audits to cases with greatest noncompliance potential. (IRS did have additional criteria for income tax examinations.)

In 1988, Collection instituted a nationwide employment tax examination program, which was to generally focus on employers whose assets were $3 million or less. For fiscal year 1989, 320 staff years were allocated to the program, but only 275 were used because local IRS management determined that needs were greater in other areas. Projected staff years for fiscal year 1990 decreased to 254. During fiscal year 1989, the program resulted in over 76,000 workers being reclassified, over 1,600 examinations, and $94 million in proposed assessments.

The resources applied to ETEP in both Examination and Collection sharply limited the number of cases examined. For example, in the Chicago district ETEP collection unit only about 120 of the estimated 3,000 leads were examined during fiscal year 1989. Also, according to a Chicago district official, the ETEP examination unit was able to examine only about one-half of the estimated 250 cases it received during fiscal year 1989, due to higher priority work and a lack of resources. Nationwide information was not readily available to determine whether this situation was a service-wide problem.

[7]Section 530 of the Revenue Act of 1978 protects employers who had a "reasonable basis" for classifying their workers as independent contractors.

While the ETEP reporting systems for both Collection and Examination provided IRS with some information to manage the programs, the systems fell short in providing measurements of the programs' effectiveness. For example, like other IRS examination programs, the systems did not track ETEP assessments through eventual collection or other resolution.

IRS generally had not been using all available information to identify employment tax delinquents. For example, in September 1989, we reported that IRS could use information returns on payments made to individuals as part of a systematic method for identifying and targeting delinquent employers who misclassified workers.[8] Our review showed that about 38 percent of the leads identified employers who misclassified workers. According to IRS officials, since we completed our work, IRS has implemented procedures to use information returns to identify delinquent employers.

CAWR

The CAWR reconciliation program is designed to reconcile information on wage and tax statements filed with SSA with information provided on various employment tax returns filed with IRS. The reconciliation is done to identify possible underreporters of employment taxes and nonfilers of employment tax returns. This program generally did not identify employment tax delinquencies until at least a year after the delinquency occurred. In addition, as many as one-half of the identified dollar delinquencies were not real; rather, they were the result of erroneous data in IRS' or SSA's records.

According to program data obtained and reported in our prior review of the CAWR program,[9] almost $1.4 billion, or about 52 percent, of the $2.7 billion in CAWR assessments made from 1981 to 1984 were abated. After abatements, there remained over $1.3 billion of net assessments, of which IRS had collected almost $500 million as of September 1987. Because CAWR program data were not readily available, we were unable to update these amounts. However, according to IRS officials, the program continued to have large dollar abatements at the time of our review. IRS is in the process of developing a report to track the outcome

[8]Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989).

[9]Tax Administration: IRS' Combined Annual Wage Reporting Reconciliation Program (GAO/GGD-89-21, Dec. 14, 1988).

of CAWR investigations. Information from this report was not available at the time of our review.

Most Programs Designed for Collecting Delinquent Employment Taxes Are Rarely Used

In addition to the normal collection process, IRS has several efforts specifically designed to collect employment tax delinquencies—monthly filing, special trust accounts, and 100-percent penalties. These programs, however, were infrequently used or were not timely. Also, like the prevention and identification efforts, IRS had not developed mechanisms to periodically measure the effectiveness of its collection efforts. (See app. III for more details.)

Monthly Filing and Special Accounts

Monthly filing and special account provisions are additional enforcement tools to collect taxes from delinquent employers. If an employer is delinquent, IRS can require the employer to file an employment tax return monthly rather than quarterly. IRS also has the authority to require the employer to deposit withheld employment taxes in a special bank account in trust for the government within 2 banking days after the taxes are withheld. If an employer does not comply with the special deposit requirements, IRS can recommend imposing criminal sanctions. These sanctions make failure to deposit in the special account a misdemeanor punishable by fines of not more than $5,000 plus the cost of prosecution and/or imprisonment of not more than 1 year.

IRS officials we interviewed could not provide any national statistics on the use of monthly filing and agreed that IRS rarely used it because it was labor intensive and generally produced few results. In the Chicago district, which has 22 collection groups, officials told us that only 2 groups were using monthly filing at the time of our review. One group had 1 monthly filer and another had 24, of which 17 were subsidiaries of one corporation.

Although IRS could have proceeded with stronger collection action through the use of special deposit requirements, it rarely did so. IRS used special deposit requirements primarily when criminal prosecution was intended. According to IRS officials, IRS rarely used special deposit requirements because U.S. Attorneys accept very few cases for prosecution. For example, Chicago district office officials were not aware of any current use of special deposit requirements. They told us they had not referred cases to IRS' Criminal Investigation Division, which in turn refers cases to the U.S. Attorney, in several years. Although nationwide

statistics were not available, IRS headquarters officials confirmed that the programs were rarely used and stated that past experience with the courts and U.S. attorneys have discouraged their use.

100-Percent Penalty Program

This program gives IRS the authority to assess responsible individuals who willfully fail to collect and/or pay withheld taxes to the federal government. Although called a penalty, it is not an amount added to the unpaid tax. Rather, it is a means for assessing the individuals who were responsible for paying the withheld taxes on behalf of the business.

IRS collected less than 10 percent of the $2.1 billion assessed under the program in 1988.[10] Two IRS studies—done in 1988 and 1989—found that the program had not been an effective collection tool because the assessments were made too late. According to the studies, IRS typically assessed the 100-percent penalty 2-1/2 years after the due date of the first delinquent employment tax return.

To increase collection and improve employer compliance, according to one study, IRS must address the business liability and consider penalty assessments much earlier. Collection's experience, the report stated, is that delays make it more difficult to identify responsible persons and could allow taxpayers time to divest personal assets.

According to an IRS official, the effectiveness of the 100-Percent Penalty Program is also hampered by the type of business that is most likely assessed the penalty. The penalty could be effective if there were any personal assets left by the time it is assessed against the responsible individuals. However, according to this official, most of the corporations that comprise 100-percent penalty cases are small "mom and pop" type businesses. The owners of these businesses typically had invested most of their personal assets in the business, and, when the business had cash problems, so did the owners. It must be acknowledged, however, that the 100-percent penalty may also serve as a prevention tool, deterring business officers from becoming delinquent.

[10]IRS can assess more than one individual a 100-percent penalty for the same business delinquency, but it is IRS' policy not to collect more than the business delinquency. Therefore, total collections of more than the liability should not be expected. IRS does not maintain information on the amounts of multiple assessments. In our report Tax Administration: IRS Can Improve the Process for Collecting 100-Percent Penalties (GAO/GGD-89-94, Aug. 21, 1989), we reported that in a sample of 100-percent penalty cases a little over twice the business liabilities were assessed in 100-percent penalties.

IRS Needs a Comprehensive Strategy to Deal With Employment Tax Delinquencies

We found that IRS lacked a coordinated Service-wide approach to address employment tax delinquencies. To develop such an approach, IRS would need information about (1) the characteristics of employment tax delinquencies and (2) the effectiveness of its current programs and procedures used to address them. At the time of our review, for example, IRS did not know the types of assessments or programs giving rise to employment tax delinquencies, nor did it have sufficient information on such key taxpayer characteristics as size of the business, length of time in operation, or industry type to understand the cause of the delinquencies. In addition, as previously stated, IRS did not know the relative cost effectiveness of its various employment tax programs and procedures. Because this type of basic management information was not readily available, IRS could not ensure that it had targeted its programs and allocated its resources effectively.

IRS did not focus on all functions giving rise to assessments for employment tax delinquencies; instead, it relied primarily on Collection to ultimately resolve the delinquencies. (Delinquencies at the collection stage represent the end result of cases that may have gone through many other IRS functions such as Taxpayer Service, Returns Processing, Criminal Investigation, Examination, and Appeals.) In this regard, IRS had not designated an official to (1) coordinate and oversee the activities of the various functional areas and (2) develop the information needed to better target employment tax efforts and evaluate and improve effectiveness.

IRS lacked the information necessary to ensure that all involved functions were coordinated to address the employment tax problem. For example, our recent work on federal agency employment tax delinquencies showed that most of the reported delinquencies were in error.[11] While we were unable to determine who made the error in most cases, we did find that actions by Returns Processing in applying and transferring payments to various tax periods compounded the problems. Because IRS did not have readily available information to determine system problems, it was unable to determine what corrective action could be taken by Returns Processing to eliminate some of the invalid delinquencies before they reached the collection stage.

As discussed earlier in this report, IRS also lacked information on the relative cost effectiveness of its various identification programs carried

[11] IRS Accounts Receivable Inventory (GAO/T-GGD-91-02, Oct. 18, 1990). This testimony was given before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives.

out by Collection and Examination. Thus, it could not determine the most effective allocation of staff resources between these programs. In addition, IRS did not know the extent to which employment tax delinquencies were caused by such issues as the misclassification of employees, the underreporting of employment taxes, the complexity of the deposit requirements, and the inability of businesses to pay the required taxes. Such information would have helped determine what types of programs or procedures needed to be emphasized more than others.

Conclusions

Employment tax delinquencies, particularly the nonpayment of withheld taxes, pose problems for IRS that require special attention. Because of this, we believe it is important that IRS establish a comprehensive plan that coordinates the efforts of the various IRS functions to resolve employer delinquencies. Prevention of delinquencies is critical. Simplifying deposit requirements, better educating employers, and targeting programs to employers most likely to be delinquent are issues that need to be explored to prevent delinquencies. These issues should be addressed by all IRS functional offices.

Identifying and collecting employment tax delinquencies are also key to an overall comprehensive approach. But IRS had not developed the management information it needed to measure the effectiveness of these programs or determine if they could be improved. Our review indicated that two identification programs—ETAP and ETEP—could be more effective if more staff resources were applied while another—CAWR—appears to be wasting valuable staff resources on unproductive cases. IRS' collection tools specifically designed for employment tax delinquencies were rarely used or were not timely. Also, little had been done to determine whether these tools could be used in a more efficient and effective manner.

One issue we noted during our review was the need for better information to measure the relative cost-effectiveness of IRS employment tax programs. Little can be done to improve the programs without the factual data needed to measure their effectiveness. Another issue that surfaced continually during our review was the lack of staff resources to fully use existing programs. However, without the information on the cost-effectiveness of individual programs, we do not know how much of the existing resources could be directed to more effective programs.

Although additional staff resources could help, new and improved program operations, particularly in the prevention area, may also be necessary to reduce employment tax delinquencies.

Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner of Internal Revenue develop a comprehensive plan to prevent, identify, and collect employment tax delinquencies. The plan should coordinate efforts among all IRS functions. The Commissioner should designate an official to oversee execution of the plan and the various programs involved. The plan should include development of the information necessary to (1) define the characteristics of employers who are delinquent in paying employment taxes and (2) measure the effectiveness of IRS' programs to prevent, identify, and collect employment tax delinquencies. Specifically, the plan should address how IRS will find answers for the following questions raised in our review:

- What are the major characteristics of employment tax delinquents and the reasons for delinquencies? What prevention programs are needed to deal with them?
- What specific changes are needed to improve the effectiveness of the FTD Alert Program?
- What is the reason for the large number of unproductive cases generated through the CAWR program, and how can this program be made more effective?
- Are the employment tax adjustment and examination programs more effective than other employment tax identification programs and, if so, how should resources be reallocated to take advantage of this?
- How can IRS improve the timeliness and effectiveness of its monthly filing, special trust accounts, and 100-percent penalty procedures to more effectively resolve employment tax delinquencies?
- If the current procedures and programs are not effective and cannot be improved, what alternatives are needed?

Agency Comments

IRS reviewed a draft of this report and provided informal oral comments. We revised the report as appropriate to address these comments. IRS agreed with our presentation of the employment tax delinquency problem and the need to increase prevention efforts and to more quickly resolve employment tax delinquencies. IRS provided us with additional information on the FTD Alert and CAWR programs, which we incorporated in the report. IRS did not comment on our recommendation.

As arranged with the Subcommittee, we are sending copies of this report to the Commissioner of Internal Revenue and other interested parties. We will make copies available to others upon request.

The major contributors to this report are listed in appendix IV. If you have any questions about this report, please call me at (202) 272-7904.

Sincerely yours,

Paul L. Posner
Associate Director, Tax Policy and
Administration Issues

Contents

Abbreviations

CAWR	Combined Annual Wage Reporting
ETAP	Employment Tax Adjustment Program
ETEP	Employment Tax Examination Program
FTD	federal tax deposit
IRS	Internal Revenue Service
SBA	Small Business Administration
SSA	Social Security Administration

Prevention Programs

IRS has two primary employment tax delinquency prevention efforts that address employment taxes. These are the Small Business Tax Education Program, which educates taxpayers on employment tax requirements, and the Federal Tax Deposit (FTD) Alert Program, which was designed to stop potential employment tax delinquencies from occurring. The programs are discussed in detail below.

Small Business Tax Education Program

IRS offers assistance to employers on all tax matters through its taxpayer service activities. These activities include (1) walk-in service where taxpayers can visit an IRS office and receive assistance with their returns; (2) toll-free telephone service that allows taxpayers to call and receive answers to specific tax questions or information on specific tax topics; and (3) Small Business Tax Education Program, which educates taxpayers on specific tax topics.

However, of the programs offered, only the Small Business Tax Education Program provides tax assistance directed specifically at businesses. This program attempts to prevent employment tax and income tax delinquencies by offering tax workshops and in-depth courses to small businesses. During fiscal year 1989, IRS spent about 32 staff years on this program.

IRS started the small business tax workshop—which is part of the Small Business Tax Education Program—in the early 1980s. The workshop, which was usually cosponsored by the Small Business Administration (SBA), typically lasted about 4 hours. In Chicago, we found that about 1 hour of the workshop was devoted to SBA programs and the remaining time to business tax obligations, including employment taxes. At the time of our review, IRS was informing businesses about this free workshop in a brochure sent to the businesses when they received their employer identification numbers. If interested, a business had to return a card for further information. The workshops were also announced on the radio and in newspapers.

As of April 1990, IRS had established about 1,300 partnerships nationwide with outside organizations to conduct the workshops. According to IRS statistics, 2,200 sessions were held during fiscal year 1989, and attendance increased from 50,000 in 1986 to about 63,000 in 1989. During fiscal year 1990, 819 individuals attended the Chicago sessions.

Beginning in 1988, IRS supplemented the workshop with a business tax course cosponsored with interested educational institutions and agencies. The course was offered in nine parts, each lasting about 3 hours. One part covered employment taxes. According to a Chicago district official, the employment tax part was the second most popular part of the course. (The record keeping part was the most popular.) Notification of this course was also made on the radio and in newspapers. According to a district official, course attendance has been lower than expected.

In addition to these efforts, IRS' Research Division began several initiatives in 1990 to better assist small businesses in meeting their tax obligations. These initiatives included a number of actions that were to test and measure the effectiveness of a variety of educational services. Some of the initiatives planned or ongoing included (1) surveying new small businesses to obtain information to help plan a tax education program, (2) issuing a monthly newsletter on basic tax issues to new businesses for a 1-year period, (3) conducting monthly workshops to assist employers in preparing employment tax returns, and (4) visiting new employers to explain and discuss their tax obligations.

FTD Alert Program

The FTD Alert Program, which began in 1972, enables IRS to identify under- and nondepositors of employment taxes and promptly contact them in an attempt to bring them into compliance with the deposit requirements. IRS considers the program a valuable tool to prevent employment tax delinquencies from accumulating. During the 10th week of every quarter, IRS' national computer center generates FTD alerts on employers with a probable tax liability meeting a specified dollar criterion who fail to make deposits during the current quarter or make them in a substantially reduced amount.

IRS data for the first quarter of 1989 showed that approximately 4.5 million, or about 85 percent, of the employers with employment tax liabilities did not meet the FTD Alert dollar criterion. IRS data also indicated that approximately 1 million, or about 96 percent, of employment tax delinquencies involved employers with tax liabilities less than the FTD Alert dollar criterion.

Approximately 2 weeks after alerts are generated, IRS' service centers are to send alert notices to employers. The notices request the employer to contact an IRS district collection office either in writing or by telephone within 10 days of the notice date. If the employer responds and is in full compliance with the deposit requirements, the alert is to be

closed. If the employer does not respond or is not in full compliance, IRS is to initiate further action.

Prior to June 1989, collection branches in IRS service centers were to retain the alerts for 3 weeks awaiting taxpayer response. The service centers processed responses to the alert notices and forwarded to the district office those that could not be closed through correspondence. Revenue officers in the district offices were required to act on the alerts as soon as possible, and if contact was delayed for more than 15 calendar days, the reason for the delay was to be noted in the taxpayer's file.

Beginning in June 1989, the service centers stopped processing responses to the alert notices and started sending the alerts to the district for resolution. The change in the process resulted from a service center steering committee recommendation to eliminate service center involvement in FTD Alert correspondence. On the basis of its evaluation of the process, the committee concluded that alerts were worked most effectively when revenue officers made timely personal contact. Service center involvement, the committee found, resulted in minimal or no time for revenue officers to pursue alerts before the return was due.

As of November 1990, FTD Alert procedures had not been updated to reflect the above changes; therefore, the specific procedures or time frames for following up on alerts at the district office had not been set. IRS' National Office issued a memo in May 1989 providing general guidance to the regions and districts on the revised process; however, the memo did not discuss time frames.

According to a National Office official, alerts should be high priority, but districts have discretion in prioritizing their work load. Therefore, the districts may not always give alerts a high priority. The district's decision on processing alerts, according to the official, generally depends on the availability of staff at the district.

A National Office official told us that the program is effective at identifying and resolving entity information problems. However, the official added that this is not the intent of the program, nor is it the most cost-efficient way to address such problems.

IRS did not have a centralized management information system to monitor the results of the FTD Alert Program. However, studies by IRS and us indicated that even when the alert did identify a potential employment

tax delinquency, IRS had very little success in preventing the delinquency. As a part of our 1978 review of IRS' collection efforts,[1] we reviewed alerts in one district and found that a significant number of employers identified as potential delinquents subsequently became delinquent for the period the alert was issued and also did not comply in the succeeding quarter. IRS reviewed the effectiveness of the FTD Alert Program in 1982 and concluded that 60 percent of the alerts were nonproductive.

Similarly, an IRS study issued in 1989 found that the FTD Alert Program did not result in collection of significantly more employment taxes. The study, however, did not discuss why the program was ineffective, nor did it recommend what should be done.

[1]IRS Can Improve Its Programs to Collect Taxes Withheld by Employers (GAO/GGD-78-14, Feb. 21, 1978).

Identification Programs

Some businesses do not voluntarily file their employment tax returns or do not accurately report their employment tax liabilities. IRS has several programs to identify these businesses. These programs—Employment Tax Adjustment Program (ETAP), Employment Tax Examination Program (ETEP), and Combined Annual Wage Reporting (CAWR)—are discussed in detail below.

ETAP

ETAP is designed to identify cases involving employers that misclassify employees as independent contractors. The program is nonlabor intensive because it is automated and uses state unemployment tax audits as the basis for tax adjustments.

IRS negotiates with state employment commissions to obtain the results of their unemployment tax audits. IRS processes audit information received from the states to determine if employers owe additional federal taxes. At the end of fiscal year 1990, 8 of IRS' 10 service centers participated in ETAP. At the time of our review, officials stated that IRS plans to start ETAP at the other two service centers in fiscal year 1991. At the end of fiscal year 1990, IRS had agreements with 31 states to receive state unemployment tax audits.

During fiscal year 1990, ETAP expended about 7 staff years (rather than the 31 staff years it had been budgeted). According to the program's coordinator, service center officials have discretion in assigning staff years budgeted to the service centers by the National Office. As a result, although the National Office budgeted 31 staff years for ETAP, service center officials decided to assign only about 7 to ETAP and the remaining 24 staff years to other programs. However, a memo from the Assistant Commissioner (Collection) to other IRS officials in August 1990 stated that IRS strongly supported ETAP even though resources were tight and that IRS had made a commitment to Congress to expand its participation in employment tax examinations in the coming years.

At IRS' Kansas City Service Center, collection branch staff work ETAP cases. Generally, on a monthly basis, states provide the service center with audit information, but only after the states have reached agreements with employers for additional payments. According to the ETAP coordinator, the service center did not work every case that it received from the states. Therefore, the center discarded cases with potential audit adjustments that would have resulted in less than a certain amount of additional tax owed. In addition, the program coordinator said that cases involving taxpayers whose returns are already under

examination within IRS are forwarded to the appropriate district examination division, and those involving potentially large wage adjustments are forwarded to the appropriate district collection division. The branch worked the remaining cases and any that could not be worked by the district collection division because of excessive work load.

The program coordinator estimated that about 40 percent of the cases involve employers that have not filed employment tax returns. For these cases, IRS prepared the return under its Substitute for Return Program.[1]

Under ETAP, IRS is to send a letter to the taxpayer proposing the adjustment and requesting a reply within 30 days. If the taxpayer responds with adequate documentation showing that no tax is owed or with the amount due, the case is to be closed. If the taxpayer does not respond in 30 days, IRS is to wait an additional 30 days before taking action. IRS is to then assess the additional tax due, and the case would then proceed through the same collection process as other delinquent accounts.

IRS officials believed ETAP has been cost effective. On the basis of IRS estimates for fiscal year 1990, ETAP assessed about $7.8 million and collected about $3 million. According to one official, the potential exists for IRS to significantly increase collections if (1) IRS fully implements the program, (2) all states participate, and (3) taxpayers continue to comply in subsequent tax years. However, the official could not provide actual results to support these statements.

ETEP - Collection Based

The purpose of ETEP is also to identify employers who misclassify employees as independent contractors. It was implemented nationwide in 1988. The Collection ETEP focuses on small businesses (assets of $3 million or less)—the group with the highest level of noncompliance in the employment tax area, according to IRS' research.

Collection staff in district offices are responsible for administering ETEP. For fiscal year 1989, 320 staff years were allocated to the program, and 275 were used. Projected staff years for fiscal year 1990 decreased to 254. The cut in resources, National Office officials said, was due to a hiring freeze and the need to have revenue officers do more traditional collection work such as collecting known delinquent accounts. In addition, officials were not optimistic that the program will receive any

[1]This program allows IRS to prepare tax returns using available data and assess taxes for those individuals and businesses that do not file returns.

additional resources in the near future. In contrast, despite the cut in resources nationwide, the Midwest Regional Office increased staff years for ETEP in fiscal year 1989 from 30 to 41. According to one Midwest Region official, regional management is committed to the program because of the program's positive results on employer compliance.

ETEP cases are based on leads from a variety of sources, including revenue officers, taxpayers, IRS' automated collection branch staff, IRS' taxpayer service referrals, other federal agencies, and state agencies. The most productive leads, according to one Chicago district office official, came from IRS sources and the Illinois Department of Employment Security. According to the official, these sources provided enough leads so that revenue officers did not have to develop their own. In Chicago, the inventory of leads was about 3,000 at the time of our review.

IRS' National Office had provided some guidance to districts on prioritizing leads based on nationwide information, such as industries most likely to misclassify employees. For the most part, however, districts relied on local criteria to rank the leads. For example, Chicago had a computer program to score leads based on industry type, number of workers, and amount of annual wages paid to workers.

Revenue officers are to evaluate the leads and, if indications of noncompliance are found, open an examination case. If not, the lead is to be rejected. If, as a result of the examination, a determination is made that the employer misclassified employees, the revenue officer should propose an assessment. A letter is to be sent informing the employer of the proposed assessment and requesting a reply within 30 days. If the employer agrees with the assessment and pays, the service center would then process the payment. If the employer does not pay or does not respond, the service center is to make the assessment and the case should be processed through the standard collection process.

IRS officials said the Collection ETEP was effective, for the resources invested, in identifying and assessing employment taxes against employers who misclassified their employees as independent contractors. During fiscal year 1989, national program results showed that 76,761 workers had been reclassified; 1,684 examinations had been completed; and $94 million of assessments had been proposed. However, the ETEP management information system did not allow IRS to evaluate the effectiveness of the program in terms of dollars collected from actual assessments. National Office officials said a new system to track a case

through the collection process from examination to collection or other resolution is scheduled to begin operation in 1991.

The consensus of IRS officials we interviewed was that ETEP could be more effective in identifying employers who misclassify employees and in assessing taxes against those employers if additional resources were allocated to the program. In addition, according to IRS officials, section 530 of the Revenue Act of 1978, which provides relief to employers who had a "reasonable basis" for classifying their workers as independent contractors, hinders IRS' effectiveness in collecting from employment tax delinquents.

However, according to a March 1990 IRS report, only $146 million of the estimated $1.9 billion of total tax lost due to misclassification was directly attributable to section 530. We addressed the section 530 issue in a report on the use of information returns as a means of identifying employers who misclassify workers.[2] In the report, we recommended that Congress consider repealing the part of section 530 that precludes prospective reclassification.

ETEP - Examination Based

The examination ETEP identifies underreporters and nonfilers of employment tax returns. IRS sharply reduced its efforts to examine employment tax returns because of problems caused by the temporary enactment of section 530 of the Revenue Act of 1978. When section 530 was extended indefinitely in 1982, Examination's efforts gradually began to increase.

Employment tax examinations result from two processes—package audits and regular employment tax examinations. Various groups within the Examination Division are responsible for conducting the examinations.

Package audits commence with the audit of individual and corporate income tax returns, including an inspection of any required employment tax returns to determine if an employment tax examination is warranted. According to the procedures for package audits, employment tax examinations should be conducted if the potential additional tax owed or the resulting improvement in voluntary compliance justifies the resources required.

[2]Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989).

Regular employment tax examinations start with leads from various sources, including informants, other federal agencies, state agencies, and other IRS units. According to an IRS Chicago district official, IRS had no standard procedures, however, for selecting the most productive leads to work. The Chicago district selects leads with the largest potential tax due. The district was also beginning to test a more systematic process for identifying potential employment tax examination cases; the system will involve the use of information returns, according to the district official. As of December 1990, test results were not complete.

Although IRS has a management information system to monitor audits done by Examination, the system did not track the outcome of proposed or actual assessments. As a result, IRS did not know how much revenue it collected from Examination ETEP. In fiscal year 1990, revenue agents examined 42,207 returns nationwide and proposed assessments totaling $210 million.

According to a Chicago district official, ETEP has been successful, but the program could have accomplished more if it was not hampered by insufficient resources. The Chicago district ETEP examination unit, for example, received about 250 leads during fiscal year 1989 but was able to work only half of the leads due to higher priority work and a lack of resources. Resource problems, the official indicated, are the result of higher priority work, a high turnover of revenue agents caused by dissatisfaction with the low pay structure, and a shortage of computers.

Our examination of Service-wide statistics related to Examination's work load showed that agents had expended less time on employment tax examinations than on individual and corporate income tax examinations, even though the employment tax examinations appeared to be at least as productive as the other types of examinations. For example, during fiscal year 1990, agents spent only 140 staff years on employment tax examinations nationwide; these examinations yielded $752 per hour in proposed assessments on closed examinations. In comparison, agents spent 1,513 and 2,183 staff years on corporate and individual income tax examinations that yielded $789 and $556 per hour, respectively.

CAWR

The CAWR program was established in 1980 to ensure that employers submit correct wage and tax withholding information to both SSA and IRS so that (1) employees' social security accounts can be properly credited

and (2) proper income and employment tax withholdings can be collected from employers. The program reconciles wage and tax statements and related transmittals filed with SSA to various employment tax returns filed with the IRS. The reconciliation provides IRS information to identify underreporters and nonfilers of employment tax returns.

The CAWR process begins when IRS receives the prior year's wage and tax statements from SSA, generally in August or September of the current year. Between that time and the end of February, IRS' computer is to compare SSA data to IRS data and identify cases with discrepancies. Starting in March and continuing through the following February, at least 1 to almost 2 years after the tax year ends, staff in IRS' 10 service centers are to begin resolving cases with discrepancies. Staff are to research cases to determine if they can be resolved by IRS. If staff cannot resolve a case, a notice is to be sent to the employer advising the employer of the discrepancy and requesting an explanation. If the employer responds with adequate documentation showing no amount due or with the appropriate amount due, the case is to be closed. If the employer does not respond satisfactorily, the taxes are to be assessed and standard collection action should commence.

According to IRS procedures, the service center is to assess the tax if the employer does not respond in 45 days. However, Kansas City Service Center staff said that, due to other work priorities, they hold "no-response" cases for up to 5 months before assessing the tax. National Office officials were not surprised that the service center waits longer than the 45 days to act on "no-response" cases. Because of the discretion service centers have in working cases, according to National Office officials, it is likely that other service centers are also waiting beyond the 45-day requirement.

As of December 1990, IRS did not have a management information system to evaluate the effectiveness of the CAWR program. IRS planned to implement a system at the service centers to track the progress of CAWR cases. However, National Office officials did not know whether the system would track cases through the collection phase. In addition, they did not know the type of management information reports that would be available to determine the results of the CAWR program.

Program data obtained and reported in a prior GAO review of the CAWR program showed that almost $1.4 billion, or about 52 percent, of the

$2.7 billion in CAWR assessments made from 1981 to 1984, were abated.[3] After abatements, there remained over $1.3 billion of net assessments, of which IRS had collected almost $500 million as of September 1987. Because CAWR program data were not readily available, we were unable to update this data. According to IRS officials, however, about half of CAWR assessments continue to be abated. Moreover, they believed these abatements result primarily from erroneous assessments caused by inaccurate SSA data and/or IRS entity data.

[3]Tax Administration: IRS' Combined Annual Wage Reporting Reconciliation Program (GAO/GGD-89-21, Dec. 14, 1988).

Collection Programs

Congress and IRS, recognizing the special nature of withheld employment taxes and the special problems their nonpayment pose, have enacted or established several specific tools to help collect delinquent employment taxes. These special programs include monthly filing, special accounts, and the 100-percent penalty. These programs are discussed in detail below.

Monthly Filing and Special Accounts

Monthly filing and special account provisions give IRS the authority to impose stronger and quicker collection action against delinquents. If an employer's taxes are not paid by the time its quarterly tax return is due, the employer is delinquent. If the employer is delinquent, one enforcement action IRS can take is to require the employer to file its return monthly rather than quarterly. IRS also has the authority to require delinquent employers to deposit withheld employment taxes in a separate bank account within 2 banking days after the taxes are collected. Finally, if the employer does not comply with the above actions, IRS can recommend that the Department of Justice prosecute the employer by seeking the imposition of criminal sanctions. These sanctions make failure to deposit in the special account a misdemeanor punishable by fines of not more than $5,000 and/or imprisonment of not more than 1 year, along with the costs of prosecution.

Generally, IRS is to consider proceeding with monthly filing and special account provisions only after other collection measures have been exhausted. To begin monthly filing or special account proceedings, IRS is to send a warning letter explaining monthly filing and special accounts to the delinquent employer. If the employer remains delinquent for at least 2 more quarters and/or the amount of the delinquency exceeds a certain dollar criteria, IRS can proceed. The decision to use monthly filing remains with the revenue officer pending management approval while special account provisions require IRS' Criminal Investigation Division's approval.

If either program is used, the revenue officer is responsible for monitoring the employer for compliance. The revenue officer monitors the employer's compliance with monthly filing by manually recording when the monthly returns were received and federal tax deposits made to the employer's bank. If the employer complies, the revenue officer is to retain the returns until all returns for the calendar quarter are received and then prepare a composite return for processing. Generally, the employer remains on monthly filing for 6 months; however, the revenue officer has the discretion to determine if a longer period is appropriate.

To monitor employer compliance with the special account provisions, the revenue officer manually tracks the employer's compliance. To accomplish this, the revenue officer verifies and records that the special account was opened, trust funds deposited were in the correct amounts, and amounts were deposited within the required time frames. The revenue officer continues to monitor the employer at least monthly to ensure compliance with these requirements.

If the employer continues to comply with the requirements for a reasonable period of time, it will no longer be required to file monthly or deposit under the special account provisions. On the other hand, if the employer fails to comply with special account provisions, IRS can recommend prosecution of the employer by seeking the imposition of criminal sanctions. The revenue officer prepares the case for referral to IRS' Criminal Investigation unit. This unit is responsible for investigating the case to determine its potential for prosecution by the Department of Justice. According to officials, every district has different informal criteria, developed by Collection, Criminal Investigation, and Department of Justice officials, for referring cases.

IRS did not have a management information system to track monthly filing or special account provisions. However, IRS officials indicated that IRS uses the programs very little, but added this could vary among districts. According to IRS National Office officials, information is not collected at the national level because the number of cases subjected to these programs is relatively small. A Chicago district official told us that only 2 of its 22 collection groups were using the monthly filing program, and as of May 1990 there were 25 monthly filing cases. One group had 24 of the cases, of which 17 were subsidiaries of one corporation. In addition, officials were not aware of any current use of special deposit requirements. They told us they had not referred cases to IRS' Criminal Investigation Division in several years.

IRS officials believed that monthly filing and special account provisions are rarely used because they are extremely labor intensive, and U.S. Attorneys rarely accept special deposit cases for prosecution. Revenue officers generally preferred not to use the programs because the processes are manual, time consuming, and not very productive in generating revenue. In addition, Criminal Investigation was not interested in pursuing employment tax cases because of the Department of Justice's lack of interest in these types of cases. Thus, according to officials, the revenue officer's time is better spent on other, more productive work.

One official in the Chicago district believed otherwise about monthly filing. The official agreed that the process is labor intensive and cases progressing beyond monthly filing and special account provisions will generally not be prosecuted. However, based on his experience with monthly filing, he believed the program is still worthwhile for IRS to pursue because of the positive effect it has had on deterring noncompliance with employment tax requirements. In addition, an IRS study found that 60 percent of employers placed under monthly filing or special accounts requirements complied with them.

100-Percent Penalty

The Internal Revenue Code gives IRS the authority to assess a 100-percent penalty against responsible individuals who willfully fail to collect and/or pay withheld taxes to the federal government. Although called a penalty, it is not a penalty in addition to the unpaid tax. It is essentially a means for assessing the individuals who were responsible for paying the tax on behalf of the business. While the penalty can be assessed in full against more than one responsible individual, it is IRS' policy to collect the amount of tax plus interest only once. It is also IRS' policy to use the penalty only when all other collection tools for securing the delinquent taxes have been exhausted.

When a business fails to pay its employment taxes as reported on quarterly returns and it appears the taxes cannot be collected from the business, a revenue officer gathers information for the potential assessment of the 100-percent penalty. In order for the 100-percent penalty to be considered, the trust fund portion of the businesses' delinquent taxes must meet a specified dollar criterion. The revenue officer recommends whether or not an assessment of the penalty should be made against each person determined to be responsible. According to IRS procedures, the revenue officer is required to make the recommendation no later than 6 months after receiving the delinquent business account.

IRS' internal audit division assessed this procedure at one district office in 1989 and found that revenue officers were not always making the determinations timely. In these situations, the amount of time expiring after the 6-month deadline ranged from 101 to 310 days, or an average of 187 days. According to the audit report, the determination of whether or not to assess the penalty should be made as soon as possible during the collection process. Collection's experience, the report went on to say, was that delays in the determination of 100-percent penalties made it

more difficult to identify responsible persons and decreased the effectiveness of the penalty as a collection tool. In addition to untimely determinations, the auditors also found there were significant time delays before the assessment was processed. These delays, according to the auditors, could allow taxpayers time to divest personal assets before IRS initiated collection actions.

Collection efforts for 100-percent penalty cases are generally the same as for other delinquencies. Collection action can be taken simultaneously against all responsible parties. Once the delinquent taxes and any accrued interest are collected in full from the business, one or more of the responsible persons, or some combination of the business and responsible persons, IRS will stop collection action.

We found in a 1989 review of the 100-Percent Penalty Program that IRS had inadequate accounting and internal controls to readily determine the correct account balances of related 100-percent penalty cases and to ensure that the correct amount was collected.[1] Instead, collection personnel relied on an extensive manual analysis of each business and related party to determine the status of the unpaid tax. We recommended that IRS establish procedures for monitoring the status of 100-percent penalty collections, including a system to provide collection employees with the information needed to accurately determine the status of the delinquency.

Since our review, IRS has implemented its 100-percent penalty Cross Reference History Module Service-wide. The module is on IRS' computer system, contains identification information on a business and its responsible parties, and is accessible to revenue officers and other collection personnel. In addition, during September 1990, IRS implemented a system that provides collection personnel access to payment and other account transaction information. As a result, revenue officers and other collection personnel do not have to maintain manual records to track 100-percent penalty cases processed after September 1990.

IRS reports showed that the use of the 100-percent penalty as a collection tool was questionable. According to an IRS study, the penalty was not effective in the collection of trust fund taxes because it was assessed several years after the corporation started accruing trust fund liabilities. The typical penalty, the study stated, was assessed more than 900

[1]Tax Administration: IRS Can Improve the Process for Collecting 100-Percent Penalties (GAO/GGD-89-94, Aug. 21, 1989).

days after the due date of the first delinquent employment tax return. In addition, of the nearly $2.1 billion in 100-percent penalties assessed during 1988, IRS expected to collect less than 10 percent, or about $189 million. IRS has initiated another study to determine if the 100-percent penalty could be effective if the delinquency was dealt with in its earliest stages.

According to one IRS official, the 100-percent penalty is a good concept that could be effective if there were personal assets left by the time the penalty is assessed against the individual officers of the corporation. However, according to the IRS official, the reason the 100-percent penalty program collects only a small fraction of assessments is that most of the corporations that make up the inventory of 100-percent penalty cases are small "mom and pop" type businesses. These owners of these businesses, the official stated, invest all of their assets in the business and when the business goes broke, so do the owners. According to the official, IRS has to do more to prevent delinquencies because the probability of its collecting delinquent taxes by enforcing the 100-percent penalty, except in the case of larger corporations, is very small.

Major Contributors to This Report

General Government Division, Washington, D.C.

Cornelia M. Blanchette, Assistant Director, Tax Policy and Administration Issues
Charlie W. Daniel, Assignment Manager
Charles G. Kilian, former Assignment Manager
Robert G. Homan, Evaluator

Chicago Regional Office

Thomas D. Venezia, Regional Management Representative
David B. Utzinger, Evaluator-in-Charge
Rose M. Schuville, Site Senior
Roger B. Bothun, Evaluator
Karin A. Van Egmond, Evaluator

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