

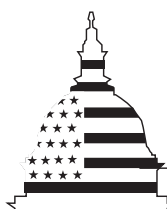
GAO

Report to the Subcommittee on
Government Management, Information
and Technology, Committee on
Government Reform, House of
Representatives

August 1999

UNPAID PAYROLL TAXES

Billions in Delinquent Taxes and Penalty Assessments Are Owed



G A O

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United States General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

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August 2, 1999

The Honorable Stephen Horn
Chairman
The Honorable James Turner
Ranking Minority Member
Subcommittee on Government Management, Information
and Technology
Committee on Government Reform
House of Representatives

The Honorable Dennis Kucinich
House of Representatives

This report responds to your request for information on payroll taxes owed to the federal government and the associated trust fund recovery penalties¹ assessed individuals responsible for the nonpayment of these taxes. You asked that we determine (1) the extent to which payroll taxes are not remitted to the federal government, (2) the magnitude of the trust fund recovery penalties assessed against individuals of organizations that withheld federal payroll taxes from employees' salaries but did not forward them, (3) the extent to which individuals who have not remitted payroll taxes are responsible for not paying these taxes at multiple businesses, (4) the extent to which businesses and individuals who failed to pay payroll taxes are also receiving federal benefits or other federal payments, and (5) the factors that affect the Internal Revenue Service's (IRS) ability to enforce compliance or pursue collections in this area.

Results in Brief

According to IRS records, at September 30, 1998, nearly 2 million businesses owed about \$49 billion in payroll taxes, or about 22 percent of IRS' \$222 billion total outstanding balance of unpaid tax assessments. The businesses that failed to remit withheld payroll taxes were typically in wage-based industries and had few available assets from which IRS could recover these taxes. They were usually small, closely held businesses using

¹The IRS can assess a trust fund recovery penalty against an individual, such as a corporate officer, whom it determines was willful and responsible for not forwarding to the government federal payroll taxes withheld from employees' salaries.

a corporate structure, but this varied throughout the country. Our review of about 200 unpaid payroll tax cases and interviews with IRS revenue officers throughout the country indicated that the most common types of businesses or industries with unpaid payroll taxes included construction companies and restaurants, although other types of businesses (including computer software, child care, and professional services such as legal, medical, and accounting firms) also have unpaid payroll taxes. Most unpaid payroll taxes are not fully collectible, and there is often no recovery potential as many of the businesses are insolvent, defunct, or otherwise unable to pay.

According to IRS records, as of September 30, 1998, trust fund recovery penalties of about \$15 billion had been assessed against, and continue to be owed by, approximately 185,000 individuals found to be willful and responsible for the nonpayment of payroll taxes withheld from employees. These individuals are typically officers of a corporation, such as the president or treasurer. IRS records do not include data on the frequency of cases in which IRS does not assess a trust fund recovery penalty against such individuals. Additionally, long-standing deficiencies in IRS systems, particularly the failure to link related taxpayer and business accounts, result in errors in IRS records that have led to the collection of amounts that have already been paid. As with unpaid payroll taxes, most trust fund recovery penalty assessments are not fully collectible and there is often no recovery potential. Many of the individuals assessed these penalties are in bankruptcy, have no available assets, are unable or unwilling to pay, or cannot be located.

IRS records indicate that nearly 25,000 individuals, or over 13 percent of the individuals assessed trust fund recovery penalties, were responsible for the nonpayment of payroll taxes at more than one business. These records also indicate 29 cases in which the same individual was assessed a trust fund recovery penalty for more than 12 separate businesses.

Individuals responsible for the nonpayment of payroll taxes and businesses that owe payroll taxes receive significant federal benefits and other federal payments. We estimate that about 16,700 businesses and individuals with unpaid payroll taxes and trust fund recovery penalty assessments, respectively, received an estimated \$7 billion in federal payments over a 3 month period. We also estimate that 12,700 businesses with unpaid payroll taxes and individuals with outstanding trust fund recovery penalties had about \$3.5 billion in outstanding Small Business Administration guaranteed loans at September 30, 1998. Finally, we estimate that about 18,800

individuals with outstanding trust fund recovery penalty assessments at September 30, 1998, were receiving \$212 million annually in Social Security, Railroad Retirement, federal retirement, and federal civilian salaries.

Several factors affect IRS' ability to enforce compliance and pursue collections of unpaid payroll taxes. Financial management system deficiencies and other internal control weaknesses affect the completeness and accuracy of taxpayer accounts, making it difficult for IRS to manage its unpaid assessments. While IRS has a Federal Tax Deposit (FTD) Alert Program designed to identify early potential tax delinquencies, IRS field representatives noted that the alerts (1) typically are not received in the field early enough to prevent employers from accumulating substantial tax delinquencies or (2) resulted in revenue officers unnecessarily contacting taxpayers who had already made their required payments. IRS field representatives also noted that certain IRS procedures, limited resources, and federal and state laws limit enforcement and collection efforts. For example, IRS is prohibited by law from sharing information on delinquent taxpayers with state licensing authorities responsible for granting licenses for new and existing businesses.

Additionally, federal law does not prevent businesses or individuals from receiving federal payments or loans when they are delinquent in paying federal taxes. The Debt Collection Improvement Act specifically excluded unpaid tax assessments from its provisions for pursuing collections on outstanding federal receivables. The Department of the Treasury is developing a mechanism to pursue collection of outstanding federal receivables as mandated by the Debt Collection Improvement Act through various collection efforts and the use of offsets against tax refunds, federal benefits, and other federal payments. Treasury also intends to include the collection of unpaid tax assessments in these efforts under the authority of the Taxpayer Relief Act of 1997. However, Treasury and other affected agencies are trying to address complex implementation issues in order to avoid undue harm to individuals. Most importantly, there is the need to address IRS' significant financial management system deficiencies and internal control weaknesses to ensure that taxpayers are not unduly harmed by inappropriate levies of federal benefits and other payments to repay taxes that have already been collected.

The IRS stated that it concurred with the issues raised in this report.

Background

Employers are required to withhold from their employees' salaries amounts for individual federal income taxes and for Federal Insurance Contribution Act (FICA) taxes, which include Social Security and hospital insurance (Medicare) taxes. In 1998, the FICA taxes withheld consisted of 6.2 percent of the employee's gross salary up to \$68,400 for Social Security taxes and an additional 1.45 percent of the gross salary for hospital insurance. Employers are also required to match the amounts withheld from the employee's salary for Social Security and hospital insurance taxes. The amounts withheld from the employee's salary for federal individual income and FICA taxes, along with the employer's matching portion of FICA taxes, comprise business payroll taxes.²

Employers are generally required to remit payroll 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. Employers must deposit payroll taxes either (1) semiweekly if their total tax liability is more than \$50,000 during a 12-month period ending June 30 of the prior year or (2) monthly if their total tax liability is \$50,000 or less during this same 12-month period. Employers are generally required to file a quarterly tax return (Tax Form 941) to report federal payroll taxes. Additionally, employers are required to report employees' earnings to the Social Security Administration (SSA) annually.

The Federal Old Age and Survivors Insurance and Federal Disability Insurance trust funds were established to fund the various Social Security benefit programs, and the Federal Hospital Insurance trust fund was established to partially fund the Medicare program. By law, these trust funds receive amounts for FICA and Self-Employment Contribution Act (SECA) withholdings.³ The Department of the Treasury has statutory responsibility for maintaining these trust funds and, through the IRS, is responsible for collecting the money that is dedicated to these trust funds. Most business payroll tax payments are made directly to Treasury through

²Federal unemployment taxes are also paid by employers. However, these taxes are not included in the unpaid payroll taxes discussed in this report.

³SECA taxes are Social Security and hospital insurance taxes required to be paid by self-employed individuals. Self-employed individuals were required to pay 12.4 percent on net earnings from self-employment up to \$68,400 in 1998 if their earnings were more than \$400 for the year and 2.9 percent of net earnings for hospital insurance taxes. Payments are generally required to be remitted quarterly. Issues related to self-employment taxes were addressed in the report *Tax Administration: Billions in Self-Employment Taxes Are Owed* (GAO/GGD-99-18, February 19, 1999) and are outside the scope of this report.

financial institutions and are deposited into the general revenue fund, where they are then distributed to the various trust funds. IRS receives the related payment data submitted by taxpayers and is responsible for maintaining records of both tax assessments, based primarily on tax returns, and taxes collected.

The information IRS receives at the time it collects several types of tax payments, including those for Social Security and hospital insurance, is not sufficient to allow IRS to attribute these payments to specific trust funds, nor could IRS' current systems accept and process such data if it were received. Additionally, under Title 42 U.S.C. sections 401 and 1395i, amounts to be transferred by Treasury to the Social Security and hospital insurance trust funds are determined by applying the applicable FICA and/or SECA tax rate to wage amounts certified by the Commissioner of Social Security. Because wage information is provided only quarterly to IRS and only annually to SSA, initial distributions to the trust funds are based on estimates prepared by Treasury's Office of Tax Analysis (OTA) and SSA's Office of the Chief Actuary, with adjustments subsequently made as a result of the SSA Commissioner's certifications.

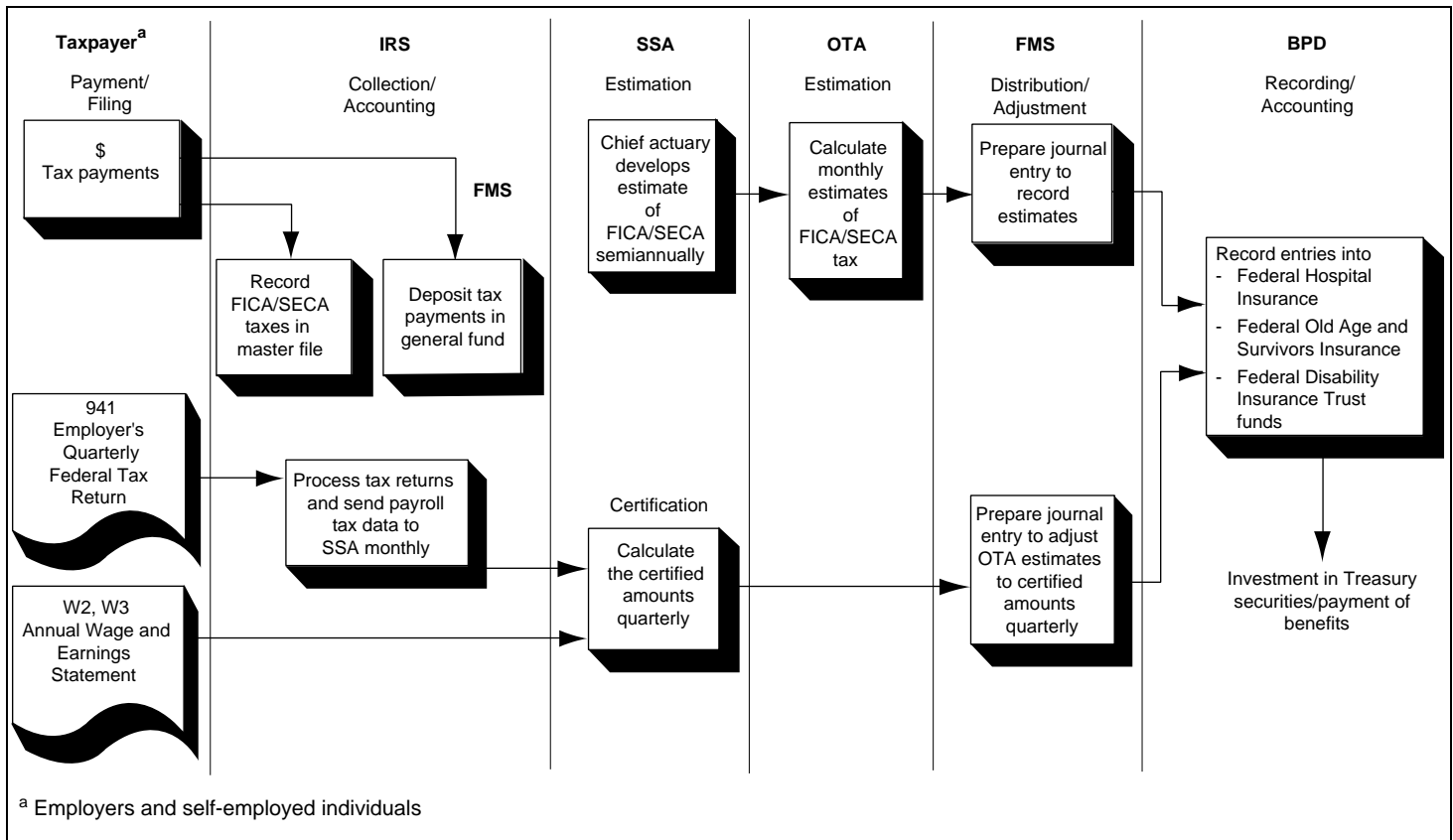
SSA's Office of the Chief Actuary develops estimates of total fiscal year employment tax revenue to be distributed to the Social Security and hospital insurance trust funds. SSA sends these estimates to OTA twice each year for use in the federal government's budget process and to determine monthly estimates of FICA and SECA taxes to be transferred from the general revenue fund to the trust funds. Monthly, OTA prepares and submits to Treasury's Financial Management Service (FMS) a document instructing FMS on the amounts to be transferred from the general revenue fund to the trust funds. FMS uses this document to process the initial distributions to the trust funds daily. Treasury's Bureau of Public Debt (BPD) records these distributions on the books and records of the trust funds.

Subsequent to this initial distribution, the SSA Commissioner certifies quarterly the amounts that should ultimately be distributed to the trust funds. In making this certification, SSA uses two sources of wage data: (1) the wage and earnings statements (W-2s and W-3s) filed by employers and self-employed individuals annually with SSA and (2) payroll tax return information (Tax Form 941, quarterly information IRS transmits on tape to SSA). The certification is sent to FMS, which uses it to prepare adjustments for the difference between the initial distributions and the SSA

Commissioner's subsequent certification. BPD records these adjustments on the books and records of the trust funds.

Figure 1 provides an overview of the process of collecting, distributing, and certifying payroll tax revenue for the Social Security and hospital insurance trust funds.

Figure 1: Overview of the Process for Distribution of FICA and SECA Tax Revenue to Trust Funds



As discussed above, the amounts distributed to the trust funds through both the initial distribution of payroll taxes and the subsequent certification/adjustment process are not based on actual amounts of tax revenue collected but rather on estimates of total tax liability derived from wage information. This ensures that individuals who work and have taxes withheld to pay into the Social Security program—or their spouses and qualified dependents—receive the appropriate level of program benefits when the individuals retire, become disabled, or die. Consequently, the

amounts distributed to the Social Security and hospital insurance trust funds are based on the wages an individual earns, not the amount the employer actually forwards to the government.

While the majority of businesses pay the taxes withheld from employees' salaries as well as the employers' matching amounts, a significant number of businesses do not. This creates a situation in which the general revenue fund subsidizes the Social Security and hospital insurance trust funds to the extent that Social Security and hospital insurance taxes owed are not collected. Over time, the amount of this shortfall, or subsidy, is significant. As of September 30, 1998, the estimated amount of unpaid taxes and interest in IRS' \$222 billion unpaid assessments balance was approximately \$38 billion for Social Security and hospital insurance taxes.⁴ While this amount excludes unpaid payroll taxes no longer in the unpaid assessments balance due to the expiration of the statutory collection period,⁵ it nevertheless provides an indication of the cumulative amount of the subsidy provided from the general fund.

When businesses withhold money from an employee's salary for federal income taxes and the employee's FICA obligation, they are deemed to have a responsibility to hold these amounts "in trust" for the federal government. To the extent that withholdings are not forwarded to the federal government, the business is liable for these amounts, as well as its matching FICA contribution. Individuals can also be held personally liable for the amounts withheld from an employee's salary for federal income taxes and the employee's FICA obligation. Under Section 6672 of the Internal Revenue Code, such individuals who are determined by IRS to be "willful and responsible" for the nonpayment of these amounts can be assessed a "trust fund recovery penalty" (TFRP). To be found willful and responsible, the individual would have to be proven to be in a position to (1) directly or indirectly prevent the payment of these withheld taxes to the federal government or (2) divert the payment of these withheld monies for other means, such as paying other creditors. It should be noted that the

⁴This estimate includes both FICA and SECA taxes but does not include federal income tax withholdings, which are a component of the reported \$49 billion in unpaid payroll taxes at September 30, 1998. Accrued interest is included in this amount because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to IRS' interest accruals.

⁵The statutory collection period for collecting taxes is generally 10 years from the date of the assessment. However, this period can be extended or suspended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

deliberate intent or desire to defraud the federal government is not necessary for IRS to assess a TFRP. For example, an individual in a business who decides to pay the business' monthly rent payment instead of remitting employee withholdings to the federal government can be found to be willful and responsible and thus assessed a TFRP. Typically, these individuals are officers of a corporation, such as a president or treasurer.

More than one individual can be found willful and responsible for a business' failure to pay the federal government withheld payroll taxes and thus be assessed a TFRP. The amounts assessed against each individual can vary depending on the extent to which each individual was determined to be willful and responsible for multiple periods of unpaid taxes. Additionally, the business itself is still liable for the entire amount of the unpaid payroll taxes. However, IRS policies require that it only collect the unpaid tax once. For example, if, after the IRS assesses a TFRP against an officer of a corporation, the business pays the entire balance of the unpaid payroll taxes, the officer would no longer be liable for the TFRP assessment. Similarly, if two officers are each assessed TFRPs related to their business covering the same period of unpaid payroll taxes and one of the officers makes a partial payment, the liabilities of both officers, as well as the liability of the business, are to be reduced by the amount of the payment.

Objectives, Scope and Methodology

The objectives of our review were to address the issues raised by the Subcommittee on Government Management, Information and Technology, House Committee on Government Reform, and through subsequent discussions with the requesters' offices, regarding unpaid payroll taxes and trust fund recovery penalties. To address these issues, we identified the following questions we needed to answer:

- To what extent are payroll taxes not remitted to the federal government?
- What is the magnitude of the trust fund recovery penalties assessed against individuals who withheld but did not forward payroll taxes to the government?
- To what extent are individuals found responsible for withholding but not paying payroll taxes at more than one business?
- To what extent do businesses and individuals responsible for withholding but not paying payroll taxes receive federal benefits or other federal payments?

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- What factors affect IRS' ability to enforce compliance or pursue collections in this area?

To answer these questions, we used a combination of (1) analyses⁶ of data maintained on IRS' automated systems, (2) detailed reviews of about 200 unpaid payroll tax and trust fund recovery penalty case files, (3) automated comparisons of IRS records of unpaid payroll taxes and trust fund recovery penalties with disbursement and loan records of FMS and the Small Business Administration (SBA), and (4) structured interviews with IRS revenue officers and Collection Division group managers throughout the country. Additionally, we interviewed IRS personnel at the National Office, obtained and reviewed available IRS information on employment tax programs and initiatives, reviewed IRS' statistical information from our prior reports on employment tax issues, and reviewed IRS' collection policies and procedures and the laws that affect IRS' use of enforcement tools.

We did not assess the controls, completeness, and accuracy of IRS, FMS, and SBA records. Furthermore, assessing the effectiveness of the IRS, FMS, and SBA practices for verifying and correcting erroneous Taxpayer Identification Number (TIN), Employer Identification Number (EIN), and name data was beyond the scope of this assignment. Nor did we attempt to identify and correct all problems relating to duplicate, misused, or erroneous TIN, EIN, and name data. Finally, we did not specifically audit the data in IRS' systems used in our various macro analyses.

We performed our work from November 1998 through May 1999 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Commissioner of Internal Revenue. The Commissioner provided us with written comments which are discussed in the "Agency Comments" section and are reprinted in appendix II.

For more details on the scope and methodology of the assignment, see appendix I.

⁶See appendix I for a discussion of the types of analyses performed and the IRS data sources used.

To What Extent Are Payroll Taxes Not Remitted to the Federal Government?

According to IRS records, as of September 30, 1998, businesses owed the federal government about \$49 billion in payroll taxes. This represents about 22 percent of the \$222 billion in IRS' inventory of unpaid tax assessments as of September 30, 1998. The \$49 billion includes about \$19 billion in unpaid tax assessments and another \$30 billion in penalties and interest.

Although unpaid payroll taxes are less than a quarter of IRS' outstanding balance of unpaid assessments at September 30, 1998, they comprise over 50 percent of IRS revenue officers' caseloads in many regions of the country. Consequently, they represent one of IRS' most significant enforcement challenges.

The Number and Age of Delinquent Payroll Taxes Are Significant

IRS records show that over 1.8 million businesses owe the total unpaid payroll taxes for more than 4.9 million separate tax periods or quarters. Nearly 50 percent of the businesses with outstanding payroll taxes are delinquent for more than one quarter. While some of these businesses have only one or two quarters of unpaid payroll taxes owed the government, others have in excess of 40 quarters of delinquent payroll taxes. Table 1 profiles the number of businesses with multiple quarters of delinquent unpaid payroll taxes.

Table 1: Businesses With Multiple Quarters of Unpaid Payroll Taxes

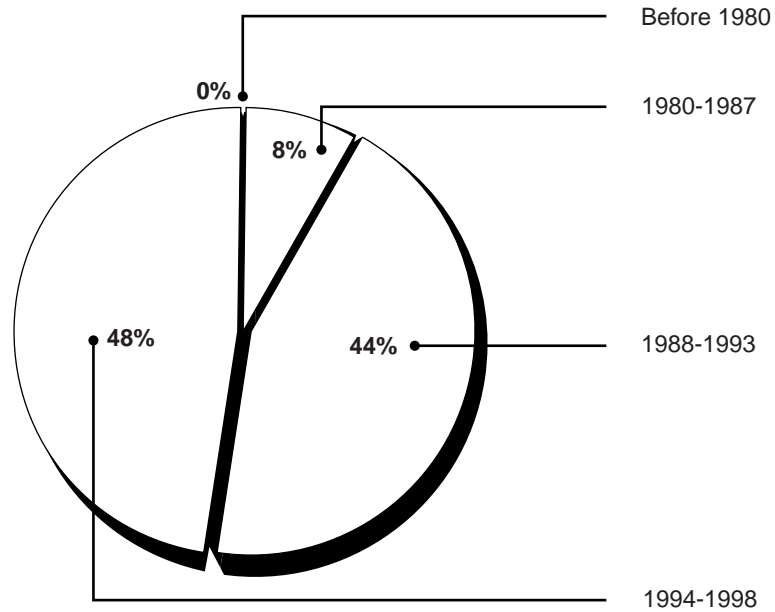
Number of businesses	Unpaid payroll taxes	
	Number of quarters	Outstanding balance ^a (Dollars in billions)
1,702,177	1 to 6	\$26.4
158,106	7 to 20	21.0
5,281	21 to 40	1.5
86	Over 40	0.1
Total	--	\$49.0

^aConsists of taxes, penalties and interest.

Source: IRS business master file.

As the table illustrates, a significant number of businesses have multiple tax periods of unpaid payroll taxes. These multiple periods of unpaid payroll taxes go back a number of years, as shown in the following figure.

Figure 2: Percent of Delinquent Quarters of Unpaid Payroll Taxes by Age



The age of these quarters of unpaid payroll taxes and their outstanding balances are further illustrated in table 2.

Table 2: Delinquent Quarters of Unpaid Payroll Taxes and Their Outstanding Balances by Age

Tax years	Unpaid payroll taxes	
	Number of quarters	Outstanding balance ^a (Dollars in billions)
1994-1998	2,348,838	\$14.4
1988-1993	2,198,493	25.4
1980-1987	407,619	9.0
Before 1980	3,491	0.2
Total	4,958,441	\$49.0

^aConsists of taxes, penalties and interest.

Source: IRS business master file.

Over 52 percent of the 4.9 million in delinquent quarters of payroll taxes predate 1994. The outstanding balance of these delinquent quarters of

payroll taxes totals over \$34 billion and represents over 70 percent of the total balance of unpaid payroll taxes in IRS' inventory of unpaid assessments at September 30, 1998. Additionally, over 8 percent of the delinquent quarters of payroll taxes predate 1988. The outstanding balance of these delinquent quarters of payroll taxes, about \$9 billion, represents over 18 percent of the total balance of unpaid payroll taxes at September 30, 1998.

Potential Collectibility of Unpaid Payroll Taxes Is Low

Our previous work on IRS' unpaid assessments⁷ has shown that older delinquent taxes have little likelihood of collection. Furthermore, because IRS continues to accrue significant amounts of interest and penalties on these delinquent taxes as they age, additional amounts that will not be collected are added to IRS' balance of unpaid assessments. IRS records indicate that over 60 percent of the \$49 billion outstanding balance of unpaid payroll taxes at September 30, 1998, consists of interest and penalties.

IRS' business master file—its detailed record of business taxpayer accounts—contains codes reflecting the status of each given taxpayer's account by tax period. These codes provide some insight into the potential for collecting on a given taxpayer account. Codes in many of the 4.9 million delinquent payroll tax accounts indicate little potential for collection. For example, nearly 1.4 million of the delinquent payroll tax accounts (28 percent) have codes indicating that the businesses which owe these taxes are no longer in existence. Similarly, for 487,000 delinquent payroll tax accounts (10 percent), IRS records indicate that the businesses that owe these taxes are insolvent or IRS has been unable to locate or contact them. For 444,000 delinquent payroll tax accounts (9 percent), IRS records indicate the businesses do not have the resources to pay the amounts owed, and 189,000 (4 percent) are owed by businesses in bankruptcy or other litigation proceedings. Consequently, these records would indicate that the majority of the unpaid payroll taxes owed the federal government are not likely to be collected.

Our review of a statistical sample of 690 unpaid tax assessments selected as part of our audit of IRS' fiscal year 1998 financial statements reinforces this conclusion. Of the 690 unpaid tax assessment accounts selected for

⁷See *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments* (GAO/AIMD-99-12, October 29, 1998).

review, 191 of these cases, with outstanding balances of about \$121 million, were unpaid payroll taxes or associated TFRPs.⁸ In our review of these cases, both we and IRS determined that about 9 percent of the outstanding balances would likely be collected.

Types of Businesses With Unpaid Payroll Taxes

There are many types of businesses with delinquent payroll taxes. IRS records break out these unpaid payroll taxes into broad categories by business type. For example, IRS' business master file includes the following categories: exempt organizations, partnerships, corporations, federal filers, state or local governments, and sole proprietorships. Within these broad categories, corporations represent about 56 percent of the total number of unique businesses with unpaid payroll taxes. Sole proprietorships represent the second most significant category, about 29 percent of the total, and partnerships represent the third most significant category, about 7 percent.

Our review of the 191 unpaid payroll tax cases and discussions with IRS revenue officers throughout the country identified additional characteristics of the businesses that have failed to forward payroll taxes to the federal government. These businesses are typically in wage-based industries, with few assets available as a potential collection source for the IRS. They are usually small, closely held businesses using a corporate structure, but this can vary by region of the country. For example, revenue officers in the New England area informed us that 80 to 95 percent of the businesses comprising their unpaid payroll tax caseloads were corporations. Conversely, revenue officers in Arkansas and Oklahoma told us that corporate forms of business comprise only 20 to 30 percent of their unpaid payroll tax caseloads.

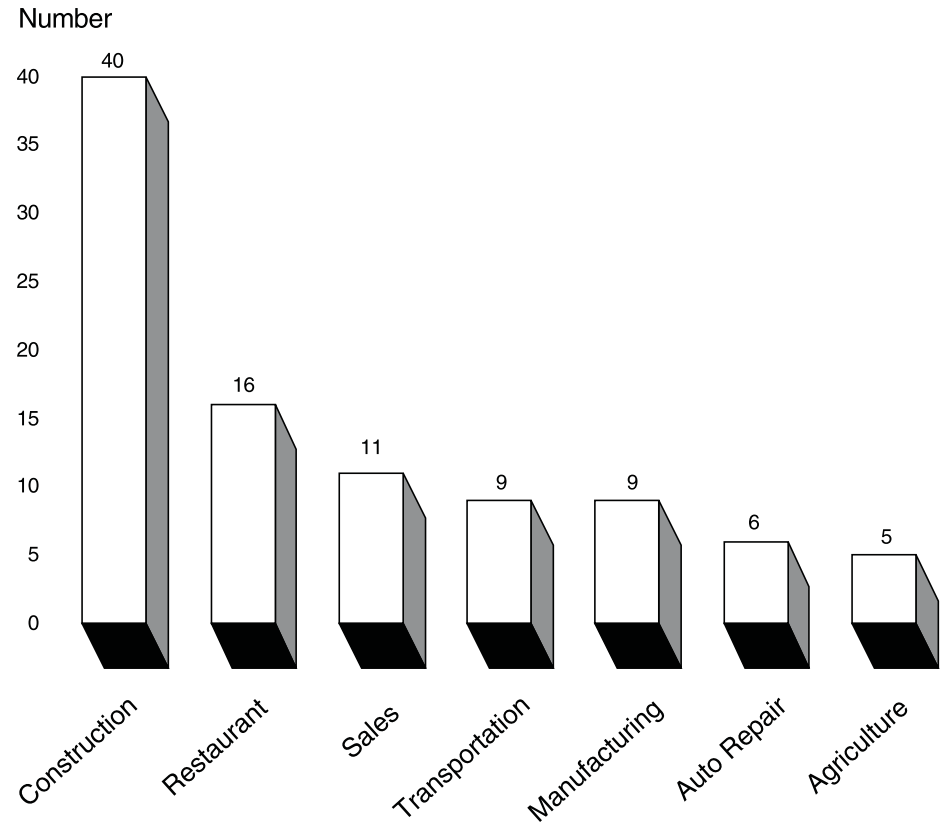
Many of the revenue officers we interviewed noted that construction and restaurants were the most common types of industries that give rise to unpaid payroll taxes. However, in areas such as Dallas, Fort Worth, Tampa, and Central California, we were told that computer software and other high technology industries comprise a significant portion of the revenue officers' unpaid payroll tax caseloads. Revenue officers also cited child

⁸While our sample of 690 unpaid assessment accounts is a representative sample, the 191 unpaid payroll tax and TFRP cases selected as part of this sample cannot be considered statistically representative of the entire population of such cases. Thus any analysis of these 191 cases cannot be projected to the entire population of unpaid payroll taxes and TFRPs. See appendix I of this report for additional details.

care and professional services, such as legal, medical, and accounting firms, as other types of businesses that give rise to unpaid payroll taxes.

Figure 3 presents the most common business/industries with unpaid payroll taxes identified in our review of the 191 cases.

Figure 3: Most Common Businesses/Industries With Unpaid Payroll Taxes From Cases Reviewed



Other types of businesses noted in our review of the 191 unpaid payroll tax cases included (1) professional services, (2) consultants, (3) education and training, (4) computer software, and (5) child care.

A majority of the revenue officers indicated that the businesses with unpaid payroll taxes typically had quarterly payroll tax liabilities of between \$10,000 and \$50,000, were undercapitalized, and experienced serious cash

flow problems. A number of the revenue officers told us they believed that the lack of sound business management skills also contributed to businesses' inability to pay their payroll taxes.

What Is the Magnitude of the Trust Fund Recovery Penalties Assessed Against Individuals Who Withheld But Did Not Forward Payroll Taxes to the Government?

According to IRS records, as of September 30, 1998, outstanding TFRPs assessed against individuals were about \$15 billion. This amount includes initial assessments of about \$9 billion and accumulated interest of about \$6 billion. IRS records indicate a total of about 237,000 separate TFRP assessments made against nearly 185,000 distinct individuals.

To understand the relationship between the \$49 billion in unpaid payroll taxes per IRS records at September 30, 1998, and the outstanding TFRP balance of \$15 billion, it is important to note several points, some of which were discussed earlier. First, a TFRP assessment is only for the federal tax withholding and FICA taxes withheld from employees' salaries; it does not include the business' or employer's matching FICA contributions. Second, a TFRP can be assessed against anyone found willful and responsible for the withholding and nonpayment of payroll taxes. If several individuals involved in a business are found willful and responsible, they can each be separately assessed a TFRP for the unpaid taxes. However, while TFRPs are assessed against one or more individuals and thus appear as separate unpaid assessments on IRS' records, the total payroll taxes owed by the business are to be collected only once. This means that if the business responsible for the unpaid payroll taxes pays some or all of its delinquent taxes, or if one of several individuals assessed a TFRP covering the same delinquent tax period pays some or all of the assessment, the tax liability for all related parties should be reduced or eliminated from IRS' records.

It is also important to note that the number and outstanding balance of TFRPs discussed above do not provide a complete picture of their magnitude or the individuals who withheld but did not forward payroll taxes to the government. Serious financial management deficiencies and internal control weaknesses, as well as policy decisions regarding when to assess TFRPs, affect the completeness and reliability of these amounts.

System Deficiencies Affect the Completeness and Accuracy of TFRP Information

In our October 1998 report⁹ on internal control weaknesses at IRS, which was based on the results of our audit of IRS' fiscal year 1997 custodial financial statements,¹⁰ we discussed serious financial management systems issues that affected IRS' ability to effectively manage and accurately report on its unpaid assessments. One of the most serious issues we discussed related to the inability of IRS to link related taxpayer accounts to ensure that they all receive appropriate credit when a payment is made on one account. This is of particular concern with respect to unpaid payroll taxes and related TFRPs. The unpaid payroll tax of a business is maintained on IRS' business master files while the TFRP assessed against an individual, or individuals, is maintained on IRS' individual master files – a detailed record of individual taxpayer accounts. These two separate and distinct databases are not integrated. Consequently, if a payment is received from the business, there is no automated entry to record the reduction in the individual, or individuals', TFRP account or accounts. This has led to instances where IRS has pursued collection against officers of a corporation for amounts that had already been paid.

IRS has attempted to correct this problem by manually entering a code on related taxpayer accounts to alert IRS personnel that related accounts exist and should be reviewed to ensure all transactions are appropriately reflected on each account. However, the use of these codes, referred to as "cross-references," has not been effective in providing the compensating link between related taxpayer accounts. As shown in table 3, both our fiscal years 1997 and 1998 financial audits identified a high incidence of unpaid payroll tax cases with TFRPs assessed against individuals in which payments were not accurately recorded in all related accounts to reflect each responsible party's tax liability reduction.

⁹See *Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management* (GAO/AIMD-99-16, October 30, 1998).

¹⁰See *Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements* (GAO/AIMD-98-77, February 26, 1998).

Table 3: Frequency of Payments Improperly Recorded to Related Taxpayer Accounts Identified in Fiscal Years 1997 and 1998

Fiscal year	Number of unpaid payroll tax cases reviewed where a TFRP was assessed	Cases reviewed where payments were not reflected on all related taxpayer accounts	
		Number	Percent
1997	83	53	64
1998	104	54	52

In our fiscal year 1998 audit, we also determined that this problem was not caused solely by the lack of an automated link between IRS' business and individual master files. In 7 of the 54 cases we reviewed where payments were not properly recorded, IRS failed to credit one individual's TFRP liability account for payments made by another individual who had also been assessed a TFRP for the same business' unpaid payroll taxes. Additionally, in 52 cases where a TFRP was assessed (50 percent), a "cross reference" was not present in the master files to alert IRS personnel that the account was related to one or several other accounts. These problems have resulted in instances of unintentional taxpayer burden, such as inappropriate federal tax liens on taxpayers' property, and affect the accuracy of reported balances of both the unpaid payroll tax and the associated TFRP.

Significant delays in recording payments also affect the completeness and accuracy of the reported amounts for both unpaid payroll taxes and TFRPs. In one instance, we found that payments were recorded to the individual's account over 8 years after they had been received. Additionally, we found that IRS did not always assess responsible individuals TFRPs in a timely manner. Specifically, we found two cases in which IRS did not assess a TFRP against officers of businesses until 36 and 55 months, respectively, after the businesses filed their payroll tax returns. During this period, these officers received tax refunds. Had IRS assessed the TFRPs more promptly, it would have been able to retain, or offset, the refunds to recover a portion of the balance of the unpaid payroll taxes.

IRS is developing an automated system application to eliminate some of these deficiencies. This system application, called the Automated Trust Fund Recovery (ATFR) system, is being designed to automate the assessment and monitoring of TFRPs. The application is to divide the

TFRP process into two distinct but interactive parts, the district office and service center functions. The district office application, which is being developed first, is to include case inventory control, monitoring of assessment determination dates, and the calculation of the TFRP. An IRS National Office official we spoke with estimated that the system application will be implemented nationwide during fiscal year 2000.

Not All Individuals Responsible for Nonpayment of Payroll Taxes Are Assessed TFRPs

In addition to the serious financial management deficiencies and internal control issues that affect the integrity of IRS' data on unpaid payroll taxes and TFRPs, IRS does not track or otherwise systemically maintain information on the number and dollar value of potential TFRPs that are not assessed. The number and dollar value of these unassessed penalties could be significant.

In determining whether to assess an individual a TFRP for unpaid payroll taxes, IRS considers a number of factors. First, IRS must be able to establish that an individual was, in fact, willful and responsible for the nonpayment of payroll taxes. Typically, individuals responsible for the nonpayment of payroll taxes are officers of a corporation, such as the president, treasurer, or controller. However, this is not always the case. For example, payroll clerks at businesses have been found liable for the nonpayment of payroll taxes and consequently assessed a TFRP.

Some businesses operate in a fashion which allows an individual without direct responsibility to nonetheless indirectly influence the nonpayment of payroll taxes. Thus, establishing that an individual was both willful and responsible is not always easy. An example of this would be a corporate director who, by all established lines of authority, has no direct involvement in the day-to-day operations of the business but who, in practice, is heavily involved in the business' operations. In one case we reviewed involving a technical school, the president and two chief financial officers of the school were each initially assessed TFRPs for the unpaid payroll taxes owed by the school. However, these officers appealed the assessments, arguing that a parent corporation, which was a firm based outside the United States, actually controlled how the school's cash was spent. The appeals were successful and the TFRP assessments were subsequently removed.

In determining whether to assess a TFRP, IRS also considers the amounts involved and the cost associated with pursuing collection actions against the individual. If IRS concludes the amounts involved do not warrant the

cost of pursuing collection, it typically will not assess the TFRP. Additionally, IRS does not assess sole proprietors and partnerships TFRPs for unpaid payroll taxes. The IRS instead believes it can best pursue collection against the individual through his or her individual tax return filing. Finally, IRS also considers the potential to collect the assessment in determining whether to assess the TFRP. If the individual has few or no assets, low earnings, and no other visible means of paying the assessment, IRS may decide not to assess the TFRP. Consequently, the numbers and dollar value of outstanding TFRPs discussed above likely significantly understate the extent to which individuals are responsible for not forwarding payroll taxes to the federal government.

Collectibility Potential on TFRPs Is Not Considered Great

While IRS considers the potential for collection in determining whether to assess a TFRP, IRS' records, our discussions with revenue officers, and our work on a sample of unpaid assessments performed as part of our audit of IRS' fiscal year 1998 financial statements indicate that the potential for significant collections on TFRPs is not great. Status codes in IRS' individual master files for about 76,000 (32 percent) of the 237,000 TFRPs assessed against individuals reflect conditions that minimize the likelihood of collection. These conditions include the following: (1) the individual cannot be located or contacted, (2) the individual is in bankruptcy proceedings or some other form of litigation, (3) the individual does not have the ability to pay the assessment, and (4) the individual is deceased.

Discussions with revenue officers throughout the country have reinforced the conclusion that TFRP assessments are not highly collectible. Many revenue officers we interviewed believe that less than 30 percent of amounts assessed as TFRPs are ultimately collected. Of the 104 unpaid payroll tax cases we reviewed where TFRPs were assessed, we determined that only 8 cases had some potential for collectibility.

To What Extent Are Individuals Found Responsible for Withholding But Not Paying Payroll Taxes at More Than One Business?

IRS records indicate that, as of September 30, 1998, nearly 25,000 individuals, or about 13 percent of the 185,000 individuals with TFRPs, have been assessed such penalties for unpaid payroll taxes at more than one business. As shown in table 4, about three-quarters of these individuals have TFRP assessments for two separate businesses, and about a quarter have been found responsible for the nonpayment of payroll taxes at three or more businesses.

Table 4: Number of Individuals With Trust Fund Recovery Penalties for Two or More Businesses

Number of businesses	Number of individuals
2	18,993
3	3,925
4	1,079
5	409
6	192
7-12	235
Over 12	29
Total	24,862

Source: IRS UNLCER files and individual master file.

As table 4 illustrates, a significant number of individuals have been found willful and responsible for the nonpayment of payroll taxes at multiple businesses. In fact, IRS' records indicate that seven individuals have been assessed TFRPs at 20 or more separate and distinct businesses. It is important to reiterate that these data may not provide a complete and accurate assessment of the degree to which such "multiple offenders" exist, due to the significant deficiencies in IRS' financial management systems and internal controls discussed above, and the fact that IRS does not always assess an individual a TFRP. Additionally, these data cannot take into consideration those individuals who establish new businesses under other names or otherwise conceal their identity.

Our review of the 191 unpaid payroll tax-related cases and our discussions with revenue officers throughout the country confirm that a significant number of individuals have been found liable for the nonpayment of payroll taxes at more than one business. Of the 104 unpaid payroll tax cases we reviewed in which TFRPs were assessed against individuals, we found that

30 (29 percent) involved individuals assessed TFRPs for more than one business. In one case, we found that an individual had TFRP assessments outstanding for four separate businesses and had been determined responsible for the nonpayment of payroll taxes at a fifth business. In all instances, the individual established and operated construction-related (electrical) companies in which he was both owner and president. Each company accumulated unpaid payroll taxes and then went out of business. Shortly after each company went out of business, the individual opened a new company in the same line of business. For the most recent business, the company has an installment agreement in effect with the IRS to pay the amounts of unpaid payroll taxes for that business; however, at the time of our review, IRS records showed that the company was substantially behind in its payments.

Most of the revenue officers we interviewed also noted that their caseloads included individuals with multiple TFRPs assessed against them. These individuals represented 1 percent to 60 percent of their caseloads. Several of the revenue officers included as “multiple offenders” individuals who had multiple TFRPs assessed against them for the same business. For example, a business may have been delinquent in paying payroll taxes throughout 1995, and an officer may have been assessed a TFRP for the unpaid taxes for that year. Subsequently, the business may have failed to remit withheld payroll taxes for 1997, and the same officer may have been assessed an additional TFRP for the 1997 unpaid taxes.

Reasons Individuals Continue to Have Unpaid Payroll Taxes

Most of the revenue officers we interviewed believe the majority of the individuals responsible for not paying payroll taxes at multiple businesses do not flagrantly disregard their responsibility to forward such payments to the federal government. Most of the revenue officers stated that these individuals lack the skills necessary to properly manage a business. Many start up a business with little capital and quickly find themselves experiencing cash flow problems. In their struggle to stay in business, these individuals prioritize and direct their payments to those recipients without which the business would quickly fail, such as employee salaries, rent, and utilities. Eventually the business is unable to sustain even these payments, and it fails. Unfortunately, these individuals do not learn from some of the mistakes they make, and are soon opening and operating a new business in much the same manner.

The revenue officers acknowledged, however, that some individuals intentionally disregard their responsibility to forward payroll taxes to the

federal government. One revenue officer noted a case in which an individual was ultimately determined to be responsible for not paying the payroll taxes at three businesses. This individual used family members to conceal his involvement in two of the businesses. He was the president of the first business and had the business assets listed in his name. After this corporation had accrued but not paid substantial payroll tax liabilities, the corporation went out of business and he established a new corporation, listing his wife as president and placing the assets in her name. He subsequently established a third corporation, this time listing his daughter as the president and placing the assets in her name. Both of these subsequent corporations also accrued significant unpaid payroll tax liabilities. The revenue officer ultimately determined that the individual was heavily involved in these two businesses through discussions with the individual's wife and daughter, who identified him as having the day-to-day responsibilities for operating the businesses.

Regardless of an individual's intent, the failure to pay withheld payroll taxes has the same effect on the federal government. Whether an individual continues to exercise poor business judgment or flagrantly disregards his or her responsibility for paying withheld payroll taxes, the federal government incurs costs to pursue collection of the delinquent tax debt and loses revenue to the extent such taxes are not ultimately collected. Additionally, as discussed previously, to the extent payroll taxes are not paid, the general revenue fund subsidizes the Social Security and hospital insurance trust funds. As a result, less funds are available to finance other federal programs.

To What Extent Do Businesses and Individuals Responsible for Withholding But Not Paying Payroll Taxes Receive Federal Benefits or Other Federal Payments?

We found that businesses and individuals responsible for withholding but not paying payroll taxes receive substantial payments from the federal government, either for federal benefits or for other payment purposes, such as federal contracts or loans. We based this conclusion primarily on comparisons of IRS records of business unpaid payroll taxes and individuals assessed TFRPs with the Financial Management Service (FMS) payment and the Small Business Administration's (SBA) loan records. We also found examples of such benefits and payments from our review of the 191 unpaid payroll tax-related assessment cases from our fiscal year 1998 financial audit.

Federal Disbursement Records Indicate Delinquent Taxpayers Are Receiving Significant Federal Payments

We matched IRS records of individuals with outstanding TFRPs with FMS payment records for Social Security benefits, federal civilian retirement benefits, federal civilian salaries, and Railroad Retirement Board (RRB) pension benefits. Based on this match, we estimate that about 18,800 of these individuals were receiving about \$212 million in annual federal benefit payments while owing almost \$2 billion in delinquent payroll taxes. Table 5 presents the benefits, the number of taxpayer matches, the estimated annual payments made to the taxpayers, and the taxpayers' tax liabilities as of September 30, 1998.

Table 5: Delinquent Taxpayers Receiving Federal Benefits at September 30, 1998

Dollars in millions

Payment type	Taxpayers	Estimated annual payments	Tax liabilities at September 30, 1998
SSA	18,199	\$ 200.4	\$ 1,902.0
Civilian Retirement	271	3.9	21.5
Civilian Salary	215	6.3	14.1
RRB	81	1.0	7.7
Total	18,766	\$ 211.6	\$1,945.3

Source: GAO analysis of FMS payments and IRS' records for trust fund recovery penalties.

We also matched FMS records of payments made to civilian vendors over a 3-month period to IRS' records of businesses with unpaid payroll taxes and individuals with outstanding TFRPs. Based on this match, we found that about 16,700 taxpayers with payroll tax liabilities of about \$507 million at September 30, 1998, received about \$7 billion in federal payments over this 3-month period. Because of the sporadic nature of these payments, we did not attempt to estimate an annual amount for these payments.

Additionally, based on our matching of IRS records of businesses with unpaid payroll taxes with SBA's records of outstanding loans as of September 30, 1998, we estimate that about 12,700 taxpayers with unpaid payroll taxes estimated at more than \$295 million had received loan disbursements totaling about \$3.5 billion. Further analysis disclosed that 38 of these taxpayers, with outstanding TFRPs of about \$1.6 million, received SBA loans estimated at \$10.6 million after IRS had assessed the TFRPs. In addition, 1,719 taxpayers (businesses and individuals) with unpaid payroll taxes of about \$31.6 million received SBA loans estimated at \$448.7 million after accumulating these tax delinquencies.

However, any conclusions drawn from this analysis must take into consideration the potential problems with the reliability and completeness of IRS data. As discussed earlier, serious deficiencies in IRS' financial management systems and internal control weaknesses have resulted in IRS' records not always portraying an accurate picture of taxpayers' account status. To the extent that payments or credits for payments have not been recorded in a taxpayer's account, the account may reflect an outstanding balance that no longer exists, possibly overstating the level of actual matches between IRS records and FMS payment records or SBA's records of outstanding loans. Additionally, to the extent assessments have not been promptly recorded in IRS systems, the number of matches of taxpayer delinquencies to either the various FMS disbursement listings or SBA's records of outstanding loans may be understated. Finally, the number of matches between IRS records and various FMS disbursement listings does not include those individuals responsible for not paying payroll taxes who were not assessed a TFRP. Consequently, there could be a significant number of individuals who were responsible for not paying a business' payroll taxes and who have received, or are currently receiving, federal benefits or other federal payments that are not reflected in the above data.

Cases Reviewed Also Identified Delinquent Taxpayers Receiving Federal Benefits and Payments

In our review of the 191 unpaid payroll tax-related assessment cases selected as part of our unpaid assessments sample, we identified instances where either businesses with outstanding unpaid payroll taxes or individuals responsible for the nonpayment of these taxes were also receiving federal benefits or other federal payments. These included six cases in which businesses and individuals were receiving federal contract payments, three cases in which individuals were receiving Earned Income Tax Credit refunds, one case in which an individual was receiving Social Security benefits, and one case in which an individual received an SBA loan. In fact, in one case we reviewed involving a computer services consulting corporation, all of the company's business involved contracts with the federal government, specifically the Health Care Financing Administration. Because the underlying case file documentation did not always include information on federal benefits or other federal payments, we were unable to determine the actual number of instances in which such benefits or payments were being received.

Revenue officers informed us that they had instances in their caseloads of businesses that had received or were receiving some form of federal benefit or payments, most notably SBA loans and federal contracts. Most of the revenue officers stated that the percentage of such cases was

relatively low, typically less than 10 percent. However, a few of the revenue officers indicated that the percentage of their cases involving businesses receiving SBA loans or federal contract payments was substantially higher. For example, several revenue officers noted that between 30 and 40 percent of these cases involved businesses which received SBA loans. This reinforces the fact that federal benefits and other federal payments are being made to businesses and individuals who have unpaid payroll taxes.

What Factors Affect IRS' Ability to Enforce Compliance or Pursue Collections in This Area?

Several factors affect IRS' ability to enforce compliance with respect to the payment of payroll taxes and to pursue collections of unpaid payroll taxes from the businesses or the responsible individuals. These factors include (1) serious financial management system deficiencies and internal control weaknesses, (2) ineffective early warning and taxpayer education programs, (3) procedural limitations, (4) federal and state laws, (5) staffing resources and other factors IRS employees perceive as affecting enforcement and collections, and (6) the capability to offset federal benefits and other federal payments against the unpaid tax assessments.

Financial Management System Deficiencies and Internal Control Weaknesses Affect Accuracy of Taxpayer Account Status

As discussed previously, IRS' financial management systems and internal controls do not provide timely, accurate, and complete information on the status of taxpayers' accounts. The lack of an automated link or interface between IRS' business and individual master files prevents IRS from having a complete record of related taxpayer accounts to ensure that all activity, such as collections, are properly recorded in all related accounts. Without this information, IRS has no assurance that its records for an individual taxpayer or business are complete and accurate. As discussed earlier, this has resulted in instances where IRS has pursued and collected amounts that were no longer owed. While IRS has made some progress in attempting to compensate for the lack of an automated interface between the two taxpayer databases, these efforts to date have not been fully effective in ensuring the accuracy of taxpayer accounts. Until adequate automated systems are implemented, significant ongoing resources will be required to compensate for these systems deficiencies. In addition, delays in assessing individuals TFRPs result in missed opportunities to collect amounts through such means as retaining or offsetting refunds against unpaid payroll taxes.

Taxpayer Education and Early Warning Programs Are Not Considered Effective

IRS has two programs to prevent payroll tax delinquencies: the (1) Small Business Tax Education Program and (2) Federal Tax Deposit (FTD) Alert Program.

The Small Business Tax Education Program attempts to prevent payroll tax and income tax delinquencies by offering education programs and tax workshops to individuals wishing to start up a business. IRS started the small business tax workshop—a part of the Small Business Tax Education Program—in the early 1980s. According to IRS officials, during fiscal year 1998, 1,912 workshops and education programs serving over 46,000 individuals were held nationwide. IRS is also working to enhance the program through several other initiatives, including developing various workshops in coordination with SBA. Many of the revenue officers we interviewed nationwide noted that this program has not been very effective in reducing or preventing delinquent payroll taxes. Others noted that there has been little demand for taxpayer education, that the attendance at these workshops has been low, and that the individuals in most need of attending these workshops did not appear to be present.

The FTD Alert Program, which was initiated in 1972, is intended to identify and prevent potential payroll tax payment delinquencies through early identification of required deposits under the FTD system that have not been made. Before the end of each quarter, IRS systems identify employers making semiweekly tax deposits who have failed to deposit their taxes during the quarter. The Alert Program targets larger employers (those who reported more than \$50,000 in payroll taxes on their quarterly Tax Form 941 filings during the previous 12-month period) who deposit semiweekly. Information regarding taxpayers who failed to make their deposits is transferred to tapes, which are sent to the service centers for printing of the alert notices and mailing to the respective district offices.

IRS designates FTD alerts as mandatory or optional. Mandatory FTD alerts are generated for semiweekly depositors who have not made deposits during the current quarter or who have made them in substantially reduced amounts and were assessed an FTD penalty¹¹ of at least \$100 in each of the four prior quarters. IRS policy requires revenue officers to contact taxpayers as soon as possible after receipt of a mandatory alert. Optional FTD alerts are issued for taxpayers who have been assessed an FTD

¹¹Taxpayers are assessed a late penalty for failure to make timely FTD deposits.

penalty of at least \$100 in two of the four quarters or in only one of the four prior quarters if the amount owed for that quarter remains outstanding.

According to IRS records, over 44,000 FTD alerts were issued from July 1, 1997, through June 30, 1998. About 38 percent of these alerts were mandatory, meaning IRS revenue officers were required to contact the taxpayer. The other 62 percent were optional FTD alerts and did not require contact with the taxpayer.

Some of the revenue officers we interviewed stated that FTD alerts were only marginally effective in preventing delinquencies. Some others noted that the alerts are not received in the field early enough to prevent employers from accumulating substantial delinquencies or to provide early warning of potential problems. For example, the criteria for issuing a mandatory FTD alert is that the taxpayer has been late in making required deposits in each of the prior four quarters. The repeated late payments are an indication of potential problems that revenue officers might be able to identify early if they are made aware of the late payments. Additionally, the time it takes to produce the alerts and send them to the district offices for assignment to revenue officers for follow up also adds to the delays in making contact with the taxpayer. By the time the FTD alerts are received and acted on, employers have fallen behind on current quarter tax deposits and are not likely to have the resources available to pay the previous tax delinquencies that precipitated the FTD alert.

Some of the revenue officers also noted that the alerts received were often invalid or unproductive. Often the taxpayer's case has already been designated as delinquent, or the taxpayer has actually gone out of business before the revenue officer makes contact. In other instances, the employer has already paid the delinquent payroll taxes between the time the FTD alert is issued and received in the field and the contact is made with the taxpayer. Some revenue officers also stated that the FTD alerts yield few collections compared to the effort expended in processing the alerts.

The revenue officers stated that IRS has no established procedures for early detection and prevention of delinquent payroll taxes other than the Small Business Tax Education Program and the FTD Alert Program. They noted that some district offices have used other early intervention techniques in the past to identify and prevent delinquencies, including contacting the employer after the initial delinquency has been identified or following up directly with the taxpayer immediately after the first notice of tax deficiency is sent to the taxpayer. However, at most districts, revenue

officers informed us that these types of early intervention techniques were no longer being used due to resource considerations.

Certain IRS Procedures Limit Collection and Prevention Efforts

According to various IRS Collection Division field personnel, another problem that inhibits IRS' ability to collect delinquent payroll taxes and to prevent taxpayers from accumulating multiple payroll tax delinquencies is that the IRS' Criminal Investigation Division (CID) and District Counsel do not prosecute taxpayers for failing to pay payroll taxes unless fraud is clearly evident. Some of these field personnel noted that even in instances where the taxpayers have multiple tax delinquencies, CID and the District Counsel appear reluctant to pursue prosecution. A few field personnel noted that IRS could seek injunctions through the U.S. Attorney's Office to prevent taxpayers from accumulating multiple payroll tax delinquencies and that the District Counsel prefers not to seek such injunctions due to the time and expense required to prosecute such cases.

Federal and State Laws Also Inhibit Compliance and Collection Efforts

Federal and state laws also affect IRS' ability to enforce compliance with respect to payment of payroll taxes or to pursue collections on delinquent payroll taxes. States, not the federal government, govern the incorporation of businesses, and state licensing authorities have the power to grant or deny business licenses for new and existing businesses. State licensing authorities can deny business licenses or license renewals for businesses which fail to pay state taxes, but they do not consider federal payroll tax delinquencies. This is in part because, in accordance with section 6103 of the Internal Revenue Code, disclosure of federal tax information without taxpayer consent is generally prohibited. IRS is precluded from sharing information such as the status of taxpayers' federal tax accounts with the state licensing authorities. Consequently, the licensing authorities cannot consider, and do not have available to them, information on federal tax delinquencies in determining whether to grant, renew, deny, or suspend business licenses. This inhibits IRS' ability to prevent individuals responsible for the nonpayment of payroll taxes from starting up a new business and repeating the practice.

According to some Collection Division field representatives, these legal disclosure prohibitions also limit IRS' ability to use other options available to some state and local taxing authorities to bring delinquent taxpayers back into compliance with their tax obligations. Specifically, these representatives noted IRS' inability to publish the names of delinquent taxpayers to increase compliance and generate collections, a process that

has been used with some success by a number of states and local taxing authorities. For example, Connecticut, Montana, and the District of Columbia publish information on delinquent taxpayers on Internet web sites. The type of information disclosed varies somewhat but can include the name of the taxpayer, responsible corporate officers, location, the types of state and/or local taxes owed (i.e., withholding or income), and the amounts owed. A Connecticut official, in particular, indicated that the delinquent taxpayer disclosure program instituted by the state has been quite successful, generating collections of about \$25 million in delinquent state taxes between January 1997 and February 1998.

One IRS field representative we spoke with also mentioned that in California, new businesses are required to post bonds for state payroll taxes as a prerequisite to the granting of a new business license. In this manner, the state is protected to some degree in the event of nonpayment of state payroll taxes. Other field representatives we spoke with noted that such a requirement with respect to federal payroll taxes prior to granting a business an employer identification number could provide similar protection to the federal government. This avenue is currently not available to the federal government.

According to some IRS field representatives, the agency's ability to pursue collections of delinquent payroll taxes and associated TFRPs is also inhibited by the property laws of some states, as well as varying interpretations of bankruptcy laws. According to some representatives, IRS is unable to enforce collection of delinquent taxes and penalties in a number of states because state laws preclude attaching liens to, and seizing, personal property. In states where Tenancy by the Entirety¹² laws exist, IRS is prohibited from attaching liens or seizing any personal property that is jointly owned by married couples when only one of the spouses is liable for the delinquent taxes. Currently, at least Alaska, Indiana, Missouri, New Jersey, New York, North Carolina, Ohio, Oregon, and Utah recognize Tenancy by the Entirety laws. Additionally, in states with Marital Joint Property laws, IRS can only apply a lien against, or seize, the delinquent taxpayer's portion of jointly owned assets. Also, according to an IRS official, some businesses in bankruptcy can continue to accumulate additional delinquent payroll taxes. When a business is in

¹²Tenancy by the Entirety is one form of jointly held property where the property is co-owned with a spouse. Each spouse owns 100-percent of the property at all times.

Chapter 11¹³ Bankruptcy Reorganization, the business can continue to operate at the bankruptcy judge's discretion. This can result in the business incurring additional tax delinquencies.

Other Factors IRS Employees Cited As Affecting Enforcement and Collections of Unpaid Payroll Taxes

In addition to the factors discussed above, Collection Division field representatives cited other factors which, they believe, have or may have an effect on their ability to enforce compliance and pursue collections on delinquent payroll taxes and TFRP assessments.

Several Collection Division field representatives stated that the current level of collection staff is not sufficient to effectively prevent, collect, and monitor delinquent payroll taxes and TFRPs. These representatives noted that due to high attrition and requirements to support other functions within the agency, an increasing number of payroll tax and TFRP cases are currently awaiting assignment to a revenue officer. Over the past two fiscal years, IRS has experienced a revenue officer attrition rate of about 10 percent, translating into a net loss of 715 revenue officers.

Some field representatives noted that revenue officers are increasingly being required to spend time supporting IRS' Customer Service and other functional areas instead of working on collection issues. According to these representatives, revenue officers are required to provide assistance to taxpayers who walk into or phone the office with an inquiry or problem. An IRS National Office official we spoke with stated that the Collection Division spent about 410 full-time equivalents supporting Customer Service, collateral duties, walk-ins, automated data processing support, and other activities unrelated to collections during fiscal year 1998.

Collection Division field office representatives stated that they believe implementation of certain provisions of the IRS Restructuring and Reform Act of 1998 could also affect the agency's enforcement and collection efforts. The act was enacted in July 1998 to, among other things, change the agency culture from one which emphasizes maximizing collections to one which provides service and assistance to taxpayers to meet their tax obligations. The IRS has publicly noted that, in the long run, the act should go a long way in improving the agency's image with taxpayers and should actually result in improved taxpayer compliance. Nonetheless, Collection

¹³In general, Chapter 11 is a reorganization proceeding of an individual, business, or other entity where creditors are paid under a plan.

Division field office representatives stated that certain provisions in the act may impact IRS' efforts to collect unpaid taxes. They said that certain provisions could lengthen the time it takes revenue officers to work cases and result in fewer cases being resolved. They also expressed uncertainty about how to operate under certain other provisions that, while intended to provide fairness to taxpayers, also contain penalties for not following the rules in these procedures.

We did not assess or otherwise verify the issues the IRS field representatives raised with respect to the act. Additionally, as this report points out, significant financial management system deficiencies and internal control weaknesses have and continue to seriously impact IRS' ability to effectively manage unpaid tax assessments.

Ability to Offset Federal Benefits and Other Federal Payments Has Yet to Be Achieved

As discussed previously, a significant number of businesses with unpaid payroll taxes and individuals assessed TFRPs receive federal benefits and other federal payments that amount to billions of dollars annually. Federal law does not prevent businesses or individuals from receiving federal payments or loans when they are delinquent in paying payroll taxes. While IRS can retain, or offset, refunds otherwise due businesses or individuals to recover some or all of the delinquent taxes owed, up to this point it has not been able to systemically pursue other federal payments made to these taxpayers to recover the delinquent taxes.

The Debt Collection Improvement Act (DCIA) of 1996 called for the centralization and aggressive pursuit of delinquent federal receivables, including delinquent loans and other forms of payments owed the federal government. The Department of the Treasury is developing a mechanism to pursue collection of outstanding federal receivables as mandated by DCIA. This includes establishing various collection strategies and efforts and using offsetting tax refunds owed businesses and individuals to recover the delinquent receivables. As part of this effort, the debtor offset program—which IRS had administered to offset certain nontax receivables such as student loans and child support against tax refunds—was shifted to FMS in January 1999.

DCIA specifically excluded federal taxes receivable and other unpaid tax assessments from its provisions. However, Treasury intends to include the collection of such amounts as part of the mechanism it is developing. Treasury intends to use as its legal authority a subsequently passed provision in the Taxpayer Relief Act of 1997, which grants IRS the authority

to place a continuous levy on a delinquent taxpayer's federal benefits to assist in recovering overdue taxes. This continuous levy has certain provisions to protect the taxpayer, such as limiting the levy to no more than 15 percent of each benefit payment.

Treasury's plan has been revised on several occasions, as it and other affected agencies try to address complex implementation issues to avoid undue harm to individuals. This will be of particular concern with respect to Treasury's plan to include unpaid tax assessments as part of its federal payment offset efforts. There will be a critical need to address IRS' significant financial management systems deficiencies and internal control weaknesses to ensure that taxpayers are not unduly harmed through the levying of federal benefits and other payments to repay amounts that have already been collected.

Agency Comments

IRS stated that it concurred with the issues raised in this report and noted that it would use the report to assist in its efforts to correct system deficiencies affecting unpaid payroll taxes and associated trust fund recovery penalties. IRS stated that to correct these system deficiencies, it would need to replace its computer systems and underlying databases. In the shorter term, however, IRS stated that it is working to implement an automated process to reduce or eliminate delays in posting trust fund recovery penalty assessments and that these efforts will provide its service centers with the information needed to more promptly and accurately establish linkages to related accounts. IRS also stated it was developing a new process to better assist taxpayers in meeting their tax obligations.

We are sending copies of this report to Senator Ted Stevens, Senator Robert C. Byrd, Senator Orrin G. Hatch, Senator Max S. Baucus, Senator Fred Thompson, Senator Joseph I. Lieberman, Senator William V. Roth, Senator Daniel P. Moynihan, Representative Bill Archer, Representative Charles B. Rangle, Representative C.W. Bill Young, Representative David R. Obey, Representative Amo Houghton, Representative William J. Coyne, Representative Dan Burton, and Representative Henry A. Waxman, in their capacities as Chair or Ranking Minority Member of Senate and House Committees and Subcommittees. We are also sending copies of this report to the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; the Honorable Jacob J. Lew, Director, Office of Management and Budget; and the Honorable Lawrence Summers, Secretary of the Treasury. Copies will be made available to others upon request.

Please contact us at (202) 512-3406 or (202) 512-9110, respectively, if you or your staffs have any questions concerning this report. Other contacts and key contributors to this report are listed in appendix III.



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Abbreviations

ARDI	accounts receivable dollar inventory
ATFR	Automated Trust Fund Recovery
BPD	Bureau of the Public Debt
CID	Criminal Investigation Division
DCIA	Debt Collection Improvement Act
EIN	Employer Identification Number
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FTD	Federal Tax Deposit
IRS	Internal Revenue Service
OTA	Office of Tax Analysis
RRB	Railroad Retirement Board
SBA	Small Business Administration
SECA	Self-Employment Contribution Act
SSA	Social Security Administration
TIN	Taxpayer Identification Number
TFRP	trust fund recovery penalty

Scope and Methodology

To determine the extent to which payroll taxes are not remitted to the federal government, we analyzed data from IRS' business master file and accounts receivable dollar inventory (ARDI) system as of September 30, 1998, to identify (1) the total number of delinquent business tax periods involving unpaid payroll taxes, (2) the total number of unique businesses with unpaid payroll taxes, (3) the total dollar amount of unpaid payroll taxes (tax assessment, interest, and penalties), (4) the age of the unpaid payroll taxes in IRS' balance of unpaid tax assessments, (5) the types of businesses that comprise the balance of unpaid payroll taxes, and (6) the current status of these businesses. We did not specifically audit the data in IRS' systems used in our various macro analyses. We supplemented these analyses by developing a profile of the types of businesses with unpaid payroll taxes that were selected as part of a statistical sample of unpaid tax assessments in conjunction with our audit of IRS' fiscal year 1998 financial statements. While the sample of unpaid tax assessments was a representative sample, the 191 unpaid payroll taxes and trust fund recovery penalties selected as part of this sample cannot be considered statistically representative of the entire population of such cases. They were selected from the total population of unpaid tax assessments and not from a separate population of unpaid payroll taxes and trust fund recovery penalties. This approach was agreed to at the outset of the assignment with the requesters.

To determine the magnitude of the trust fund recovery penalties assessed against individuals that withheld but did not forward payroll taxes to the government, we analyzed data from IRS' individual master file and ARDI as of September 30, 1998, to identify (1) the total number of outstanding TFRPs, (2) the total dollar amount of the outstanding TFRPs (penalty assessment and interest), (3) the total number of unique individuals with outstanding TFRPs, and (4) the current status of these individuals as reflected in IRS' systems. Again, we did not audit the data used in our analyses.

To determine the extent to which individuals are responsible for withholding but not paying payroll taxes at more than one business, we analyzed information from IRS' individual master file ARDI and UNLCER systems to determine the number of unique business identification numbers representing different businesses associated with each individual assessed a TFRP. We did not audit the data used in our analyses.

To determine the extent to which businesses with delinquent payroll taxes and individuals assessed TFRPs are receiving federal benefits, payments,

or loans, we performed a match of data records from IRS' ARDI with data records from FMS and SBA. The ARDI extract was as of September 30, 1998. The FMS and SBA record extracts were as of May 1998 and September 1998, respectively.

IRS' ARDI extract was selected from taxpayer accounts that met its criteria of delinquent payroll tax and trust fund recovery penalties in fiscal year 1998. It consisted of over 1.8 million taxpayers (businesses) that owed payroll taxes. The taxpayer records were extracted from IRS' business master file, with a total outstanding balance of about \$49 billion. The extract also contained about 185,000 trust fund recovery penalty taxpayer records from IRS' individual master file with a total outstanding balance of about \$15 billion.

The FMS extract contains records from several federal agency sources including SSA, civilian retirement annuity, RRB, civilian salaries, and vendor payments. FMS provided one month of records for SSA, federal retirement annuity, and RRB benefits. Civilian salary records and vendor payments contain 1 semi-weekly period and a 3-month period of data, respectively. We excluded from the FMS match any SSA payments made to dependent children; a surviving spouse, age 60 and older; a surviving divorced spouse, age 60 and older; a disabled surviving spouse; and a survivor receiving lump-sum death benefits. We completed the matching exercise using only the primary taxpayer identification number or employer identification number.

The SBA records we received were from three loan programs--the 7(a) Business Loan program and both Home and Business Disaster Loan programs--and represented loans in SBA's inventory as of September 30, 1998. SBA provided a total of about 457,000 records with a total disbursed loan value of about \$48.2 billion. For our analysis, we used only the 7(a) Business Loans, which consisted of about 182,000 records with a total disbursed loan value of \$39.3 billion.

Because the SSA, vendor payment, and SBA analyses were the results of samples, the estimates used in the report are subject to sampling errors. Sampling errors measure the extent to which estimates from samples of these sizes and structures can be expected to differ from the total population values. From the sample estimates, together with estimates of their sampling errors, interval estimates can be constructed with prescribed confidence that they each include actual population values. Each of our estimates is surrounded by a 95-percent confidence interval.

To evaluate the accuracy of our matches, we validated the Social Security numbers and employer identification numbers in all data matches (IRS, FMS, and SBA records). To check the accuracy of the civilian retirement, RRB, and civilian salary records, as well as the individual master file-matched SBA and vendor records, we performed a 100-percent verification of their entire universe.

Table I.1 shows the results of the 100-percent verification test of the matched universe, the estimated payments/loan amounts, and the associated tax liability balances.

Table I.1: FMS/SBA Record Matches by Benefits, Payment, and Loans

Dollars in millions

Benefits, payments, and loan sources	Record count	Taxpayer matches	Payments and loans paid to taxpayers	Taxpayers' tax liabilities at September 30, 1998
Civilian Retirement	2,324,200	271	\$0.329	\$21.5
Civilian Salary	2,026,150	215	\$0.242	\$14.1
RRB	745,546	81	\$0.081	\$7.7
Vendor (individual master file)	2,543,732	176	\$0.441	\$18.7
SBA (individual master file)	182,008	228	\$16.500	\$96.4

Source: Our analysis of FMS benefits and payments, SBA loan records, and IRS records for unpaid payroll taxes and trust fund recovery penalties.

To validate the accuracy of the SSA records, as well as the business master file-matched SBA and vendor records, we calculated the 95-percent confidence level, using a representative sample of matched records from these universes. The vendor records were not estimated annually because of the sporadic nature of these payments.

Table I.2 shows the number of estimated taxpayer matches, the estimated payment/loan amounts, and the estimated outstanding tax liabilities associated with these matches.

Table I.2: SSA, Vendor, and SBA Sampled Matches, Payments, and Liabilities

Dollars in millions

Payment source	Record count	Taxpayer matches ^a	Payments and loans paid to taxpayers	Taxpayers' tax liabilities at September 30, 1998
SSA	40,108,592	18,199 ^b	\$16.7 ^e	\$1,902 ^h
Vendor (business master file)	2,543,732	16,533 ^c	\$7,007 ^f	\$488 ⁱ
SBA (business master file)	182,008	12,463 ^d	\$3,355 ^g	\$279 ^j

Note: Upper and lower bounds for matched items as indicated in the footnotes are 95 percent confidence intervals.

^aEstimated matches by TIN and name.

^b17,941 to 18,456.

^c15,860 to 17,207.

^d11,841 to 13,084.

^e16.6 million to \$16.9 million.

^f6,901 million to \$7,113 million.

^g3,091 million to \$3,620 million.

^h1,882 million to \$1,922 million.

ⁱ160 million to \$734 million

^j\$171 million to \$386 million.

Source: GAO analysis of FMS benefits and payments, SBA loan records, and IRS records for unpaid payroll taxes and trust fund recovery penalties.

To determine the factors affecting IRS' ability to enforce compliance or pursue collections of payroll taxes and TFRPs, we conducted structured interviews at all 33 IRS district office locations. These interviews were with revenue officers and group managers from IRS' Collection Division. We also interviewed IRS personnel at the National Office. Additionally, we obtained and reviewed available IRS information on employment tax programs and initiatives. We also reviewed IRS' statistical information from our prior reports on employment tax issues. Finally, we reviewed IRS' collection procedures and policies and the laws that affect IRS' use of enforcement tools.

Comments From the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 14, 1999

Mr. Jeffrey C. Steinhoff
Acting Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Steinhoff:

Thank you for the opportunity to review and comment on your draft report entitled "Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed." We share your concerns with the issues raised in the report and view them as an opportunity to further the Internal Revenue Service's (IRS) goal of providing service to each taxpayer, service to all taxpayers, and productivity through a quality work environment.

IRS management recognizes the system deficiencies with respect to the Trust Fund Recovery Program (TFRP). While you have identified improvements needed in the short term, the IRS' underlying databases need to be completely replaced to have full resolution of this problem. Until IRS replaces its fundamental computer systems, we are phasing in enhancements to our current process. In the first phase, we will pilot a system designed to reduce, or eliminate, the delays in posting the trust fund recovery penalty assessments. In September 1999, we will pilot a system that automates aspects of the TFRP manual process. The successful attributes of this system are planned for implementation in FY 2000.

The second phase being formulated will provide the service centers with the necessary information to more timely and accurately establish the linkages needed to identify and post payments to all associated accounts. In the interim, we have instructed our service center directors to certify that all backlogs annotations of TFRP cross reference transcripts have been eliminated, or will be eliminated by the end of fiscal year 1999.

In addition, we are prototyping a new process as part of our redesign of the collection process. The "Mentor and Monitor New Employers" prototype will inform new employers of education and assistance opportunities at the time they receive their Employer Identification Numbers, contact employers in need of additional assistance by telephone to help them understand and comply with tax laws, monitor their tax compliance with reminder telephone calls, and provide assistance to resolve delinquencies.

**Appendix II
Comments From the Internal Revenue
Service**

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We understand the significance of the approximately \$49 billion (\$19 billion in unpaid tax assessments and \$30 billion in penalties and interest) in payroll taxes owed the federal government and will use your report to assist in our efforts to correct the deficiencies within the TFRP system.

If you have any further questions, please let me know, or your staff may contact Charles W. Peterson, Assistant Commissioner (Collection), at (202) 622-5100.

Sincerely,

Charles O. Rossotti

Charles O. Rossotti

GAO Contacts and Staff Acknowledgements

GAO Contacts

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