United States General Accounting Office

GAO

Report to the Secretary of the Treasury

April 1993

FEDERAL TAX DEPOSIT SYSTEM

IRS Can Improve the Federal Tax Deposit System

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Accounting and Financial
Management Division

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April 28, 1993

The Honorable Lloyd Bentsen
The Secretary of the Treasury

Dear Mr. Secretary:

As part of our ongoing financial audit of the Internal Revenue Service (IRS), we are reviewing the systems that IRS uses to collect the federal government's revenues. This report evaluates IRS's current procedures for collecting the necessary accounting and payment data for the Federal Tax Deposit (FTD) system, which collects taxes paid by private sector businesses and governmental entities and accounts for over 80 percent of IRS's tax receipts. It also assesses the efforts that the IRS and Treasury's Financial Management Service (FMS) have underway to modernize this process.

Results in Brief

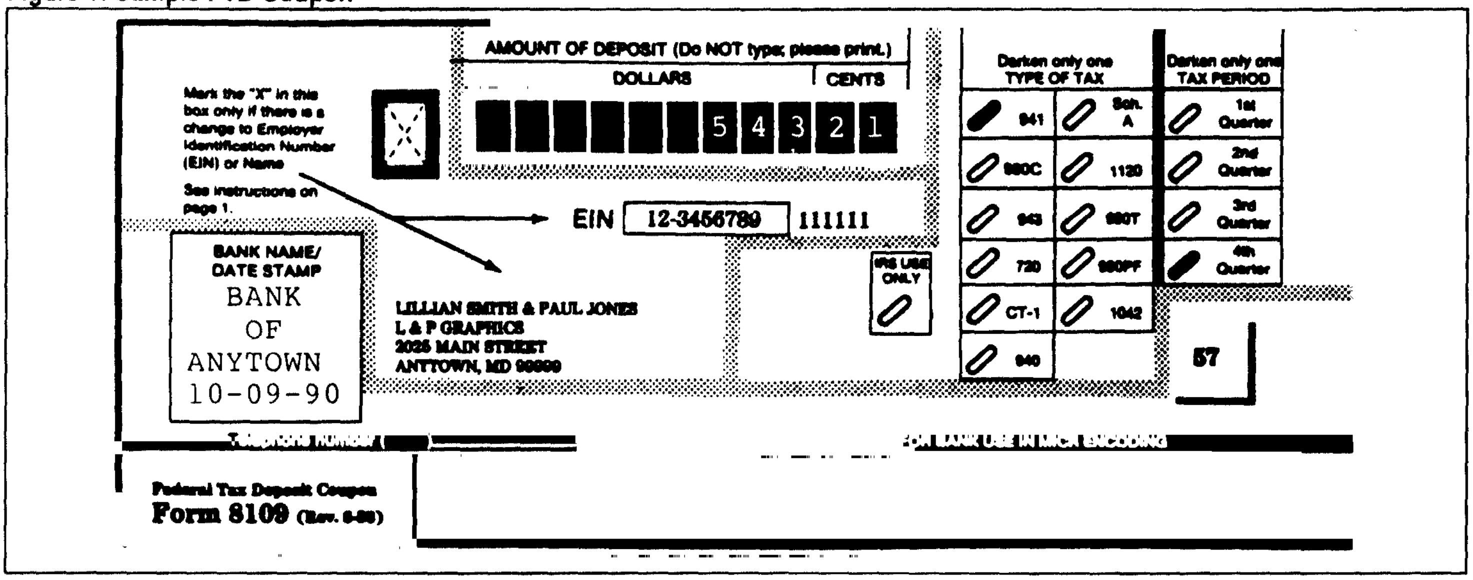
The current paper-based FTD system, which collects payment and tax data separately, allows numerous errors to be introduced into the process. Resolving such errors is both time-consuming and costly to the IRS and taxpayers. Also, the current system approach costs Treasury about $145 million annually because of a 1-day delay in funds availability to Treasury. Recognizing that FTD system automation can provide substantial savings, Treasury in 1986 began efforts to automate the FTD system and accelerate the collection of tax revenues by 1 day. IRS has developed several prototype systems which automate this process, address several systemic problems, and allow same-day fund availability to Treasury.

The candidate systems for national application do not address the business problem of separately reporting accounting and payment data. However, because of the potential for about $145 million in annual savings, it may be beneficial to proceed with one or more of these models if a nationwide system can be implemented by IRS's current target date of 1994. But, if full-scale implementation continues to be delayed, as it has been virtually since the inception of the project, and the projected cash management savings would be further delayed, the best course of action may be to incorporate concurrent reporting of tax payment and the related accounting data with the current initiatives. After discussing a draft of this report with us, Treasury officials told us that they had made significant changes in project direction, including a commitment to concurrent reporting of accounting and payment data. They plan to perform the necessary analyses this year to decide whether to pursue the cash management savings first or to bring both components on at the same time in order to reduce taxpayer confusion.

Background

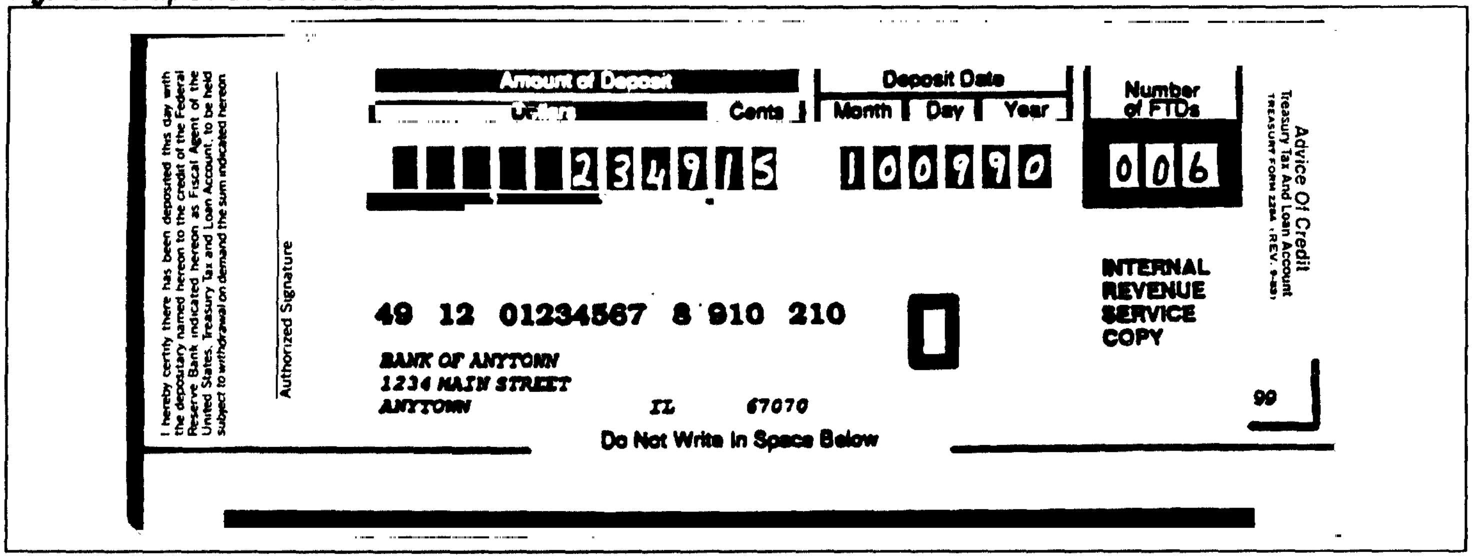
The Department of the Treasury collects the majority of the government's tax revenues through the paper-based FTD system. The FTD system is used by employers, referred to here as taxpayers, to pay 11 types of taxes, including employment (employee income tax withholding and social security), corporate income taxes, and excise taxes. Taxpayers use FTD coupons to enter the dollar amount, tax quarter, and type of tax being paid. The taxpayer's name, address, and employer identification number are usually encoded by IRS on the FTD coupons before being sent to the taxpayer. (See figure 1.)

Figure 1: Sample FTD Coupon



Generally a taxpayer submits the FTD coupon, with the payment, to a financial institution (depositary) designated by a Federal Reserve Bank (FRB) to accept tax deposits or submits it directly to the FRB. The frequency of payment depends on a variety of factors, including the type of tax and amounts owed. Each day, the depositary totals all the FTD payments received and prepares a summary document referred to as an Advice of Credit. (See figure 2.)

Figure 2: Sample Advice of Credit



I hereby certify there has been deposited this day with the depositary named hereon to the credit of the Federal Reserve Bank indicated hereon as Fiscal Agent of the United States, Treasury Tax and Loan Account, to be held subject to withdrawal on demand the sum indicated hereon

Authorized Signature

Amount of Deposit

Cents

Deposit Date

Month Day Year

100990

Number of FTDs

006

INTERNAL REVENUE SERVICE COPY

Advice Of Credit

Treasury Tax And Loan Account

49 12 01234567 8 910 210

BANK OF ANYTOWN
1234 MAIN STREET
ANYTOWN IL 67070

99

Do Not Write In Space Below

A copy of the Advice of Credit is submitted to the appropriate FRB, which transfers funds from the depositary's reserve account to a Treasury account on the next business day. FRBs provide the Advice of Credit information to the IRS for reconciliation to Advice of Credits submitted by the depositaries with their FTD coupons. During fiscal year 1992, IRS processed approximately 85 million FTD coupons totaling over $905 billion.

After receiving the FTD coupons and the corresponding Advice of Credits from a depositary (usually 4 to 7 days after the tax deposit), the IRS service center uses optical character readers to electronically record the information contained on the FTD coupons by posting the payments to taxpayer accounts. The service center then reconciles the individual payments on the FTD coupons with the total amount of funds transferred to the federal government shown on the accompanying Advice of Credit. After this reconciliation is performed, the payment data is summarized by tax type (i.e., employment taxes, corporate income taxes, and excise taxes) and reported to Treasury. Treasury uses these summary amounts to forecast cash receipts and to estimate trust fund investments.[1] Appendix I contains a flowchart of the current payment process.

[1]Actual collections are compared to the cumulative year-to-date projections before Treasury finalizes its borrowing needs for future periods. In addition, Treasury uses this information daily to determine whether it has excess operating cash that can be invested. Treasury also uses the amount for each type of tax collected to estimate the amounts to be invested in the various trust funds daily. For example, during November 1992, Treasury's formula called for transferring 46.6 percent of the employment taxes to the social security trust funds.

Taxpayers are required to file a tax return that provides additional information (accounting data) not provided on the FTD coupons. For example, after the end of each quarter, the taxpayer must prepare and file an Employer's Quarterly Federal Tax Return (Form 941). This return summarizes the payroll activity for the quarter and allocates the tax liability to the appropriate tax categories (income tax withholding, social security, etc.). It also captures other tax data such as the total wages subject to withholding. (See figure 3.)

The IRS compares the accounting data provided on each taxpayer's return to the payment data received on the taxpayer's FTD coupons to verify that amounts owed have been paid. Any variances will likely require correspondence with the taxpayer for reconciliation. (Appendix II contains a flowchart of the current procedure for processing the accounting data contained on the tax returns and reconciling it to the payment information on the FTD coupon.) Also about 1 year after the returns have been filed, Treasury compares the actual amounts shown on the employer's tax returns for the various trust funds to the estimated amounts already deposited and makes the necessary adjustments.

Our reports and IRS studies have documented problems affecting taxpayer burden and IRS productivity in the current FTD system, and Treasury, principally IRS and FMS,[2] has been working for several years to revise the FTD system. In recent years, IRS and FMS have considered adopting electronic funds transfer technology and are currently testing several prototype systems. GAO has also developed and reported on a conceptual approach for improving the FTD system which discusses, among other things, the importance of linking tax accounting and payment data to properly record payments to taxpayer's accounts.[3]

[2]Part of FMS's responsibilities include improving the federal government's cash management by ensuring agencies use the proper collection and payment systems. Because the FTD improvement projects may significantly affect the federal government's cash management and FMS is responsible for developing and defining the requirements for the depositaries who process the current FTD coupons, FMS expertise was sought and provided.

[3]Discussion Paper: A Conceptual Approach for Improving IRS's Federal Tax Deposit System (December 1990).

Figure 3: Sample Employer's Quarterly Federal Tax Return

Form **941** (Rev. January 1991) Department of the Treasury Internal Revenue Service 4141

Employer's Quarterly Federal Tax Return

▶ See Circular E for more information concerning employment tax returns.
Please type or print.

Your name, address, employer identification number, and calendar quarter of return. (If not correct, please change.)

Name (as distinguished from trade name): LILLIAN SMITH & PAUL JONES
Date quarter ended: 12-31-90
Trade name, if any: L & P GRAPHICS
Employer identification number: 12-3456789
Address and ZIP code: 2025 MAIN STREET, ANYTOWN, MD 99999

OMB No. 1545-0029 Expires: 5-31-93
T / FF / FD / FP / I / T

If address is different from prior return, check here ▶ ☐ (IRS Use)

If you do not have to file returns in the future, check here . . . ▶ ☐ Date final wages paid . . . ▶

If you are a seasonal employer, see Seasonal employers on page 2 and check here . ▶ ☐

1a	Number of employees (except household) employed in the pay period that includes March 12th ▶	1a		
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) ▶ 1b –			
2	Total wages and tips subject to withholding, plus other compensation ▶	2	13608	60
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. ▶	3	1320	03
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶	4		
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	1320	03
6a	Taxable social security wages (Complete line 7) $ 13608.60 × 12.4% (.124) =	6a	1687	47
b	Taxable social security tips $ × 12.4% (.124) =	6b		
7	Taxable Medicare wages and tips $ 13608.60 × 2.9% (.029) =	7	394	65
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	2082	12
9	Adjustment of social security and Medicare taxes (see instructions for required explanation)	9		
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶	10	2082	12
11	Backup withholding (see instructions)	11		
12	Adjustment of backup withholding tax for preceding quarters of calendar year ▶	12		
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13		
14	Total taxes (add lines 5, 10, and 13)	14	3402	15
15	Advance earned income credit (EIC) payments made to employees, if any ▶	15		
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	3402	15
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ▶	17	3402	15
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS ▶	18		
19	Overpayment, if line 17 is more than line 16, enter here ▶ $ ______ and check if to be: ☐ Applied to next return OR ☐ Refunded.			

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor. ▶ ☐

Show tax liability here, not deposits. IRS gets deposit data from FTD coupons. (Do NOT Show Federal Tax Deposits Here)

Date wages paid		First month of quarter		Second month of quarter		Third month of quarter
1st through 3rd	A		I		Q	
4th through 7th	B		J		R	
8th through 11th	C	543.21	K		S	621.21
12th through 15th	D		L	567.89	T	
16th through 19th	E		M		U	
20th through 22nd	F	446.30	N		V	
23rd through 25th	G		O	478.66	W	744.88
26th through the last	H		P		X	
Total liability for month	I	989.51	II	1046.55	III	1366.09
IV Total for quarter (add lines I, II, and III). This should equal line 16 above ▶						3402.15

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Paul Jones Print Your Name and Title Paul Jones, V.P. Date 01-05-91

For Paperwork Reduction Act Notice, see page 2.

Objectives, Scope, and Methodology

Our objectives were to determine whether the current process of separately reporting accounting and payment data (1) creates undue taxpayer burden and adversely affects IRS productivity and (2) whether the FTD improvement projects will affect these two areas.

Although the FTD system is basically the same for the 11 types of taxes, our review focused on employment taxes since the majority of revenue is generated by this type of tax. To determine whether taxpayers correctly prepared the FTD coupons and IRS correctly posted the FTD payments, we statistically sampled 1,100 of the 3.4 million FTD coupons processed during the August 1990 reporting cycle at the following 5 centers: Cincinnati, Fresno, Memphis, Ogden, and Philadelphia. We chose these centers to provide wide geographic coverage and because they accounted for 44 million, or over 50 percent, of the FTD coupons processed during fiscal year 1990. We compared the data on the FTD coupon with the data recorded in IRS's records. We researched any differences to determine whether the difference was caused by taxpayer error or IRS processing error.

To assess the reliability of the data submitted on quarterly returns for employer taxes (Form 941), we used the results of IRS's Program Analysis System. IRS uses this system to quantify the problems with employment tax returns by taking a sample of the returns processed and identifying the errors made by the taxpayer and IRS. We did not determine the reliability of the sampling or reporting process IRS used.

We discussed the system development efforts to automate the FTD system with Treasury officials and reviewed available system documentation to determine if the proposed design included features that would improve data reliability, reduce taxpayer burden, and increase IRS productivity.

We performed our work from August 1990 through January 1993. Our audit was performed in accordance with generally accepted government auditing standards.

Limitations of the Current System

The current FTD system creates undue taxpayer burden and reduces IRS productivity because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund or other account is not provided with the payment. Therefore, IRS must match the accounting information shown on the tax return to the payment information contained on the FTD coupons submitted by the taxpayer.

Whenever differences occur, the taxpayer and IRS must expend significant resources to reconcile these differences.

The current system's design allows for errors to be introduced from three different sources—the taxpayer, the financial institution (including the FRBS) processing the payments, and IRS. We found that IRS properly records the payment information shown on the FTD coupons. However, in order to properly record these payments, IRS had to change the information on 20 percent of the coupons included in our sample because taxpayers had provided incorrect or incomplete data. Also, IRS reviews have shown that both taxpayers and IRS make significant numbers of errors in preparing and processing the information submitted on tax returns.

One effect of such errors in recording the payment and accounting data is extra work for taxpayers and IRS. In 1990, we reported that in 1988,[4] IRS estimated that it may have erroneously assessed about 317,000 penalties amounting to $324 million because it did not know the specific deposit period to which the taxpayers' deposits should have been applied when calculating the penalties. In addition, these erroneous penalties create erroneous receivables and, thus, diminish the reliability of the amounts IRS reports as its accounts receivable balance.

Errors Associated With FTD Coupons

Our review of a statistical sample of FTD coupons processed during the August 1990 reporting cycle at 5 IRS service centers showed that taxpayers made errors or omitted critical data on 20 percent of the coupons submitted. Taxpayers omitted or incorrectly recorded either the tax period (18.6 percent), tax type (.5 percent), or both (1.3 percent).

IRS's internal controls were generally effective in detecting and correcting many taxpayer errors. However, IRS cannot detect and correct all errors. For example, a difficult taxpayer error for IRS to detect and correct is when the taxpayer specifies the incorrect quarter on its FTD coupon for employment tax payments submitted during the first month of a quarter. In one case, a taxpayer deposited about $2,600 for its third quarter tax liability on July 26, 1991, but mistakenly showed on the FTD coupon that this payment should be applied to the second quarter. When IRS received the second quarter tax return, which did not contain the accounting information for the $2,600 payment, and compared it with the payment information contained on the FTD coupon, a refund was provided to the taxpayer since the total payments received for that quarter were greater

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

than the amount the tax return showed was due. However, when the taxpayer filed the tax return for the third quarter, a notice of underpayment was generated since the FTD payments recorded for that quarter were less than the payment amount shown on the tax return as due. Through correspondence and return of the refund check, it was resolved that a timely FTD payment had been made but, because of taxpayer error, the payment was credited to the wrong quarter.

In the above example, IRS did not detect the incorrect quarter designated by the taxpayer because the coupon was submitted during the first month of the quarter. Since it is normal to have payments received during the first month of a quarter that apply to the previous quarter, IRS understandably assumed that the information was correct even though it was not.

However, according to IRS officials and our observations, IRS has procedures that automatically identify and correct apparently incorrect quarters marked on coupons processed. For example, assume a taxpayer made a tax deposit on August 15, 1991, for a third quarter tax liability, and incorrectly identified it as a second quarter payment on the FTD coupon. When processing the FTD coupon, IRS would assume it was a potential taxpayer error and record it as a third quarter payment. IRS routinely makes such adjustments since experience has shown that the vast majority of payments made during the second and third month of a quarter are associated with that quarter. IRS notifies taxpayers of such changes to ensure that its adjustments are correct. These IRS actions reduce the possibility of erroneous refunds or notices of underpayment.

Depositaries also contributed to FTD processing problems. We identified numerous instances where the taxpayer made a timely FTD payment as required, but the depositary did not accurately record the payment date.[5] Typically in these cases, the FTD coupon was stamped by the depositary with a date later than the date it actually received the payment or contained no date at all. In such cases, the taxpayer, although having paid on time, receives a penalty notice for late payment of taxes. The burden of proof then rests on the taxpayer to demonstrate and document that the taxes were paid on time as required. During January 1992, we reviewed IRS case files relating to FTD reconciliation and found an example where a

[5]In October 1990, FMS, which is primarily responsible for establishing and monitoring the federal government's relationships with depositaries, began to assess penalties to the depositaries for such cases. The penalties represent the earnings value of funds lost to the Treasury due to the untimely processing of FTD coupons. In fiscal year 1991, FMS reviewed 1,379 cases and assessed penalties amounting to $97,374 related to 674 cases from 155 institutions. According to FMS officials, the remaining 705 cases fell below the penalty threshold of $50 established by FMS, and the supporting documents were discarded.

taxpayer received a penalty notice totaling $4,416 for two late tax payments. The payments of $100,814 and $106,481 were due on December 17, 1990, and January 2, 1991, respectively. The FTD coupons that were forwarded to the IRS service center were date stamped by the depositary 1 day later, that is, December 18 and January 3, respectively. In this case, the taxpayer was able to document with canceled checks and copies of the FTD coupons that the deposit was in fact made on the due date, and the penalties were abated.

All the above conditions require correspondence with the taxpayer and result from the IRS practice of obtaining the necessary accounting information separately from payment data on the FTD coupon. Some of these may also require correspondence between FMS and the financial institutions. According to an IRS official and our observations, when the error results in a notice of late payment or underpayment, the burden of proof rests on the taxpayer. Although the penalties should be abated after the taxpayer proves that the correct tax amount was deposited on time but erroneously recorded, the process is both time-consuming and costly to the taxpayer and the IRS. Furthermore, such cases do not improve taxpayer relations.

Errors Associated With Tax Returns

IRS analyses have found that both taxpayers and IRS make numerous errors in preparing and processing the tax returns associated with FTD payments. As a result, IRS routinely selects a sample of employment tax (941s) returns and notes the number and types of errors. Since employment taxes constitute the majority of the revenue collected through the FTD system and IRS management has identified the corresponding returns as a significant problem area, we examined problems with employment tax returns. Table 1 shows the number of those returns that IRS said contained errors for the period calendar year 1990 through August 1992.

Table 1: Number of Employers' Quarterly Federal Tax Returns Containing Errors

(In millions)

Calendar year	Total returns processed	Returns with errors	Taxpayer errors	IRS errors
1990	20.7	1.7 (8 percent)	.1	1.6
1991	20.9	2.3 (11 percent)	.2	2.1
1992a	12.5	1.2 (10 percent)	.1	1.1

[a]Data is as of August 1992.

Source: IRS

As shown above, between calendar year 1990 and August 1992, IRS has reported that about 10 percent of the returns contained errors. The types of taxpayer errors included omission of data, incorrect data, math errors, and entry of data on the wrong line. IRS errors included data entry mistakes or failure to input data. Although this summary information cannot be used to determine how many of the taxpayer and IRS errors would have caused additional correspondence between the taxpayer and IRS, these findings show that problems exist in accurately preparing and recording the tax return data. Inaccurate tax return data creates additional discrepancies to be resolved, thus decreasing IRS's productivity and increasing taxpayer burden.

IRS's Automation Efforts Did Not Focus on Errors Associated With Reporting Accounting and Payment Data Separately

Since 1986, IRS and FMS have had efforts underway to automate the FTD process. Four system improvement efforts are directed at improving the current process, but only one focuses on the significant problems that result from reporting accounting and payment data separately. The other three systems are primarily directed at automating the current FTD system. Although they provide efficiency and internal control improvements and are designed to improve cash flow, reduce paperwork, and minimize processing delays caused by some financial institutions, they do not eliminate the need to reconcile payment coupons and the related tax return data.

Efficiency and Internal Control Improvements Should Result From the System Improvement Efforts

Since 1986 when Treasury began efforts to modernize the FTD system, numerous delays in its implementation have occurred, even though the study which recommended the current modernization concept stated that current (1986) technology was available. For example, in 1988, Treasury estimated that an automated FTD system could be implemented nationwide by 1991. In 1991, the estimate was revised to 1993 while the current estimate is 1996.

Increasing automation of the current paper-based process, which is the focus of the FTD systems improvement efforts, can (1) provide for same day deposit of tax receipts to Treasury's account at the Federal Reserve,[6] (2) eliminate the potential for undetected delays in transferring funds to Treasury, (3) help eliminate the types of taxpayer errors on the current FTD coupons that are detected and corrected by IRS in its processing of the paper FTD coupons, and (4) reduce the efforts spent by taxpayers, financial

[6]Although these systems use the current process for estimating trust fund collections, they do accelerate the information used to make these estimates by 4 to 7 days. (See discussion in the background section.)

institutions, and IRS to handle and process about 85 million FTD transactions annually. These actions should provide significant benefits. For example, achieving same-day rather than next-day transfers of tax collections from depositaries to the Treasury yields savings of about $145 million per year, assuming a 4 percent interest rate. Appendix III contains a description of the four current efforts that Treasury has undertaken to improve the FTD system, and appendix IV contains a comparison of the current system to these efforts.

However, we are concerned that two projects may not address the problem of depositaries delaying the transfer of tax receipts because they place responsibility for collecting the actual tax deposits with the depositaries, much like the existing system. Under such an approach, Treasury will need very strong controls to ensure that these depositaries are not delaying the transfer of collections. As of January 1993, Treasury was unable to provide us with the controls that it will use to ensure that these depositaries do not delay transferring tax payments to Treasury's federal reserve account.

Simultaneous Reporting of Accounting and Payment Data Is Needed

The primary weakness in three of the current system development efforts is that Treasury's projects appear to be directed solely at automating the current processes. Numerous errors and reconciliation problems result from incorrectly prepared coupons and tax returns. The result of a mismatch between the FTD coupon and its tax return is generally a penalty notice or an improper refund. Although penalties caused by erroneous data should be abated by IRS, the lengthy resolution and reconciliation process to determine if an abatement is proper unnecessarily consumes IRS and taxpayer resources.

Although IRS has stated that it sees a need to develop a method that allows taxpayers to electronically file the employment tax returns, the data on the electronic returns will still need to be compared and reconciled to the payment data. IRS envisions that automating the FTD related tax returns will eliminate some of the data integrity problems associated with the current paper-based process. However, this is basically automating the current paper-based process while not resolving the problems caused by separately reporting accounting and payment data. Only the fourth project, the FEDTAX program, available only to federal agencies, addresses this fundamental problem. For the FEDTAX program, discussed in appendix III, the federal agency provides both the payment and the corresponding accounting information when the tax payment is made. Since the federal agency's tax return is generated by the FEDTAX system from the payment data, discrepancies should not occur. However, this system cannot be used by the private sector because it cannot accept payments from outside the government. It was designed solely to transfer funds between federal agencies' accounts.

We believe that collecting the accounting data currently contained on tax returns with the payment data on the FTD coupon is critical if the problems in the current process are to be significantly reduced. Adopting this method provides the potential for benefits beyond those envisioned from Treasury's current projects, even allowing for electronic tax returns. For example, it should (1) greatly reduce the number of forms prepared and processed by the taxpayer and IRS, (2) eliminate the related reconciliations that IRS must perform under the current system, and (3) significantly reduce processing errors and the related erroneous refunds and penalty assessments.

A potential contributing factor to not addressing this basic business problem was that Treasury did not effectively coordinate its system development efforts. Treasury has one team developing a solution to FTD paper coupon processing and another team addressing electronic filing FTD related tax returns. In hindsight, a better approach may have been for Treasury to focus on the business problem of how to collect and record tax payments to the proper trust funds or other accounts.

The risk of not adequately addressing IRS's business problem of separately reporting accounting and payment data is compounded because its system improvement initiatives are not running concurrently. Its approach for collecting payments is well underway, with four systems now undergoing various stages of testing and implementation. In contrast, IRS's plans for electronic filing of the returns associated with FTD payments are in the early stages and not yet well defined. This sequencing, combined with the widely acknowledged fact that modifying systems after they are designed and implemented is more difficult and costly than properly designing them initially, may jeopardize achievement of an ideal solution as part of the current initiatives.

Comments by Treasury Officials

We discussed a draft of this report with Treasury officials. After our meetings, Treasury modified the focus of its efforts to consider how best to capture accounting and payment data. It is our understanding that these plans include developing an approach which allows Treasury to achieve the cash management savings and then modifying the system to capture the accounting and payment data shortly thereafter. However, IRS does not consider these plans firm since it has not done the work necessary to determine whether this is the best approach or whether it would be better to wait and bring both components on at the same time in order to reduce taxpayer confusion. IRS plans to perform the necessary analyses during the current year. For example, Treasury's current plans call for issuing an "Invitation of Expression of Interest" in December 1993. Treasury's purpose in issuing this document will be to procure a financial service contract that will allow taxpayers to transmit accounting and payment data concurrently. According to IRS, this will help it concurrently determine (1) whether obtaining accounting and payment data is cost beneficial, (2) the impact on taxpayer burden, and (3) the best methods for implementing this approach.

Conclusions

Treasury's primary focus in its current FTD improvement and electronic filing efforts has been in automating the current process instead of resolving the problems related to matching the accounting information on the tax returns to the payment data on the FTD coupons. Conceptually, these independent development efforts may address some of the data integrity problems present in the current paper-based process. Although the methods that Treasury was considering would achieve one of Treasury's primary objectives—accelerating the government's cash collections which is very important and should be expedited—they will do little to address the current systemic problems that increase taxpayer burden and reduce IRS productivity. However, Treasury has recently modified its views on the FTD automation efforts and now plans to address how the accounting and payment data should be captured.

Recommendation

To further reduce taxpayer burden and improve IRS productivity, we recommend that the Secretary of the Treasury direct the Commissioner of the Internal Revenue Service and the Commissioner of the Financial Management Service to monitor the revised FTD automation efforts and ensure that the work on the automated FTD system for the private sector maintain the proper focus on how to capture the necessary accounting data with the payment data.

This report contains a recommendation to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Governmental Affairs; the Chairman and Ranking Minority Member of the Senate Committee on Finance; the Chairman and Ranking Minority Member of the House Committee on Government Operations; the Chairman and Ranking Minority Member of the House Committee on Ways and Means; the Chairman and Ranking Minority Member of the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations; the Chairman and Ranking Minority Member of the Subcommittee on Oversight, House Committee on Ways and Means; the Chairman and Vice Chairman of the Joint Committee on Taxation; the Director of the Office of Management and Budget; the Chairman of the Board of Governors of the Federal Reserve System; the Acting Commissioner of the Internal Revenue Service; the Commissioner of the Financial Management Service; and other interested parties. Copies will be made available to others upon request.

Please contact me at (202) 512-9454 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix V.

Sincerely yours,

Jeffrey C. Steinhoff

Jeffrey C. Steinhoff
Director, Civil Audits

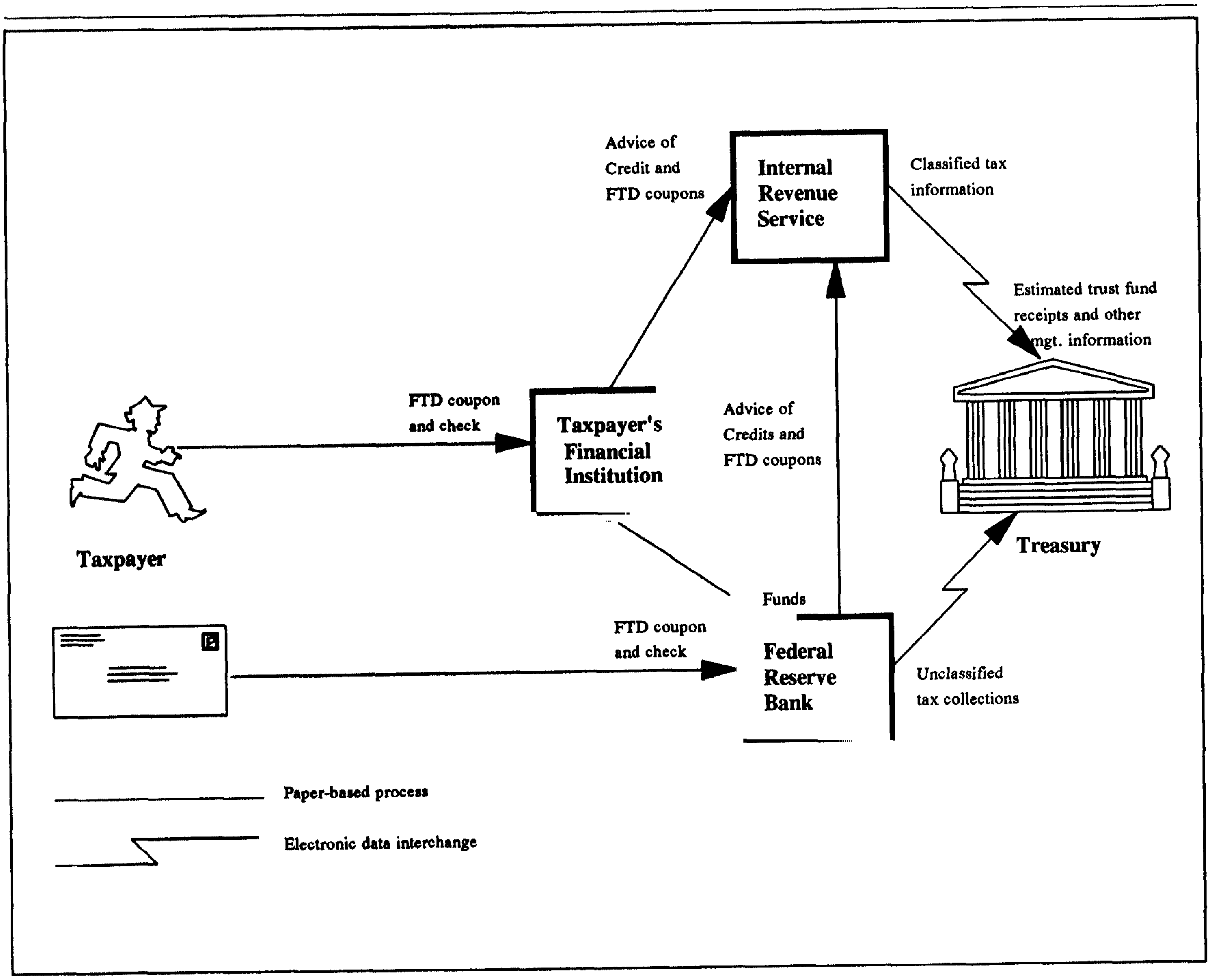
Contents

Figures

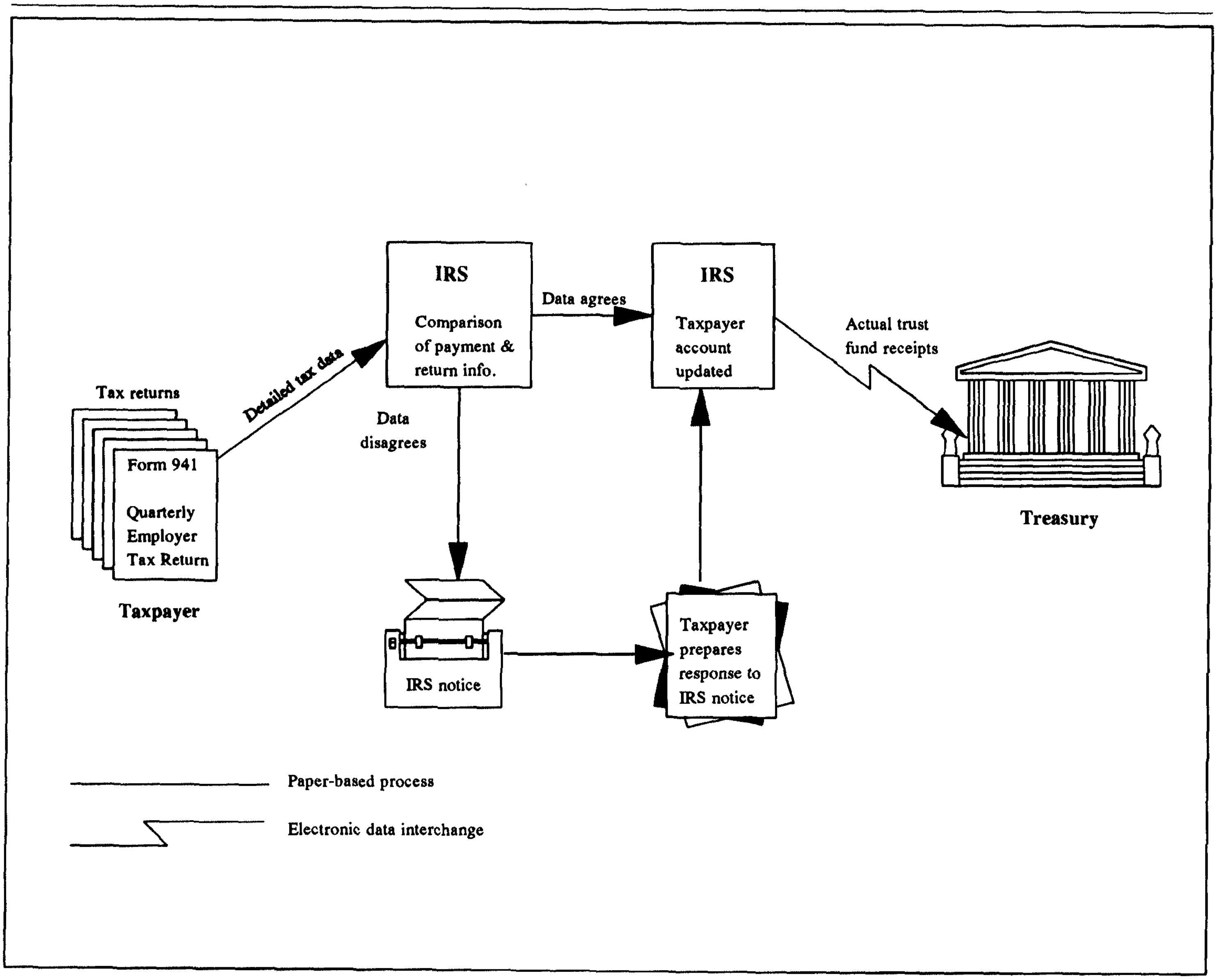
Abbreviations

ADEPT	Automated Deposit of Electronic Payments for Taxes
FRB	Federal Reserve Bank
FMS	Financial Management Service
FTD	Federal Tax Deposit
GOALS	Government On-Line Accounting Link System
IRS	Internal Revenue Service

Federal Tax Deposit System: Tax Payments



Federal Tax Deposit System: Accounting Data



Treasury Efforts to Modernize the FTD Process

IRS made the first significant change to the FTD process in 1984 by introducing optical character readers in its service centers to record the paper-based FTD coupon information. It has continued to perform studies on how to improve and further automate the process. Recently, Treasury has undertaken five efforts to further automate the FTD process, four of which are currently in use.

A major reason for further automating the FTD process is to provide for same day deposit of tax payments to Treasury's Federal Reserve account. Elimination of the overnight use of funds by depositaries will result in Treasury savings of about $145 million per year, assuming a 4 percent interest rate.[1] Under the current system, the taxpayer makes the tax deposit and the depositary transfers the funds to Treasury's account at the Federal Reserve on the following business day. With the use of electronic payment methods, this 1-day delay can be eliminated.

Previous Treasury Efforts

In 1986, an FTD Redesign Work Group was established to develop a conceptual redesign. The group consisted of representatives from the Federal Reserve, the Office of the Fiscal Assistant Secretary, the Internal Revenue Service, and the Financial Management Service. After evaluating several alternatives, in August 1987 the Group issued a report entitled, An Electronic Revenue Network For Collecting Federal Taxes - Proposal For A Conceptual Design, recommending that a centralized federal tax deposit system be adopted with IRS functioning as the central processor. In January 1988, the Treasury Deputy Secretary approved the concept. Feasibility studies continued and culminated in the initiation of tests for the electronic reporting and collection of federal tax deposits. This first test was the Automated Deposit of Electronic Payments for Taxes (ADEPT). Initiated in 1989, ADEPT's primary purpose was to develop information on the issues that needed to be considered in an electronic FTD system.

The ADEPT concept was officially approved by Treasury to develop an automated FTD system, using electronic funds transfer. ADEPT was designed to be a general tax payment system allowing for the payment of several types of federal tax liabilities to IRS. However, the focus of the ADEPT test was on processing and depositing some corporate tax payments for federal tax deposits. The system was ready to process tax payments in April 1990. Payments were initiated by business taxpayers through

[1]During fiscal year 1991, Treasury earned about $1.3 billion of interest income on its Treasury Tax and Loan accounts.

participating financial institutions or independent firms serving as payroll processors. This could be done through any medium in use by the depositary which was authorized to process tax payments, including the teller, telephone, or personal computer. The ADEPT test was completed in June 1991. Treasury commissioned a report to identify the lessons learned during this test to help them in future efforts.

Current Treasury Efforts

Building on the results of the ADEPT test, Treasury currently has four systems development efforts underway designed to further automate the FTD process. Two of these projects involve commercial depositaries, a third uses a federal reserve bank (Treasury's fiscal agent), while the fourth is operated by Treasury.

The first three projects are similar and basically automate the payment process and the collection of the information on the current FTD coupon. The primary benefits of these three projects are that they will result in significant cash management savings and eliminate the paper FTD coupons.

In March 1991, Treasury solicited industry for proposals for an electronic FTD system. Treasury accepted two proposals by the April 1991 submission deadline. It also received a separate proposal from a federal reserve bank to provide an electronic FTD system which was also accepted. Under these projects, the taxpayer transmits tax payment data (employer identification number, amount, tax type, and quarter) to IRS electronically through an intermediary. As with the current process, the taxpayer then submits the necessary tax returns, and IRS compares the electronic payments to the information on the tax return. Any differences are resolved through the current reconciliation process. As discussed previously, the efforts to resolve these differences are costly and time-consuming for both the taxpayer and IRS.

The fourth system, available exclusively to federal agencies, not only automates the FTD coupon and payment process, but also collects the necessary accounting data concurrent with the payment data. Thus, the problems experienced in matching the information on the FTD coupons and the related tax returns should be virtually eliminated. In mid-1992, Treasury implemented a system to automate the transfer of federal agency tax withholding payments and quarterly return information through Treasury's Government On-Line Accounting Link System (GOALS). Using GOALS, FEDTAX allows each federal payroll office to submit their employee withholding and other tax payment information electronically. The funds are then transferred from the agency to IRS, which eliminates the current process of federal agencies sending checks and FTD coupons to Federal Reserve Banks.[2] The accounting information submitted with the payment information provides the basis for the agency's quarterly tax return. At the end of each quarter, this breakdown is presented to the agency for review. Following review, and any necessary modifications, the return information is approved by the agency. Since FEDTAX ensures that the tax return data is obtained from the payment data, mismatches should not occur. Appendix IV compares key features of each project to the current FTD system.

The three system projects available for use by the private sector are very similar conceptually. The primary differences are how certain technical components, such as funds transfer, are accomplished. The following is a description of each system.

Project A: Electronic Federal Tax Deposit Cash Concentration Test System

The Electronic Federal Tax Deposit Cash Concentration Test System will function essentially as follows. One day before the tax due date, taxpayers transmit tax payment information (e.g., amount, tax type, and quarter) to a depositary. By a designated cut-off time, the taxpayer's depositary reports the tax payment information to the cash concentrator (also a depositary) via such devices as personal computers, touchtone telephones, or voice telephones. The cash concentrator transmits the tax payment information on that day to IRS for processing. On the tax due date, funds are transferred to Treasury's account at a Federal Reserve Bank. Information will also be transmitted to Treasury for trust fund investment and cash forecasting purposes. As with the current FTD system, according to Treasury officials, taxpayers will be required to file the appropriate tax returns. IRS will then reconcile the payments shown on the returns to the payment information reported previously through the FTD Concentration System.

Project B: Centralized Processor System

The Centralized Processor System allows taxpayers to report FTD payment data (e.g., amount, tax type, and quarter) directly to the centralized processor (depositary) via personal computer, touchtone telephone, or an operator 1 day before the tax due date. The evening before the tax due date, tax payment information is transmitted to IRS for processing. On the tax due date, funds will be transferred to Treasury's account from the taxpayer's account. Information will also be transmitted to Treasury for trust fund investment and cash forecasting purposes. As with the current FTD system, according to Treasury officials, taxpayers will be required to

[2]Federal Reserve Banks process about 45,000 federal agency payments totaling $38 billion annually.

file the appropriate tax returns. IRS will then reconcile the payments shown on the returns to the payment information reported previously through the Centralized Processor System.

Project C: TAXLINK-FRB

The TAXLINK-FRB System also provides for participating taxpayers and federal depositaries to report FTD information (e.g., amount, tax type, and quarter) to a centralized processor. For this test, the Minneapolis Federal Reserve Bank acts as the centralized processor. The Federal Reserve Bank will electronically transmit the detailed tax information to IRS. On the tax due date, funds will be credited to Treasury's account. Information will also be transmitted to Treasury for trust fund investment and cash forecasting purposes. As with the current FTD system, according to Treasury officials, taxpayers will be required to file the appropriate tax returns. IRS will then reconcile the payments shown on the returns to the payment information reported previously through the TAXLINK-FRB System.

Project D: FEDTAX

FEDTAX, a joint initiative of FMS and IRS, will automate the transfer of federal agency tax withholding payments and quarterly return information through GOALS, a system which allows all government agencies to transmit financial information electronically. Using an enhanced program of GOALS, each federal payroll office will submit its employee withholding and other tax payment information electronically to Treasury. The movement of funds will occur from the submitting agency to IRS. This system will eliminate the current process of federal agencies submitting checks and the supporting FTD coupons to a Federal Reserve Bank. FTD payments entered through FEDTAX will be immediately transmitted electronically from the agency to Treasury for posting to the agency's IRS accounts.

The system also prepares the initial quarterly tax return, which is given to the agency for review and modification. After approval, the agency files the return with IRS electronically. When IRS compares the FTD payment data with the tax return, no differences should result since the payment information is directly linked to the tax return.

Comparison of Current FTD System to Treasury's Planned Electronic FTD Systems

		Treasury projects			
Features	**Current system**	**A**	**B**	**C**	**D**
Allows payment of all taxes collected under current FTD system (except Railroad Retirement which is being phased out of the FTD process).	Yes	Yes	Yes	Yes	Yes
Uses a paper-based process to transfer majority of payment information.	Yes	No	No	No	No
Uses a paper-based process to transfer majority of accounting information provided by the tax return.	Yes	Yes	Yes	Yes	No
Minimum number of days before tax due date that taxpayer must provide information.	0	1	1	1	0
Stores information for more than 1 day for taxpayers if data is provided before due date and withdraws funds from the taxpayer's account on the due date.	No	No	No	Yes	N/A
Taxpayer initiates the tax payment request that results in the funds transfer.	Yes	Yes	Yes	Yes	Yes
Provides reference number.	Yes	Yes	Yes	Yes	Yes
Provides funds availability to Treasury on same day as funds are withdrawn from taxpayer's account.	No	Yes	Yes	Yes	N/A
Provides accurate and timely cash forecasting data in advance of actual collection.	No	No	No	No	N/A
Reduces quantity of tax returns that are required to be filed and the associated manual reconciliation efforts.	No	No	No	No	Yes
Eliminates potential for undetected bank delays in transferring funds to Treasury.	No	No	No	Yes	N/A
Reduces the revenue earned and costs incurred by depositaries in processing FTD payments.	No	Yes	Yes	Yes	N/A
Taxpayer knows amount and day of payments that will be charged to its account before withdrawal is made.	Yes	Yes	Yes	Yes	Yes
Allows taxpayers to select depositaries that will make their tax payments.	Yes	Yes	Yes	Yes	N/A
Allows upfront edits to improve data integrity.	No	Yes	Yes	Yes	Yes

Notes:

Treasury's projects are identified as follows: A - Electronic FTD Cash Concentration Test System; B - Centralized Processor System; C - TAXLINK - FRB; and D - FEDTAX.

N/A stands for not applicable.

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