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on Investigations, Committee on
Homeland Security and Governmental
Affairs, U.S. Senate

November 2006

INTERNAL REVENUE SERVICE

Procedural Changes Could Enhance Tax Collections





GAO
Accountability Integrity Reliability

Highlights

Highlights of [GAO-07-26](#), a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

GAO previously testified that federal contractors abused the tax system with little consequence. While performing those audits, GAO noted that the Internal Revenue Service (IRS) records sometimes contained inaccurate or outdated tax information that prevented IRS from taking appropriate collection actions against those contractors, including submitting their tax debt to the Federal Payment Levy Program (FPLP) for collection.

As a result, GAO was asked to review IRS's coding of tax debt excluded from the FPLP to determine whether (1) IRS tax records contain inaccurate status or transaction codes that exclude tax debt from the FPLP, (2) IRS's monitoring could be strengthened to ensure the accuracy of its status and transaction codes, and (3) other opportunities exist to increase the amount of tax debt included in the FPLP.

What GAO Recommends

GAO makes four recommendations to IRS to increase the amount of tax debt eligible for the FPLP and six recommendations to evaluate the appropriateness and ongoing validity of IRS's hardship designations. IRS agreed with five of our recommendations and partially agreed with two others. IRS disagreed with three recommendations due to workload, cost, or taxpayer rights considerations. GAO reiterated its support for its recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-26.

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

INTERNAL REVENUE SERVICE

Procedural Changes Could Enhance Tax Collections

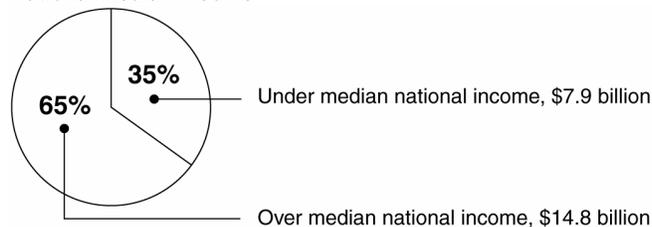
What GAO Found

IRS tax records had inaccurate information that resulted in it erroneously excluding cases from the FPLP and other tax collection actions. The FPLP is a cost-effective automated system used to collect unpaid taxes from certain federal payments. GAO estimates that as of September 30, 2005, over 500,000 tax records—equating to about \$2.4 billion in tax debt—contained inaccurate codes that IRS systems used to exclude tax debts from the FPLP. Inaccuracies included tax debts coded as having active installment agreements even though the tax debtor had stopped making payments.

IRS's monitoring of cases was insufficient to identify and correct the coding errors GAO identified. Additionally, IRS's monitoring of financial hardship cases is not sufficient to ensure their ongoing accuracy. IRS grants tax debtors experiencing financial difficulty a hardship designation that excludes them from the FPLP and other tax collection activities until their income increases. To measure this, IRS solely uses the income reported on the tax debtor's annual tax returns. However, IRS does not monitor those tax debtors to ensure they are filing and paying current taxes. For 31 financial hardship cases GAO examined, 24 had ceased to file tax returns.

Although IRS has increased the amount of tax debt it submits to the FPLP, additional policy changes could further improve the program's effectiveness. Since 1992, IRS has almost tripled the maximum income it allows tax debtors in financial hardship to earn; raising it to \$84,000 in 2004—almost double the national median income. As a result, whereas in 1992 no one earning above the median income was considered to be in financial hardship (and therefore excluded from the FPLP), in 2005 almost two-thirds of the tax debt in financial hardship was owed by individuals earning over the median income. Although a financial hardship designation may be appropriate in many situations, allowing relatively high-income tax debtors to avoid tax collection action, including the FPLP, calls into question the fair application of the tax system and may contribute to noncompliance.

Tax Debt Associated With Debtors in Financial Hardship Who Can Earn Over the 2004 National Median Income



Source: GAO analysis of IRS data.

IRS policy also limits the amount of tax debt in the FPLP by excluding \$5 billion in tax debt from the program while IRS is pursuing levies from other assets or income sources. Additionally, during notification IRS excludes individuals' tax debt from the FPLP about twice as long as legally necessary.

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Abbreviations

ACS	Automated Collection System
FMS	Financial Management Service
FPLP	Federal Payment Levy Program
IRS	Internal Revenue Service

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United States Government Accountability Office
Washington, DC 20548

November 15, 2006

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

As the nation's tax collector, the Internal Revenue Service (IRS) collects approximately \$2 trillion in taxes from businesses and individuals annually. The vast majority of the tax revenues flow into the federal government by voluntary payments from compliant taxpayers. However, while most taxpayers comply with the tax laws and pay their taxes as required, a significant number do not. At September 30, 2005, IRS's records reflected about \$250 billion of unpaid taxes. In addition, IRS estimates that about \$300 billion in additional taxes go unassessed and therefore uncollected every year.

IRS's collection process is heavily dependent upon its automated computer systems and the information that resides within these systems. In particular, the status and transaction codes in each taxpayer's account in IRS's master file taxpayer database¹ are critical to IRS in tracking the collection actions it has taken against a tax debtor and in determining what, if any, additional actions should be pursued. For example, IRS uses a specific transaction code to identify tax debtors it has designated as being in financial hardship and who are thus unable to pay their tax debt. IRS uses these status and transaction codes to identify cases it should exclude from the Federal Payment Levy Program (FPLP), which is an automated method of collecting tax debt by offsetting federal payments made to individuals and businesses, as well as from other collection actions.

¹IRS's master files contain detailed records of taxpayer accounts.

In congressional hearings held in February 2004 and June 2005,² we testified that Department of Defense and civilian agency federal contractors abused the federal tax system with little consequence. In those hearings, we noted that IRS excluded significant amounts of tax debt from the FPLP for either statutory or policy reasons, thus limiting opportunities to automatically collect from those who had not paid their federal taxes. While performing those audits, we noted that IRS records sometimes contained inaccurate or outdated tax information that prevented it from taking certain collection actions against those contractors, including using the FPLP to collect at least some of the outstanding tax debt.

On the basis of those audits and your request, we initiated a review of the status and transaction codes within IRS's master file database of taxpayer accounts to assess the accuracy of these codes and the effect inaccurate or outdated codes in the master file database could have on the FPLP and IRS's other collection efforts. The specific objectives of this report were to determine (1) whether and to what extent IRS tax records contain inaccurate or out-of-date status or transaction codes that exclude collection of tax debt through the FPLP; (2) whether IRS's monitoring policies, procedures, and practices could be strengthened to ensure the accuracy and timely updating of its status and transaction codes; and (3) whether opportunities exist to increase the amount of tax debt subject to collection through the FPLP.

Tax debts may be excluded from the FPLP for either policy or statutory reasons.³ To meet our objectives, we selected statistical samples of IRS's outstanding tax-due accounts that were excluded from the FPLP as of September 30, 2005. We examined the underlying records to determine whether or not IRS had documentation supporting the accuracy of the status and transaction codes both when they were originally entered in IRS's systems and at the point in time of our review. We supplemented our review of IRS records with information gathered through data mining. For those sample items for which we determined the codes were inaccurate or

²GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-414T](#) (Washington, D.C.: Feb. 12, 2004), and *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax Systems with Little Consequence*, [GAO-05-683T](#) (Washington, D.C.: June 16, 2005).

³In the FPLP, IRS divides tax debt records into either included or excluded categories based on the status and transaction codes in the tax debt account. Further, IRS identifies excluded tax debt records as those that are excluded because of a statutory requirement or because of an IRS policy decision.

out of date, we reviewed IRS's policies and procedures related to the FPLP to determine whether and how IRS policies, procedures, or practices could be strengthened to improve the ongoing accuracy of those codes and thus increase the volume of tax debt that would be included in the FPLP. Finally, we reviewed IRS's exclusion categories to identify opportunities for IRS to modify its exclusion criteria so that more tax debt is subject to collection through the FPLP. See appendix I for more detailed information on the scope and methodology of our work.

Our work was performed from November 2005 through September 2006 in accordance with generally accepted government auditing standards.

Results in Brief

IRS's tax records contain inaccurate or out-of-date information that resulted in IRS erroneously excluding tax debt from the Federal Payment Levy Program (FPLP) and possibly other collection actions. Although our review of tax debt excluded from the FPLP did not identify a high percentage of FPLP-related coding errors, the errors did prevent IRS from taking collection against tax debtors owing billions of dollars in tax debt. Based on a review of two statistical samples of cases excluded from the FPLP, we estimate that 6 percent of tax debts excluded from the FPLP for statutory reasons and 1 percent excluded for policy reasons were in error. On the basis of those error rates, we estimate that over a half-million tax records with about \$2.4 billion in tax debt were erroneously excluded from the FPLP, as of September 30, 2005.

IRS did not identify and correct the coding errors we found because it did not sufficiently monitor the timely updating of the status and transaction codes or the effect of computer programming changes. In our sample transactions, we found that IRS did not identify six computer-programming-related coding errors because it did not fully assess the effect of certain computer-programming changes on taxpayer account status codes. Similarly, IRS did not identify a bankruptcy-related coding error because it did not monitor the timely updating of the bankruptcy-related transaction codes. In addition, although we found no coding errors in the coding of cases designated as financial hardship cases, our analysis revealed that IRS's policies for monitoring the status of such cases are not sufficient to ensure the ongoing accuracy of hardship designations. To illustrate, when IRS determines that a tax debtor is in financial hardship and, as such, is deemed unable to pay, IRS excludes the debt from the FPLP, as well as other collection actions. IRS then limits its monitoring of the cases to an automated review of the tax debtor's income as reported on the debtor's subsequent years' income tax returns. However, for 24 of

the 31 sample cases coded by IRS as being in financial hardship, the tax debtor had ceased to file tax returns. As a result of its policy to limit its monitoring of financial hardship cases for tax debtors who ceased to file tax returns, IRS had no way to determine whether the tax debtors' financial condition had improved such that the tax debt should be included in the FPLP and other collection actions.

IRS has increased the amount of tax debt subject to collection through the FPLP by over \$28 billion over the past 2 years. Nonetheless, opportunities exist for IRS to amend its policies to allow billions of dollars in additional tax debt to be included in the FPLP. For example, of the \$247 billion in unpaid taxes owed as of September 30, 2005, \$23 billion, or almost 10 percent, is owed by tax debtors IRS has designated as being in financial hardship; therefore, IRS does not attempt to collect their outstanding tax debt. IRS allows tax debtors earning up to \$84,000—almost twice the median income for all households in the United States—to be designated as being in financial hardship. In total, IRS has placed tax debtors collectively owing over \$6 billion in tax debt in its top financial hardship income threshold of between \$76,000 and \$84,000. Because they have been designated by IRS as being in financial hardship, although they are earning relatively high incomes, these tax debtors are excluded from the FPLP and do not face other tax collection action from IRS. From 1992 to 2004, IRS almost tripled the maximum amount it allows tax debtors to earn before being subject to collection action, far above the rate of inflation. IRS could not provide us any data analysis that supported those increases. As a result of those large increases, almost two-thirds of all tax debt IRS has designated as being in financial hardship is owed by tax debtors IRS allows to earn more than the national median household income before their unpaid tax debt again becomes subject to IRS collection action. In contrast, in 1992, no tax debtor with a financial hardship designation was allowed to earn more than the median household income without becoming subject to collection action.

IRS policies also continue to exclude from the FPLP about \$5 billion of tax debt that has been assigned to its Automated Collection System (ACS). In ACS, IRS enforcement personnel attempt to make telephone contact with tax debtors to collect the unpaid tax debt. By excluding tax debts in the ACS from the FPLP, IRS may be limiting its ability to utilize a viable collection mechanism. We also found that IRS's policies exclude all tax debt from the FPLP until IRS completes its notification process. During this process, IRS sends a series of up to four separate notices to tax debtors demanding payment of their taxes—a process that by IRS policy can take up to 6 months for individuals with income tax debt. IRS is

statutorily required to send two notices before initiating the levy process, but IRS's current policies prevent cases from timely entering the FPLP while it sends out multiple notice letters, a process that can take almost twice as long as statutorily required. Although each notice letter generates some collections of tax debt, IRS receives over 70 percent of all notice collections from its first notification letter. Once IRS fulfills the two-notice statutory requirement, IRS could submit the tax debt to the FPLP while continuing to send the tax debtor additional notifications. Doing so could facilitate the timely movement of tax debt into the program and could thus expedite and increase tax collections.

We are making ten recommendations to the Commissioner of Internal Revenue for executive action, including four recommendations designed to improve IRS's monitoring of tax debt, to increase the amount of tax debt in the FPLP, or to accelerate how quickly tax debt enters the program, and six recommendations to help ensure IRS's financial hardship designations are appropriate.

IRS agreed with five of our recommendations, partially agreed with two other recommendations, and disagreed with the remaining three recommendations. IRS agreed to (1) evaluate steps necessary to ensure the timely termination of defaulted installment agreements, (2) evaluate the appropriateness of its current financial hardship income thresholds, (3) implement policy changes to govern how financial hardship thresholds are changed in the future, (4) evaluate whether to include noncompliance with filing requirements as a factor in reactivating cases in financial hardship, and (5) evaluate the feasibility of referring tax debtors with financial hardship designations to IRS's withholding compliance program for special attention if they do not pay their current tax obligations.

IRS partially agreed with our recommendation to add language about IRS's ability to levy income and assets to its early notification letters, stating it would consider adding such language to some of the later notices, but not the first notice. Based on IRS's comments, we have modified our recommendation to add such language beginning with the second notice. IRS also partially agreed with our recommendation to review tax debtors' financial conditions to verify the continued validity of its financial hardship designation, stating that it did not agree with conducting such a review every 3 years, but that it would study and consider including a time factor for such reviews. Based on IRS's comments, we have modified our recommendation to conduct such verification periodically.

IRS disagreed with our recommendation to put tax debt into the FPLP early in the notice phase to accelerate the collection process, stating that over two-thirds of tax debtors pay their tax debt in full after IRS notifies them of the debt. IRS also did not agree with our recommendation that it add additional tax debt to the FPLP when collection officials were considering using other forms of levy. IRS was concerned with the potential to inadvertently issue duplicate levies and thereby cause tax debtors unanticipated hardship. In addition, IRS did not agree with our recommendation that it change the closing codes for tax debt cases designated as being in financial hardship prior to the income threshold level changes that occurred in 2004. IRS stated that doing so may be difficult and may not be cost effective.

We continue to believe that all ten current recommendations in this report, if implemented, will assist IRS in its tax administration duties. See the “Agency Comments and Our Evaluation” section of this report for a more detailed discussion of the agency comments. We have reprinted IRS’s comments in appendix II of this report.

Background

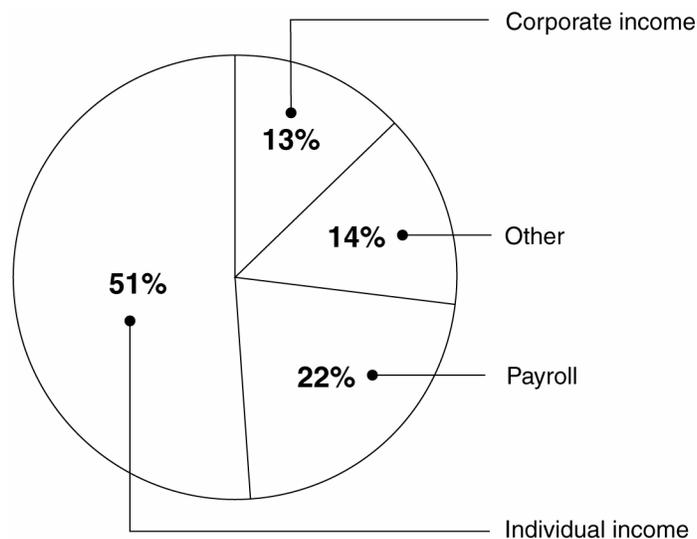
In its role as the nation’s tax collector, IRS is responsible for collecting taxes, processing tax returns, and enforcing the nation’s tax laws. Since 1990, we have designated IRS’s enforcement of tax laws as a governmentwide high-risk area.⁴ In attempting to ensure that taxpayers fulfill their obligations, IRS is challenged on virtually every front. While IRS’s enforcement workload—measured by the number of tax returns filed—has continually increased, only recently have the resources IRS has been able to dedicate to enforcing the tax laws begun to increase. IRS estimates that the annual gross tax gap, that is, the difference between what taxpayers should pay on a timely basis and what they actually pay, is about \$345 billion. IRS has reported that its enforcement activities, coupled with late payments, recover about \$55 billion of that amount, leaving an annual net tax gap of almost \$300 billion. IRS has a statutory

⁴Additionally, we designated IRS’s financial management and systems modernization as high-risk areas in 1995. GAO, *High-Risk Series: An Overview*, [GAO/HR-95-1](#) (Washington, D.C.: February 1995). In 2005, two of IRS’s high-risk areas—collection of unpaid taxes and earned income credit noncompliance—were consolidated to make a single high-risk area called enforcement of tax laws. Also in 2005, IRS’s high-risk areas of business systems modernization and financial management were merged into a single high-risk area called business systems modernization. GAO, *High-Risk Series, An Update*, [GAO-05-207](#) (Washington, D.C.: January 2005).

limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the assessment.⁵

The amount of cumulative outstanding tax debt that IRS has identified either through taxpayer reporting or through its various compliance programs is also substantial. As of September 30, 2005, IRS's master file database of taxpayer accounts reflected about \$250 billion in cumulative outstanding taxes owed by businesses and individuals. The amount of unpaid taxes ranges from small amounts owed by individuals for a single tax period to millions of dollars owed by businesses. The taxes owed include individual income, corporate income, payroll, and other types of taxes, as shown in figure 1.

Figure 1: Types of Taxes Owed, as of September 30, 2005



Source: GAO analysis of IRS data.

As a part of its tax administration, IRS maintains over 24 million separate tax debt account records in its master file database for businesses and individuals. Within the master file database, IRS records collection actions and the current status of tax debts through a series of codes. The codes,

⁵The 10-year period can be extended or suspended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period in connection with an installment agreement, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS's records for decades.

referred to as status or transaction codes, display a host of information, including the stage of the collection process the tax debt is in; the capacity of a tax debtor to pay, such as whether a tax debtor is considered to be experiencing financial hardship; or other data such as whether the tax debtor is under an arrangement with the IRS to pay the tax debt in installments. IRS uses these codes to monitor and manage its inventory of outstanding tax debt and its tax collection efforts.

Federal Payment Levy Program

To improve the collection of unpaid taxes, the Congress, in the Taxpayer Relief Act of 1997,⁶ authorized IRS to collect delinquent tax debt by continuously levying (offsetting) up to 15 percent of certain federal payments made to tax debtors.⁷ The payments include federal employee retirement payments, certain Social Security payments, selected federal salaries, and contractor and other vendor payments. Subsequent legislation increased the maximum allowable levy amount to 100 percent for payments to federal contractors and other vendors for goods or services sold or leased to the federal government.⁸ The continuous levy program, now referred to as the Federal Payment Levy Program (FPLP), was implemented in 2000. Under the FPLP, each week IRS sends the Department of the Treasury's Financial Management Service (FMS) an extract of its tax debt files. These files are uploaded into the Treasury Offset Program.⁹ FMS sends payment data to this offset program to be matched against unpaid federal taxes. The program electronically compares the names and taxpayer identification numbers on the payment files to the control names (first four characters of the names) and taxpayer identification numbers of the debtors listed in the offset program. If there is a match and IRS has updated the weekly data sent to the offset program to reflect that it has completed all statutory notifications, the federal payment owed to the debtor is reduced (levied) to help satisfy the unpaid federal taxes.

⁶Pub. L. No. 105-34, 111 Stat. 788 (Aug. 5, 1997).

⁷26 U.S.C. § 6331(h).

⁸26 U.S.C. § 6331(h)(3).

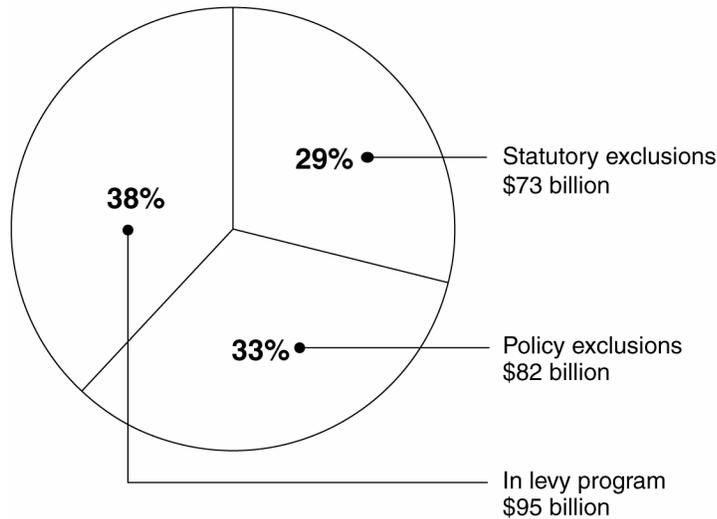
⁹The Treasury Offset Program is an automated process administered by the Department of the Treasury's FMS in which certain federal payments are withheld or reduced (offset) to collect delinquent tax and nontax debts owed to federal agencies, including IRS. For the FPLP, FMS matches federal payments to the tax-debt records sent to it by IRS, and when a match occurs, FMS offsets (levies) the federal payments and transmits the amount levied to IRS to reduce the tax debtor's outstanding debt and sends the residual to the debtor.

In creating the weekly extracts of tax debt to forward to FMS for inclusion in the offset program, IRS uses the status and transaction codes in the master file database to determine which tax debts are to be included in or excluded from the FPLP. For example, IRS cannot levy the assets of individuals and businesses to recover tax debts while the tax debtor is involved in a bankruptcy proceeding. In such cases, IRS uses the bankruptcy status code in the master file to block the tax debt from being submitted to the FPLP. Under other circumstances, IRS collection personnel can enter a transaction code into the tax debtor's tax account to block the debt from being levied through the FPLP. Consequently, the accuracy and appropriateness of status and transaction codes is vital to the effective operation of the FPLP. We reported in 2004 that incorrect or out-of-date IRS status and transaction codes in IRS's records had inappropriately blocked delinquent tax debt from being referred to the FPLP.¹⁰

IRS currently excludes 62 percent of all tax debt from the FPLP because of either statutory or policy reasons. As shown in figure 2, at September 30, 2005, IRS excluded over \$73 billion (29 percent) from the FPLP for statutory reasons and about \$82 billion (33 percent) for policy reasons.

¹⁰GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005).

Figure 2: IRS Tax Debt by FPLP Status, as of September 30, 2005



Source: Source: GAO analysis of IRS data.

Cases excluded from the FPLP for statutory reasons include tax debt that had not completed IRS's notification process, or tax debtors who filed for bankruptcy protection or other litigation, who agreed to pay their tax debt through monthly installment payments, or who requested to pay less than the full amount owed through an offer in compromise.¹¹

Cases excluded from the FPLP for policy reasons include those tax debtors whom IRS has determined to be in financial hardship, those filing an amended return, certain cases under criminal investigation, and those cases in which IRS has determined that the specific circumstances of the cases warrant excluding it from the FPLP.

Improvements in the Levy Program

Since the inception of the FPLP, we have identified numerous issues that have impeded the levy program from achieving its full potential. In response to many of the issues we raised, IRS and other agencies have made numerous improvements to the levy program that have contributed to increased tax collections. IRS and FMS officials, along with Department of Defense, General Services Administration, Office of Management and

¹¹An offer in compromise is an agreement between a tax debtor and IRS that resolves the tax debtor's tax debt by accepting less than full payment.

Budget, and Department of Justice officials, created a multiagency task force—referred to as the Federal Contractor Tax Compliance Task Force—in 2004, primarily to address the issues raised in our 2004 report related to defense contractors and the FPLP.¹² The multiagency nature of the task force reflected that the involvement of several agencies was required for the FPLP to reach its full potential. The task force, which has now become a semipermanent body, has worked toward its stated goals and, along with the efforts of the individual agencies, has been instrumental in making significant improvements in the program. For example, the task force has achieved its goal of adding most of the Department of Defense’s payment systems to the FPLP.

IRS, in conjunction with the task force, has made several policy changes directed toward increasing the amount of unpaid tax debt that it is submitting to the FPLP. For example, IRS altered its policies to include the following tax debt in the levy program that had previously been excluded:

- cases waiting in a “queue” to be actively worked by an IRS collections official—formerly IRS blocked such cases from the FPLP for a year each time a case entered the queue;
- nearly half of the cases assigned to its Automated Collection System (ACS);¹³
- most cases in the field that are being worked by an IRS revenue officer; and
- cases that have low dollar balances and cases for which the IRS has been unable to locate or contact the tax debtor.

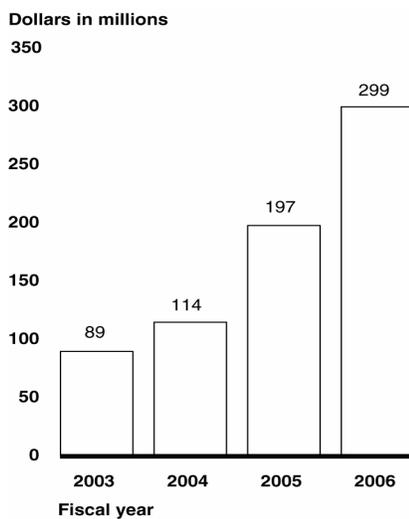
IRS has also worked with FMS to improve the process of matching tax debtor names between FMS’s payment files and IRS’s tax debt files to increase the number of payments and debts that are matched. This work was important because the FPLP relies on matching both the tax identification number and the control name in the payment to those in the tax files to identify a federal payment for levy.

¹²Federal Contractor Tax Compliance Task Force, *Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations* (Washington, D.C.: Oct. 26, 2004).

¹³The ACS is an automated telephone-based system designed to schedule and follow up on incoming calls from, and outgoing calls to, tax debtors. ACS personnel make contact with tax debtors by phone to attempt to collect outstanding tax debt.

The FPLP has proved to be a cost-effective means of collecting outstanding tax debt from tax debtors who receive payments from the federal government, and the improvements IRS and other agencies have made in the program have significantly increased tax collections since 2003, as shown in figure 3.

Figure 3: Value of Levy Program Collections, Fiscal Years 2003 through 2006



Source: GAO analysis of IRS data.

Although the FPLP collected almost \$300 billion dollars in previously unpaid taxes during fiscal year 2006, the program has an even greater effect on total tax collections. In previous reports, we have estimated that IRS collects three times the amount of the direct levy collections through voluntary revenues received as a result of taxpayers responding to IRS's notice that their federal payments would be levied.¹⁴

Coding Errors Excluded Tax Debt from the FPLP

To maximize the effectiveness of the FPLP as a tool to collect outstanding federal taxes, it is crucial that IRS record and maintain accurate status codes for all tax debt within its systems. To test the accuracy of the codes, we selected statistical samples of tax debt excluded from the FPLP for both statutory and policy reasons to determine if these status codes

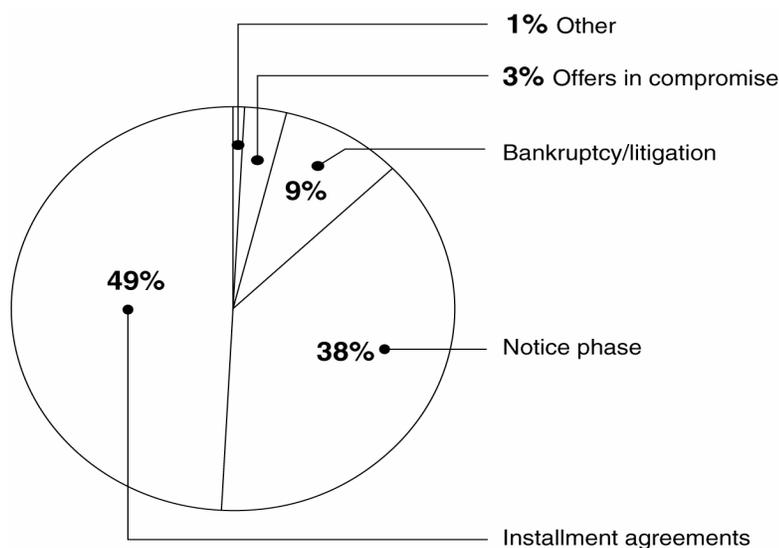
¹⁴GAO, *Tax Administration: Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved*, [GAO-03-356](#) (Washington, D.C.: Mar. 6, 2003).

appropriately reflected the current condition of the tax debt. Our testing of IRS's exclusion codes consisted of samples of 100 tax debts excluded for statutory reasons, and 100 tax debts excluded for policy reasons as of September 30, 2005. While our review of the sample of tax debts excluded for policy reasons did not identify a significant number of coding errors that would affect the FPLP, our review of the sample of tax debts excluded for statutory reasons did. On the basis of our samples, we estimate that over a half-million tax records with over \$2.4 billion in tax debt were erroneously excluded from the FPLP.

Errors in Statutory Exclusion Codes

At September 30, 2005, IRS had about \$73 billion of outstanding tax debt associated with about 9 million tax records that were excluded for statutory reasons. As shown in figure 4, these tax records were almost exclusively in four statutory exclusion categories: notice, bankruptcy, offers in compromise, and installment agreements.

Figure 4: Percentage of Tax Records in Statutory Exclusion Population Categories, as of September 30, 2005



Source: GAO analysis of IRS data.

In reviewing the 100 tax records coded as statutorily excluded tax debt, we identified six instances in which the records were incorrectly coded. Table 1 presents the number of errors we found by exclusion category.¹⁵

Table 1: Results of GAO’s Statistical Sample of IRS Statutory FPLP Exclusions

Statutory exclusions	Number of cases	Number of errors
Installment agreements	44	4
Notice phase	40	1
Bankruptcy/litigation	11	1
Offers in compromise	5	0
Total statutory exclusions	100	6

Source: GAO analysis of IRS data.

As indicated in table 1, four of the errors we identified involved tax debtors erroneously coded as paying on an installment agreement and thus excluded from the FPLP.¹⁶ In each of the four cases, IRS had not terminated the installment agreement within 5 months after the tax debtor stopped making agreed-to payments. Although IRS’s guidance on the installment agreement termination process does not contain a specific time frame, 5 months is the minimum amount of time that would elapse if IRS’s Internal Revenue Manual requirements on terminating installment agreements were laid out in a timeline. In one of the cases, IRS took 23 months to terminate the agreement after the tax debtor had stopped making payments.

One error involved tax debt that had been erroneously kept in IRS’s notice phase. The notice phase is IRS’s first phase in the tax debt collection process and consists of a series of letters IRS sends to tax debtors informing them of the tax debt and requesting payment. Each letter is represented by a specific status code. The one error we identified in this exclusion category resulted when an IRS computer programming change in 2005 inadvertently blocked certain status codes from being updated and thus prevented the related tax debt from exiting the notice phase. IRS

¹⁵We did not project an error rate for the individual statutory exclusion subcategories because a statistical projection was valid only for the statutory exclusion category as a whole.

¹⁶As noted in their titles, fig. 4 shows the percentage of tax records in the population by category, whereas table 1 shows number of tax records in our sample by category.

personnel took action to correct this systemic error after we informed them of the issue.

We also found one bankruptcy-related case erroneously excluded from the FPLP due to IRS failing to reverse a bankruptcy transaction code after the bankruptcy had ended. According to IRS officials, IRS's time frame for initiating action to reverse a bankruptcy code is 30 days after bankruptcy actions have been completed. However, in this case, the bankruptcy had ended almost a year before the time of our review, yet IRS had not updated the status code in the tax debtor's account. IRS reversed the bankruptcy code after we informed IRS personnel of the issue. However, as a result of the error, the tax debt had been erroneously excluded from the FPLP and all other collection action for almost a year. We found no errors in the status codes for the five offer in compromise cases we reviewed.¹⁷

In total, the errors we found in the sample of tax records excluded for statutory reasons equate to a 6 percent projected error rate. As a result of these errors, we estimate that over a half-million tax records containing about \$2.4 billion in uncollected tax debt were erroneously excluded from the FPLP.¹⁸

Errors in Policy Exclusion Codes

At September 30, 2005, IRS had about \$82 billion of outstanding tax debt associated with about 7 million tax-period records that were excluded for policy reasons. As shown in figure 5, tax records were excluded primarily for three reasons: cases designated as financial hardship, cases currently in or awaiting assignment to IRS's collection function,¹⁹ and cases

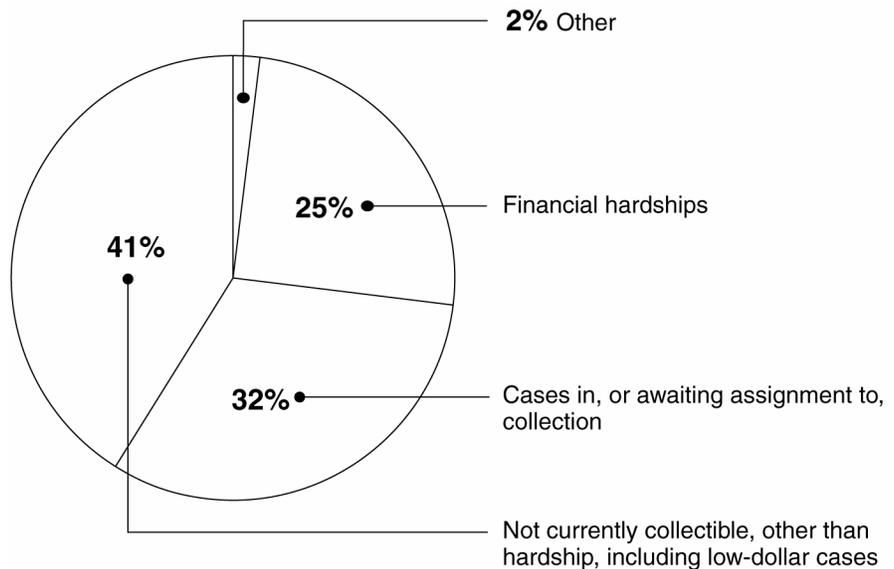
¹⁷When tax debtors believe that they cannot pay their delinquent tax debt in full, they can make an offer to IRS to pay something less than the full amount to satisfy their debt. IRS may accept offers that are commensurate with the tax debtor's ability to pay, which IRS determines through an analysis of the taxpayer's financial condition. IRS is statutorily prohibited from levying the property of the tax debtor while it considers the tax debtor's offer.

¹⁸The 95 percent confidence interval associated with the projected 6 percent error rate ranges from 2.2 percent to 12.6 percent. This range means that we are 95 percent certain that the true error in the entire population of statutorily excluded tax debt is between 2.2 percent and 12.6 percent. The range means that between 202,000 and 1,142,000 tax records equating to between \$56 million and \$6.8 billion in tax debt were erroneously excluded from the FPLP.

¹⁹When IRS has completed sending its initial series of notices to the tax debtor, IRS assigns the tax debt to active collection whether through the ACS system or to a revenue officer in the field, or it puts the tax debt into a queue awaiting assignment to active collection.

designated as currently not collectible for reasons other than financial hardship, including low-dollar cases.

Figure 5: Percentage of Tax Records in Policy Exclusion Population Categories, as of September 30, 2005



Source: GAO analysis of IRS data.

IRS is authorized to exclude tax debt from the FPLP based on a policy determination of financial hardship.²⁰ Tax debt in the other two categories is excluded on a case-by-case basis. In other words, the categories, themselves, are not explicitly excluded from the FPLP, but individual cases in those categories may be excluded by IRS personnel based on the circumstances of the particular case. For example, cases that are in IRS's field collection status being worked by a revenue officer are generally eligible for the FPLP; however, the revenue officer can block the tax debt from inclusion in the FPLP when the officer determines that pursuing other collection actions may be more effective.

²⁰IRS is required to release the levy on all or part of the tax debtors' property, including property subject to FPLP, if IRS determines that levying the property is creating a financial hardship on the tax debtor. 26 U.S.C. § 6343(a)(1).

In reviewing the 100 tax records coded as excluded for policy reasons, we identified one instance in which the records were incorrectly coded. Table 2 presents the results of our review of the sampled cases.

Table 2: Results of GAO’s Statistical Sample of IRS Policy FPLP Exclusions

Policy exclusions	Number of cases	Number of errors
Cases in, or awaiting assignment to, collection	36	1
Cases IRS considers not currently collectible, other than hardship, including low-dollar cases	33	0
Financial hardships	31	0
Total policy exclusions	100	1

Source: GAO analysis of IRS data.

The one coding error we found involved a tax debtor who defaulted on an offer in compromise, but IRS did not put the tax debt into the FPLP. Although IRS correctly coded the tax debtor as having defaulted on the agreed-to payment terms of the offer, IRS’s system had not been programmed to reverse the original “pending” code that IRS personnel placed in the tax debt record while IRS was considering the tax debtor’s offer.²¹ Even though the tax debtor had defaulted on the offer, the unreversed pending offer code continued to exclude the case from the FPLP. On the basis of our finding, IRS implemented a computer programming change to reverse existing pending codes for defaulted offer in compromise cases.

We found no errors in the cases that IRS had designated as currently not collectible for reasons other than financial hardship. Although IRS is not going to actively seek collection from them, these cases are generally included in the FPLP. However, IRS tax collections personnel can exclude these cases from the FPLP on a case-by-case basis.

²¹When a tax debtor submits an offer in compromise, IRS personnel place a transaction code in the computer system indicating that they are considering the merits of the offer. This “pending” transaction code also stops all tax collection actions until IRS has decided whether or not to accept the tax debtor’s offer. Once accepted, IRS places an additional code in the system indicating that there is an “active” offer in compromise. Both the pending and the active offer codes need to be reversed before a tax debt can be made eligible for the FPLP.

Our review of the limited data IRS retains related to financial hardship cases and our own review of the tax debtor's financial condition using available IRS information and outside data sources did not identify any cases in which we believe IRS had erroneously coded a tax debtor as being in financial hardship. However, as discussed later, we do believe that IRS's existing processes increase the risk that outdated status codes related to financial hardship cases could occur and not be detected.

In total, the errors we found in the sample of tax records excluded for policy reasons equate to a 1 percent projected error rate.²²

More Effective Monitoring Could Prevent Errors and Help Ensure Ongoing Accuracy of Account Status

IRS's current monitoring of the ongoing status of accounts did not identify and correct the errors in our sample. In addition, although we found no errors in the coding of financial hardship cases, our analysis revealed that the design of IRS's policies for monitoring the status of such cases is not sufficient to ensure the ongoing accuracy of hardship designations.

Monitoring Did Not Identify Tax Debt That Should Have Been Eligible for Levy

The coding errors we identified in our samples of tax debts excluded from the levy program for statutory and policy reasons could have been avoided if IRS had more effectively monitored the ongoing status of accounts to detect and prevent delays in putting tax debt into the FPLP.

In the one case from our sample of statutory exclusions involving a bankruptcy-related coding error, the transaction code blocking the case from inclusion in the FPLP was not reversed within IRS's stated time frame. IRS policy is that bankruptcy codes should be reversed within 30 days after a bankruptcy judge has dismissed the case.²³ In such cases, the tax debtor again becomes liable for repaying the tax debt. IRS did not reverse the bankruptcy code in a timely manner because the case was

²²The estimated error is 1 percent and is associated with a 95 percent confidence interval of from 0.03 percent to 5.4 percent. We did not project an error rate for the dollars associated with policy error rate. We also did not project an error rate for the individual policy exclusion subcategories because a statistical projection was valid only for the overall policy exclusion category as a whole.

²³When a judge dismisses a bankruptcy case, the debtor is denied any debt relief.

repeatedly transferred to different IRS personnel without anyone taking action to reverse the code. As a result of confusion caused by the repeated transfer of the case within IRS and no one person having responsibility for monitoring the disposition of the case, IRS did not recognize that the bankruptcy code had not been reversed until we notified IRS officials during our review of the case.

In the four coding errors we identified involving installment agreement cases, the errors were caused by a computer programming problem—corrected in January 2006—that prevented the installment agreement codes from automatically reversing within IRS’s systems.²⁴ Generally, IRS’s computer systems automatically begin the process to reverse an active installment agreement code after a tax debtor fails to make two scheduled monthly payments, but that did not happen in these cases. IRS officials were unable to determine specifically why this occurred, and stated that they do not monitor whether installment agreement transaction codes are reversed within the 5-month time frame indicated by IRS’s Internal Revenue Manual for terminating installment agreements.²⁵ Until the installment agreement code is reversed in the system, the tax debt remains excluded from the FPLP. Had IRS been monitoring the timely termination of installment agreements, these cases would have come to IRS’s attention and afforded it an opportunity to investigate the cause.

Two coding errors—one statutory exclusion case and the other a policy exclusion case—were also caused by deficiencies in IRS’s computer programs. In the statutory exclusion case, the tax debt did not automatically move through the notice process because IRS did not include one of its several notice status codes in a computer programming change. As a result, when the programming change was implemented, the existing cases in that notice status were prevented from automatically continuing their movement through the notice phase and into collection.

²⁴When IRS agrees to allow a tax debtor to repay tax debt through installment payments, IRS personnel place a transaction code into IRS computer systems. This transaction code stops all tax collection actions except the installment agreement payments until the code is reversed.

²⁵The 5-month time frame is not specifically cited in the Internal Revenue Manual. Rather, the manual lays out the process for terminating an installment agreement as follows. IRS waits 1 month after the tax debtor misses the first payment. If the tax debtor does not send in the next payment, IRS’s computer system generates a letter informing the tax debtor that IRS intends to terminate the agreement. IRS gives the tax debtor 90 days—3 months—to respond. IRS allows a total of about a month for processing and mailing, bringing the total time to 5 months.

As a result, these cases remained excluded from the FPLP and other collection actions. After we brought this case to IRS's attention, it took corrective action to address this programming deficiency. In the second case, involving a policy exclusion related to a defaulted offer in compromise, IRS continued to exclude the tax debt from the FPLP because, although IRS personnel properly entered a code indicating a default on an offer in compromise, IRS's systems did not reverse the code indicating the case had an initial pending offer. IRS had recently implemented a programming change to the way it processes offer in compromise-related transaction codes so that the code that reverses an active offer in compromise transaction code also reverses any pending offer in compromise codes related to the same tax case. However, the programming change only affected offer in compromise cases occurring subsequent to the date the change was implemented; it did not affect pending offer codes that existed prior to the programming change. After we notified IRS personnel of the error we identified, they took corrective action to reverse the status code in this and similar cases.

Monitoring of Financial Hardship Cases Does Not Consider Tax Debtors Who Fail to File Tax Returns or Pay Current Taxes

As discussed earlier, in our sample of tax debt cases excluded from the FPLP for policy reasons, we found that all 31 cases that were excluded due to the tax debtor being designated by IRS as being in financial hardship were correctly coded based on IRS's existing policy and our review of the limited documentation IRS maintained regarding the tax debtor's income. However, we found deficiencies in IRS's procedures for monitoring the ongoing status of financial hardship cases, which hinders IRS's ability to ensure the ongoing accuracy of the financial hardship designation. This, in turn, could result in additional tax debt that should be eligible for levy not being forwarded to the FPLP.

To make the determination of whether a tax debtor is facing financial hardship and thus does not have the means to pay the tax debt, IRS analyzes the tax debtor's financial condition using guidelines for allowable costs. On the basis of these guidelines, IRS officials place individuals in one of nine income categories, or income thresholds. These thresholds represent income level ceilings above which the tax debtor again becomes subject to IRS's collection actions, including forwarding of the tax debt to the FPLP. Once IRS designates a tax debtor as being in financial hardship, it performs an automated evaluation of the debtor's income based upon their annual tax return filings. Specifically, IRS compares the income reported on the tax debtor's tax return to the threshold level assigned to the tax debtor. If the reported income exceeds the threshold, the financial

hardship designation is terminated and the tax debt becomes subject to collection and can be put into the FPLP.

IRS policy discourages any other monitoring or follow-up of financial hardship cases beyond the automated match. IRS does not routinely update the tax debtor's allowable expenses or perform a periodic review—such as once every 3 years—of the tax debtor's overall financial condition. In fact, the Internal Revenue Manual directs IRS personnel working financial hardship cases to not request future follow-up reviews to check on compliance with future income tax filing requirements or to update a tax debtor's financial condition.

Consequently, IRS relies only on the accuracy of the information reported in the tax return filed by the tax debtor, with no review of income information reported to IRS by third parties, such as Form W-2 and Form 1099 information reports,²⁶ to assess the ongoing accuracy of hardship designations. IRS's procedures do not require it to remove a tax debtor from the financial hardship status if the tax debtor fails to file a tax return, and failing to file does not flag the case for IRS personnel to perform a review of the financial hardship designation. Because of its monitoring policy, when a tax debtor with a financial hardship designation does not subsequently file an annual income tax return, IRS has no means of determining whether the tax debtor's financial condition has improved and the hardship designation should be terminated. Since individuals designated as being in financial hardship are excluded from the FPLP—as well as all other tax collection actions—not knowing whether the hardship designation remains valid can result in IRS inappropriately excluding the tax debt from the FPLP.

Generally, individuals with a financial hardship designation who do not file a tax return are treated like other nonfilers: they can be eventually subject to review by IRS's automated substitute-for-return process. In that review, IRS examines other available data on the taxpayer, assesses whether a tax return should have been filed, and estimates the amount of tax due. However, that process generally does not occur for more than a year after the failure to file, and only individuals who meet certain criteria are

²⁶IRS receives various information returns from third parties, including forms W-2 and 1099, that are used to report an individual's income. The W-2, the wage and tax statement, reports wages, salaries, and tips paid to employees and the taxes withheld from them. The Form 1099 is used to report various types of income other than wages, salaries, and tips.

reviewed. A financial hardship designation is not one of the criteria and, therefore, these cases do not have a high priority.

On the basis of our review of the sample cases, ceasing to file is not an uncommon occurrence for tax debtors with hardship designations. Twenty-four of the 31 tax debtors designated as financial hardship in our sample cases had ceased filing tax returns after IRS had determined the tax debtor was in financial hardship.

IRS's current practices also do not prevent tax debtors with a financial hardship designation from accumulating additional tax debt by not paying their current taxes. A financial hardship designation puts a tax debtor's past debt in abeyance, but the hardship designation does not automatically exempt the tax debtor from paying current taxes. However, we found that IRS does little to prevent the further accumulation of tax debt by these tax debtors. Of the 31 tax debtors with financial hardship designations in our sample cases, we found that 4 filed but had not paid income taxes subsequent to being identified as a financial hardship case. As with not filing a tax return, accumulating new tax debt does not cause IRS to automatically terminate the financial hardship designation, and IRS's procedures allow IRS personnel to include the newly acquired tax debt into the hardship designation, sometimes without any additional analysis of the tax debtor's financial condition. Thus, a tax debtor's ever-increasing tax debt can remain excluded from the FPLP as well as other collection actions.

The effect of IRS's collection policy regarding financial hardship tax debtors who accumulate new debt is essentially to both cease collection of old debt and not require tax debtors to pay the current taxes they owe. Allowing such tax debtors to continually not pay current taxes without consequence appears to be giving tax debtors with financial hardship designations an additional exemption from paying current taxes as well as old tax debt and may contribute to the noncompliance of other taxpayers.

In fiscal year 2006, IRS initiated a withholding compliance program that has potential to help prevent wage-earning tax debtors from accumulating more unpaid tax debt. The program is designed to identify individuals who incur tax debt because they did not have their employer withhold sufficient wages to cover their taxes due for the current year. The program identifies those debtors and requires their employers to increase the withholdings. However, due to resource constraints, IRS actively pursues only a small portion of the tax debtors who underwithhold. Additionally,

while the program prioritizes cases for review, a financial hardship designation is not a prioritization criterion.

Policy Changes Could Allow Billions of Dollars in Tax Debt to Enter the FPLP

IRS has significantly improved the effectiveness of the FPLP by making an additional \$28 billion in unpaid tax debt eligible for the program since 2004. However, certain changes in IRS's policies could result in additional billions of dollars in tax debt entering the levy program for potential collection or entering the program earlier. Under current IRS policy, all tax debt for which the debtor is designated as being in financial hardship, including those debts associated with tax debtors earning relatively high income levels, are excluded from the levy program. In addition, half of the cases in IRS's ACS are excluded from the program, as are all cases throughout IRS's notification process.

IRS Excludes Many Cases from the FPLP with Incomes Exceeding the National Median Income

IRS has established policies that allow it to designate tax debtors earning up to \$84,000—nearly twice the national median income of about \$44,000²⁷—as being in financial hardship. IRS is authorized to grant tax debtors a designation of financial hardship when collection of the tax debt would cause the tax debtor to be unable to pay his or her reasonable basic living expenses.²⁸ IRS's Internal Revenue Manual provides examples of financial hardship cases, such as a disabled taxpayer who lives in a modest house that has been equipped to accommodate the disability and whose fixed income is not sufficient to both meet his or her living expenses and pay the tax debt. IRS has the authority to determine allowable living expenses according to the unique circumstances of individual tax debtors; however, unique circumstances do not include the maintenance of an affluent or luxurious standard of living.

Once designated as being in financial hardship, the tax debtors are excluded from the FPLP and are also exempt from any other IRS collection action until their self-reported income rises above one of nine designated income thresholds. Since 1992, IRS has almost tripled the

²⁷Department of Commerce, Economics and Statistics Administration, U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2004*, issued August 2005. National median income is based on 2004 data for all races and all households. Fifty percent of households have incomes below and 50 percent have incomes above the median.

²⁸See 26 C.F.R. §301.6343-1(b)(4).

income it allows tax debtors in financial hardship to earn without pursuing collection, but IRS does not have documentation of any data analysis that justified the large increases. Consequently, as of September 30, 2005, about 65 percent of the tax debt in the financial hardship category was owed by tax debtors who were allowed to earn more than the national median income before being subject to collection actions. Of the \$247 billion total tax debt in IRS's records, IRS is not pursuing collection of almost 10 percent of that amount—\$22.6 billion—as a result of its financial hardship determinations.

As discussed previously, IRS makes a determination as to whether a tax debtor qualifies as a financial hardship case based on an analysis of the amount of income earned and the allowable expenses owed by the tax debtor.²⁹ If IRS determines that a tax debtor is unable to pay the outstanding tax liability due to financial hardship, it places a financial hardship transaction code in the tax debtor's account. The transaction code is assigned one of nine subcodes (called closing codes) indicating the income threshold level ceilings at which IRS has determined that the tax debtor should be able to begin repaying the tax debt. Tax debtors will not face any IRS collection action³⁰ until their total positive income—roughly equivalent to adjusted gross income—exceeds the designated income threshold ceiling. IRS's financial hardship income thresholds range in \$8,000 increments from \$20,000 to \$84,000, as depicted in table 3.

²⁹IRS's Internal Revenue Manual describes allowable expenses as those expenses that are necessary to provide for a tax debtor's family's health and welfare and/or production of income. The allowable expenses must be reasonable and are based in part on national and regional standards.

³⁰Although IRS does not engage in active collection actions against a tax debtor with a financial hardship designation, IRS does retain any future income tax refunds and uses them to reduce the tax debtor's outstanding tax debt.

Table 3: IRS's Financial Hardship Income Thresholds

	Income threshold ceilings effective 2004–present	Number of tax records at September 30, 2005	Total tax debt at September 30, 2005 (dollars in billions)
1	\$20,000	306,900	\$2.1
2	28,000	173,600	1.3
3	36,000	213,900	2.0
4	44,000	223,000	2.5
5	52,000	203,700	2.5
6	60,000	169,000	2.3
7	68,000	148,900	2.3
8	76,000	91,300	1.2
9	84,000	286,600	6.4
Total		1,816,900	\$22.6

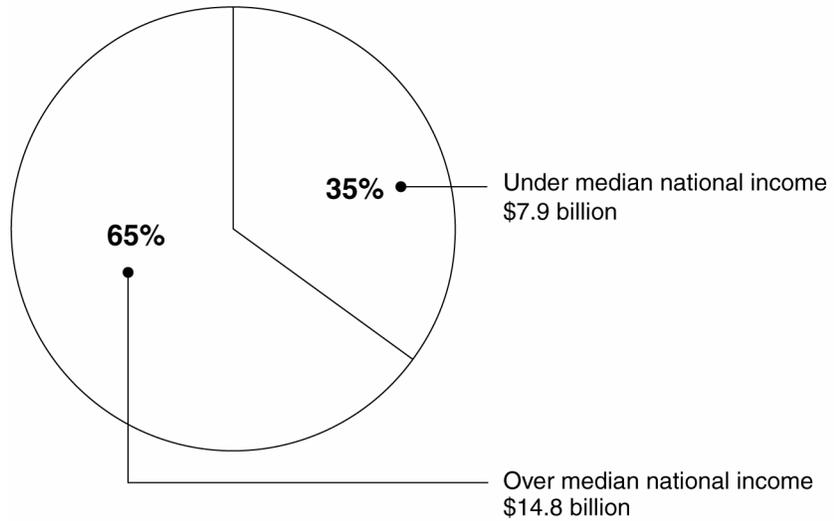
Source: GAO analysis of IRS data.

Five of the nine income thresholds included in IRS's financial hardship designation have upper range ceilings above the 2004 national median household income of \$44,389. Of the approximately 1.8 million tax debt records designated as financial hardship in IRS's unpaid assessments database at September 30, 2005, approximately half—about 900,000—were debts owed by tax debtors in one of the five income threshold categories above the national median. Over 286,000 tax records—with associated tax debt of about \$6.4 billion—were for tax debtors in the top income level threshold for financial hardship of up to \$84,000.

The exclusion of tax debt from collection actions may be appropriate in many circumstances to provide relief for those experiencing financial difficulty. However, as shown in figure 6, \$14.8 billion in tax debt (65 percent of the tax debt) in financial hardship is owed by tax debtors whom IRS will allow to earn more than the national median household income before they have to begin repaying their tax debt.³¹

³¹Due to the rounding used in table 3, there is a 0.1 difference between the sum in the table and the sum in the text and fig. 6 for those tax debtors allowed to earn more than the national median household income.

Figure 6: Tax Debt Associated with Debtors in Financial Hardship Who Can Earn Over the 2004 National Median Income, as of September 30, 2005



Source: GAO analysis of IRS data.

As shown in table 4, IRS's income thresholds used to determine whether tax debtors are experiencing financial hardship and therefore cannot currently pay their outstanding tax debt have not always been this high. IRS significantly increased each of the nine income thresholds in 1997 and again in 2004. IRS had previously set rates in 1992. The 2004 increases averaged 77 percent but the individual threshold increases ranged from 100 percent for the lowest threshold to 68 percent for the highest.

Table 4: IRS's Financial Hardship Income Thresholds Ceilings

	Income thresholds ceilings effective 1992–1997	Income thresholds ceilings effective 1997–2004	Income thresholds ceilings effective 2004–present
1	\$6,000	\$10,000	\$20,000
2	9,000	15,000	28,000
3	12,000	20,000	36,000
4	15,000	25,000	44,000
5	18,000	30,000	52,000
6	21,000	35,000	60,000
7	24,000	40,000	68,000
8	27,000	45,000	76,000
9	30,000	50,000	84,000

Source: IRS.

In justifying the large increases from previous threshold ceilings, IRS stated that the new 2004 thresholds more accurately reflected current economic conditions and that the new values were supported by Bureau of Labor Statistics data and were consistent with the allowable expenses in IRS guidance. IRS also stated that the revised income thresholds were based on an analysis of allowable expense standards for high-cost geographic areas considered in conjunction with current Bureau of Labor Statistics poverty levels. Though it raised the top threshold to \$84,000, IRS had considered raising its top threshold for financial hardship to \$100,000.

Other than the above statements, IRS could not provide documentation of any data analysis that supported its reasons for the large increases since 1992. However, measures of median income raise questions about the size of the increases to the income thresholds for financial hardship determinations. As table 5 depicts, IRS's increases in the financial hardship income thresholds has had the effect of raising the maximum income threshold from about equivalent to the national median income in 1992 to almost twice the median income in 2004. With respect to high-cost areas, New Jersey's \$61,359, the highest state median income in 2004,³² was well

³²Department of Commerce, Economics and Statistics Administration, U.S. Census Bureau, *Income, Earnings, and Poverty From the 2004 American Community Survey*, (Washington, D.C.: August 2005).

below IRS's 2004 top three income threshold levels. The lowest state median income in 2004 was \$31,500.

Table 5: Historical IRS Maximum Income Thresholds and Household Median Incomes

Year	IRS's maximum financial hardship income threshold	National median income for all households ^a	Percentage maximum level above/below median income
1992	\$30,000	\$30,636	- 2.1%
1997	50,000	37,005	+ 35.1
2004	84,000	44,389	+ 89.2

Source: IRS and U.S. Census Bureau.

^aMedian income is stated in 2004-equivalent dollars.

As a result of these large increases, almost two-thirds of all tax debtors with IRS financial hardship designations are allowed to earn more than the national median household income in 2004 before their unpaid tax debt again becomes subject to IRS collection action. In contrast, in 1992, no tax debtor with a financial hardship designation was allowed to earn more than the median income without becoming subject to collection action.

Measures of inflation also raise questions about the size of IRS's increases. Bureau of Labor Statistics national inflation rate data indicate that the effects of inflation would have justified lower increases. For example, using inflation data from 1997 to 2004, the top 2004 threshold would have been about \$60,000,³³ far below IRS's \$84,000 level, and would have kept the top threshold at roughly 35 percent above the national median income as it was in 1997.

Exacerbating the effect of IRS's increases in its hardship thresholds was the policy it used to implement the increases. IRS did not change the subcodes indicating the income threshold ceilings or reexamine the financial condition of tax debtors when it raised the income thresholds ceilings. For example, the IRS subcodes indicating that tax debtors were in the highest income threshold of \$50,000 prior to the threshold increases were not updated to reflect the new thresholds. Thus the tax debtors remained in the highest income threshold and were allowed to earn up to

³³Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers*, <http://www.bls.gov>, downloaded August 16, 2006.

\$84,000 before IRS would begin taking collection action. Therefore, after the 2004 increases, the tax debtors in the top income threshold category were allowed to earn \$34,000 more annually before IRS would remove the tax debtor from the financial hardship exclusion category and begin pursuing collection of the outstanding tax debt. IRS neither reassessed the financial condition of tax debtors with existing financial hardship designations nor changed their existing designation to one that closely matched their original income threshold amount.

Allowing relatively high income tax debtors, such as those earning \$84,000, to avoid tax collection action calls into question the fair application of the tax system and may contribute to noncompliance by other taxpayers. In addition, dramatically increasing the financial hardship income threshold ceilings has effectively resulted in increasing the number of tax debtors IRS classifies as being in financial hardship. This, in turn, reduces the portion of IRS's inventory of tax debt under active collection and reduces the portion eligible for inclusion in the FPLP.

IRS Continues to Exclude Substantial Tax Debt in ACS from the FPLP

Although IRS made policy changes in 2004 to allow about 40 percent of the tax debt in ACS to enter the FPLP, IRS continues to exclude the other 60 percent. The ACS is an automated call system designed to schedule and follow up on IRS's outgoing calls to, and incoming calls from, tax debtors. ACS personnel's primary activity is to contact tax debtors by phone to attempt to collect outstanding tax debt. At September 30, 2005, the ACS contained an inventory of about \$8 billion of unpaid tax debt. To manage the large inventory of tax debt in ACS, IRS has divided the ACS inventory into 40 subcategories. In general, those subcategories describe the status of IRS collection actions within ACS, such as indicating that an installment agreement is pending or specifying a collection action that is awaiting approval by a supervisor.

Prior to 2005, all the tax debt in ACS was excluded from the FPLP. In 2005, in response to issues raised in our 2004 review of Department of Defense contractors with outstanding tax debt,³⁴ IRS changed its policies to allow some of the tax debt assigned to ACS to enter the FPLP. However, IRS has continued to exclude tax debt in 19 of the 40 ACS subcategories from the FPLP. Those 19 subcategories contain 60 percent, or about \$5 billion, of

³⁴GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-95](#) (Washington, D.C.: Feb. 12, 2004).

the total tax debt in the ACS inventory. Two of the excluded subcategories, which IRS calls R-5 and I-6, contain approximately \$3.9 billion of tax debt, and involve cases in which IRS is placing a levy against a tax debtor's assets. These "paper" levies, as IRS refers to them to distinguish them from automated FPLP levies, are generally one-time levies placed against a tax debtor's bank accounts or other financial assets, although they can also be an ongoing garnishment of wages. FPLP levies, in contrast, are continuous levies of all federal payments, including federal salaries, pensions, social security, and contractor-related payments.

IRS has the authority to levy a tax debtor's assets to collect outstanding tax debt. Therefore, simultaneously levying through both the paper levy process and the FPLP would seem to be appropriate, especially since many paper levies are one-time levies of a tax debtor's assets. Additionally, the FPLP is a cost-effective means of collecting from tax debtors. By excluding tax debt from the FPLP while IRS personnel are working on a paper levy, IRS is relegating the FPLP to a secondary role in the tax collection process. Because of its potential, we have previously recommended that IRS use the FPLP as one of the first steps in the IRS collection process and keep the debt in the levy program until the taxes are fully paid.³⁵

IRS Excludes All Tax Debt from Levy during the Notification Process

At September 30, 2005, IRS had excluded \$25.1 billion from the FPLP because it was in the process of notifying the tax debtor of the taxes owed. The Internal Revenue Code prohibits IRS from levying a tax debtor's assets, including doing so through the FPLP, until the tax debtor has been given time to respond to a notice from IRS that a tax debt exists. IRS's process of issuing a series of notice letters and waiting for the tax debtor to respond can take 6 months for individuals. IRS excludes tax debt from the FPLP during the entire notice phase.

For individuals, the notification process consists of sending a series of three or four computer-generated letters with increasingly urgent language notifying the tax debtor of the debt and requesting payment. Per the Internal Revenue Manual, IRS waits 5 weeks between letters and up to 10 weeks after the last letter before moving the tax debt into one of IRS's active collection statuses such as ACS. Consequently, the notification

³⁵ [GAO-04-95](#).

process can take up to 6 months or longer to complete, during which time IRS excludes the tax debt from other collection activity, including the FPLP.

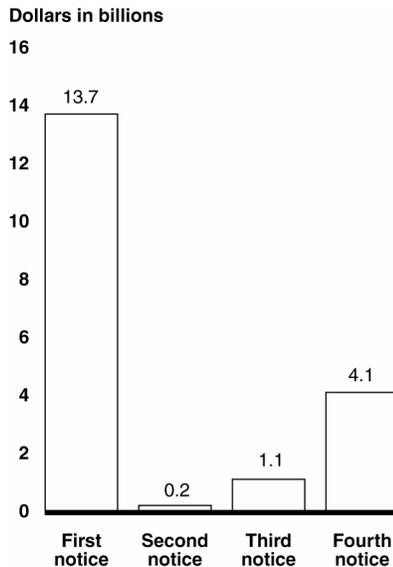
Although IRS excludes all tax debt from the FPLP during the entire notice process, legally, tax debt could be included in the FPLP in about 3 months—about half way through the general notice process for individuals.³⁶ IRS must allow the tax debtor 90 days after notification of a potential tax debt liability to respond. If IRS does not receive a response within that period, it can issue a notice of tax deficiency and demand for payment. If the tax debt is not paid within 10 days after notice and demand for payment, IRS can initiate the procedures for levy, including forwarding the tax debt to the FPLP. Under this scenario, IRS could forward tax debt to the FPLP about 14 to 15 weeks after the first notice is sent to the tax debtor, and IRS could fulfill its statutory requirement with only two notices before initiating the levy process.³⁷ For business tax debt, IRS essentially follows this sequence. The notice process for business tax debt consists of only two notices and is generally completed in about 15 weeks, at which time the tax debt can be included in the FPLP.

In addition to putting tax debt into the FPLP sooner in the overall tax collection process, IRS could potentially enhance the tax collection potential of notices by informing the tax debtor early in the process of sending notice letters that unpaid tax debt can be subject to levy. As shown in figure 7, about 70 percent of tax collections resulting from notice letters are received as a result of IRS's first notice letter. Very little is collected from subsequent notices until the last notice letter, which includes specific language of IRS's authority to levy or place a lien on the tax debtor's property.

³⁶26 U.S.C. §§ 6212(a), 6303(a), and 6331(a),(d). The time frames described in the text assume the tax debtor does not contest the amount of the tax assessment. If contested, the time frames are extended until there is resolution as to the amount owed.

³⁷Prior to initiating the levy process, IRS is required to assess the tax due liability in accordance with 26 U.S.C. § 6201. Prior to actually making the levy, IRS is required to send a notice of intent to levy, 26 U.S.C. § 6331(a), and a prelevy Collection Due Process hearing notice that informs the tax debtor of his or her right to a hearing, 26 U.S.C. § 6330(a). Both the intent to levy and the Collection Due Process notice can be combined on one letter. IRS typically waits 10 weeks after issuing the Collection Due Process notice before actually making the levy through the FPLP. IRS can inform the taxpayer of IRS's levy authority within the first communication to the taxpayer, including the deficiency notice, or in any other notice letters.

Figure 7: Collections from IRS Notification Letters in Fiscal Year 2005



Source: GAO analysis of IRS data.

The FPLP is a powerful tool for encouraging collection that goes beyond the direct taxes collected through federal payment levies. We have previously estimated that the threat of a levy brings in over three times more collections than the levy itself.³⁸ IRS could take advantage of this potential during the notice phase if it were to inform tax debtors early in the notice process that their tax debt could be included in the FPLP.

Conclusions

Although the collection of taxes is always important, it takes on added prominence in times of severe budgetary uncertainty. As the nation's tax collector, IRS must seek out and utilize the most cost-effective means of collection at its disposal and apply those means to the broadest application of tax debt. The FPLP is a cost-effective program that has enabled IRS to greatly increase collection. The program's full success is dependent on the accuracy of IRS's status and transaction codes as well as the appropriateness of IRS's policies, procedures, and practices regarding the exclusion of tax debt from the FPLP. Improvements are needed in both arenas. The errors we identified in the status and transaction codes of tax debt cases highlight potential problem areas that have led to tax debt

³⁸ [GAO-03-356](#).

being inappropriately excluded from levy action and therefore require IRS's attention. With regard to its current policies, IRS continues to exclude over 60 percent of all tax debt from the FPLP and does not appear to have fully adopted our previous recommendation to use the FPLP as one of the first steps in the tax collection process. Viewing the FPLP as a primary and efficient collection tool could lead IRS to reevaluate its FPLP exclusion policies and to reduce the extent and length of time tax debt is excluded. Such changes hold the potential to subject billions of dollars in additional tax debt to the FPLP, thus increasing the government's chances of collecting some of this tax debt.

IRS faces tough challenges in balancing its tax collection activities against its available resources. In times of tough budgetary constraints, this can provide an incentive to close cases quickly or otherwise reduce the active tax collection inventory, possibly at the expense of maximizing tax collections. While reducing the number of active cases does, in fact, reduce the resources required, it can also have the effect of reducing collections, diminishing compliance, and eroding the public's confidence in the fairness of the tax system. For instance, in financial hardship cases, beyond those tax debtors granted relief from paying tax debt due to unexpected financial difficulty, each tax debtor who is allowed to avoid filing required tax returns or paying current taxes, or who is perceived to live well while facing little tax collection consequence, represents not only less money for vital federal programs but one more advertisement for others to do the same. Therefore, in setting financial hardship or other tax collection policies, it is incumbent upon IRS to be particularly judicious in setting income threshold levels and monitoring tax debt to ensure that it is acting fairly toward all taxpayers.

Recommendations for Executive Action

To increase the amount of tax debt eligible for, and to expedite the entry of tax debt into, the FPLP, we recommend that the Commissioner of Internal Revenue take the following actions:

- monitor the timely termination of defaulted installment agreements to help ensure tax debt is made available to the FPLP as soon as possible;
- place tax debt in the notice phase into the FPLP as soon as legally possible;
- consider adding language to IRS's second communication in the notice process informing the tax debtor that IRS has the authority to collect the debt by levying the tax debtor's income and assets if the tax debt is not paid voluntarily; and

-
- modify FPLP exclusion policy to allow tax debt in ACS subcategories R-5 and I-6 that is being considered for a levy on financial assets through paper levies to be concurrently included in the FPLP.

To help ensure that IRS's financial hardship FPLP exclusions are appropriate, we recommend that the Commissioner of Internal Revenue take the following actions:

- reevaluate whether the dollar ranges for existing financial hardship income thresholds, especially those that exceed the national median income, are appropriate and reasonable;
- consider changing the financial hardship closing codes for tax debtors designated as being in financial hardship prior to the 2004 income threshold increases to a closing code that most closely corresponds to the originally designated income threshold—for example, tax debtors who were in a threshold of \$50,000 prior to the change would be given a different subcode (closing code) so that the tax debtor's income ceiling stays as close to the original \$50,000 ceiling as possible under the new income thresholds;
- establish a policy so that in implementing future financial hardship income threshold changes, tax debtors' financial hardship subcodes (closing codes) are changed to ones that maintain the tax debtor's income ceiling as close as possible to the ceiling prior to the change;
- establish a policy to review tax debtors' financial condition periodically to verify the continued validity of the financial hardship designation;
- evaluate the ongoing validity of the financial hardship designations whenever tax debtors fail to file their annual tax returns by comparing third-party income information to the tax debtors' designated financial hardship income threshold ceilings; and
- refer tax debtors with a financial hardship designation to IRS's withholding compliance program for special attention if those tax debtors do not pay their current income tax obligations.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS noted improvements made to the FPLP and the extent to which such improvements have resulted in increased collections while at the same time ensuring that taxpayer rights have been protected. IRS also described several initiatives it had undertaken to improve its program for taxpayer accounts classified as currently not collectible, including a study to determine whether changes to IRS's allowable living expense tables, used in the determination of financial hardship status, would be appropriate given the availability of additional economic data. We made 10 recommendations: IRS agreed with 5, partially agreed with 2, and disagreed with 3. We modified the 2

recommendations with which IRS partially agreed in order to address issues raised by IRS while retaining the intent of our recommendations.

With respect to the four recommendations we made to either increase the amount of tax debt eligible for the FPLP or expedite the entry of tax debt into the FPLP, IRS agreed with one recommendation, partially agreed with another, and disagreed with the remaining two recommendations. IRS agreed with our recommendation that it monitor the timely termination of defaulted installment agreements, and noted it would identify those taxpayer accounts in installment agreement status but which show no payment activity within the last 60 days and determine if it needs to change the way it monitors installment agreements. While IRS disagreed with our recommendation that it add language about its legal authority to levy income and assets to its first notice letter, it stated that it would consider adding stronger language regarding possible enforcement activity in subsequent collection notices. As an explanation for its reluctance to include this course of action in the event of nonpayment, IRS noted that it had received criticism in the past for early aggressiveness and not affording taxpayers an opportunity to voluntarily satisfy their liability. While IRS is not legally precluded from providing language concerning its enforcement powers in the initial taxpayer notice, we understand IRS's desire to attempt to provide sufficient opportunity for taxpayers to voluntarily comply with their tax obligations without threat of enforcement action. Accordingly, we have modified our recommendation to add informative language about IRS's levy starting with the second taxpayer notice rather than the first. The important point to us is that IRS inform the tax debtor of its levy authority earlier in the process.

IRS disagreed with our recommendation that it place tax debt in the notice phase into the FPLP as soon as legally possible, stating that it believed its current notification process was the most cost effective. In stating its position, IRS noted that over three-fourths of tax debtors pay their tax debt after receiving the first notice, and that it believed the action recommended is not appropriate for individual taxpayers who have a high payment rate during the notice process. We do not believe that our recommendation would diminish the effectiveness of IRS's notice process, especially the voluntary tax collections resulting from the first notice. In fact, those tax debtors who would typically pay their debt upon receipt of the initial notice would be unaffected by the action we are recommending. Although implementing our recommendation would allow IRS to begin levy procedures during the notice phase, in practice, the tax debt generally would not be levied before IRS completes the notice phase. As we discuss in our report, tax debt could be included in the FPLP about three months

after IRS notifies the tax debtor of the tax liability, giving the tax debtor sufficient time to respond to both the first and second notices before the levy process would actually commence. Additionally, once the levy process begins, IRS must still send the tax debtor a Collection Due Process notice and wait about two and one-half months before levying a payment through the FPLP. Consequently, tax debt would not generally be levied before the notice phase is completed. However, by starting the levy process during the notice phase, IRS would be able to begin levying payments earlier than would otherwise be the case if the tax debtor does not voluntarily fully pay or otherwise resolve the tax debt during the notice phase because IRS would not have to continue to delay levy action while it issues the Collection Due Process notice and waits for the tax debtor to respond.

IRS also disagreed with our recommendation that it modify its FPLP exclusion policy to allow tax debt in two subcategories of its ACS to be eligible for the FPLP, citing concern that this could result in duplicate levies and thereby create unanticipated hardships for taxpayers. IRS also noted that it attempts to issue levies on cases within these ACS subcategories that could generate more in collections than would be collected through the FPLP due to the program's limit of 15 percent of each federal payment made to the tax debtor. We do not believe these concerns have merit. We believe that IRS's current process for manually blocking tax debt from the FPLP would provide a sufficient safeguard against duplicate levies while at the same time preserving adequate flexibility for other collection actions. As we discuss in our report, IRS has the ability to block, and, on a case by case basis, does block individual tax debt accounts from levy through the FPLP. IRS could apply this same approach to these two ACS subcategories. To manually block tax debt from the FPLP, IRS can place a transaction code in the tax debtor's account that blocks the FPLP from automatically levying the tax debt. The same transaction code can be placed in the tax record if IRS wants to levy more than the 15 percent allowable under the FPLP. This process would allow IRS to increase the effectiveness of the FPLP while preserving its ability to use paper levies when appropriate and minimizing the risk of duplicate levies.

With respect to the six recommendations we made to help ensure that IRS's financial hardship FPLP exclusions are appropriate, IRS agreed with four recommendations, partially agreed with one recommendation, and disagreed with the remaining recommendation. Specifically, IRS agreed with our recommendations to (1) reevaluate whether the dollar ranges for existing financial hardship income thresholds are appropriate and

reasonable; (2) establish a policy that when future financial hardship thresholds are changed, tax debtors' hardship closing codes are changed to ones that maintain the tax debtor's original income ceiling; (3) evaluate the ongoing validity of financial hardship designations whenever tax debtors fail to file their annual tax returns; and (4) refer tax debtors with a financial hardship designation to IRS's withholding compliance program for special attention if those tax debtors do not pay their current income tax obligations. Although IRS agreed to reevaluate whether the dollar ranges for existing financial hardship income thresholds are appropriate and reasonable, it raised concerns that imposing a rigid national median amount would disregard circumstances such as family size, medical needs, and geographic variations in average income. It is important to note that our recommendation does not advocate imposing the national median amount as a rigid maximum threshold limit. We recognize that IRS attempts to accommodate the needs of tax debtors with varying family sizes, geographical locations, and various other circumstances. However, as our report discusses, between 1992 and 2004, IRS raised its top financial hardship income threshold ceiling from an amount equal to the median national household income to an amount almost twice the median income without any detailed analysis supporting either the large increases or the deviation in the relationship of these thresholds from the national median income.

While IRS disagreed with our recommendation that it establish a policy to review tax debtors' financial condition every 3 years to verify the continued validity of the financial hardship designation, IRS did agree to consider including a time factor. Specifically, IRS noted that as part of its initiatives to improve its program for taxpayer accounts classified as currently not collectible, of which financial hardship is a significant aspect, it will consider including a time factor. Accordingly, we have modified our recommendation, replacing "every 3 years" with "periodically" to reflect IRS's willingness to consider including a time factor for reviewing a tax debtor's financial condition. However, in deciding upon the time factor to use, we believe that IRS should take into account that tax debt is typically only legally available for collection for 10 years. Thus, implementing a time period of greater than 3 years could result in IRS affording itself only one opportunity to reconsider the validity of the financial hardship designation.

Finally, IRS stated that it could not agree with our recommendation that it consider changing the financial hardship closing codes for tax debtors designated as being in financial hardship prior to the 2004 increases it implemented in the income thresholds until it has determined how many

tax debt accounts would be affected by the recommendation. IRS said that implementing the recommendation to change existing closing codes would require significant computer programming and system changes that it may not be able to implement, and which may not be cost effective. Our recommendation is for IRS to consider changing the hardship closing codes for the affected accounts; we are not recommending that IRS must do so. Implicit in our use of the word “consider” in our recommendation is a cost-benefit determination. In considering whether to change the hardship closing codes, IRS should take into account the work and cost involved in making this change as well as the potential for increased collections in determining the cost effectiveness of any modifications. However, we do believe that IRS erred in not changing the financial hardship closing codes for existing cases when it implemented the 2004 increases in the income thresholds. As discussed in our report, by not changing the closing codes, IRS allowed tax debtors who it previously believed could begin paying off their tax debt at a certain income threshold to immediately begin earning up to, on average, 77 percent more before IRS would hold them liable for their tax obligations. This created the potential for inequitable treatment between taxpayers in these same income brackets who pay their taxes and tax debtors who do not, especially when some of those tax debtors, on the day IRS changed the thresholds, were thereafter allowed to earn up to \$34,000 more income without IRS considering whether they continued to warrant the hardship designation. Consequently, in considering whether or not it is cost effective to implement a change in the closing codes of the effected accounts, IRS should also consider the issue of fairness with respect to the taxpayer population as a whole.

We are sending copies of this report to the congressional committees with jurisdiction over IRS and its activities, the Secretary of the Treasury, the Commissioner of Internal Revenue, and interested congressional committees and members. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you have any questions about this report, please contact me at (202) 512-3406 or sebastians@gao.gov. Key contributors to this report are listed in appendix III. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.



Steven J. Sebastian
Director
Financial Management and Assurance

Appendix I: Scope and Methodology

To determine whether and to what extent Internal Revenue Service (IRS) tax records contain inaccurate or out-of-date status or transaction codes that exclude them from the Federal Payment Levy Program (FPLP), we used IRS's unpaid assessments database as of September 30, 2005, to select two statistical samples. We used IRS's criteria for the statutory and policy exclusions from the FPLP to segment the tax records in the unpaid assessments database into the two categories. The population of statutory exclusions consisted of 9,068,508 tax records that contained tax debt of \$72,167,432,455. The population of policy exclusions consisted of 7,183,880 tax records that contained tax debt of \$81,492,531,369. We selected a statistical sample of 100 tax debts that were excluded from the levy program based on IRS's designation of their tax record as being excluded because of a legal—statutory—requirement of the Internal Revenue Code. We also selected a statistical sample of 100 tax debts that were excluded from the levy program based on IRS's policy determinations.

We randomly selected probability samples from the populations of tax debt accounts excluded from the FPLP for statutory reasons and policy reasons. With these probability samples, each tax account in each of the populations had a nonzero probability of being included and that probability could be computed for any account. Each sample tax account selected was subsequently weighted in the analysis to account statistically for all the tax accounts of its respective population. The sample we selected from each population was only one of a large number of samples that we might have drawn because for each sample we followed a probability procedure based on random selections. Since each sample could have provided different estimates, we express our confidence in the precision of each sample's result as 95 percent confidence intervals, which are intervals that would contain the actual population value for 95 percent of the samples we could have drawn. As a result, we are 95 percent confident that the confidence intervals presented in this report will include the true values in the respective study populations. For the statistical error rate projection, we used a point estimate with a 95 percent confidence interval. The projected point estimate combined with the confidence interval surrounding the point estimate means that although we estimate the error rate to be at the point, we are 95 percent confident that the true error rate is somewhere between the interval's lower and upper limits.

For each sampled tax period, we obtained and reviewed IRS records on the status and history of tax collection action with particular emphasis on actions that affected the FPLP status of the tax debt. We performed additional searches of criminal, financial, and public records. We

compared each sampled tax debt to IRS's FPLP exclusion and inclusion criteria and determined the accuracy of the status or transaction code that excluded the tax debt from the FPLP. We categorized a sample tax debt as an error if the tax period did not meet at least one exclusion criterion or had exceeded IRS's time frame for ending an exclusion, such as the time frame for terminating an installment agreement. In some cases, the time frame for terminating an installment agreement was exceeded at the time IRS provided us records to review rather than at the September 30, 2005, date of the unpaid assessments database.

To determine whether IRS's policies, procedures, and practices could be strengthened to ensure the accuracy and timeliness of its status and transaction codes, we reviewed IRS's Internal Revenue Manual and interviewed IRS officials to obtain criteria, guidance, and internal controls on (1) coding cases for inclusion and exclusion from the FPLP (2) processing cases in the notice phase; and (3) processing and terminating cases in installment agreements, offers in compromise, and financial hardship.

To determine whether opportunities exist to increase the amount of tax debt included in the FPLP, we analyzed the effect of IRS's exclusion criteria as well as the potential effect of changes in the exclusion criteria on the amount of tax debt included in the FPLP. In assessing the effect of potential changes in the statutory exclusions, we compared the potential for modifying IRS's existing FPLP exclusion criteria within the exclusion's legal framework, and we discussed the potential changes with cognizant IRS officials.

Data Reliability Assessment

For the IRS database we used, we relied on the work we perform during our annual audit of IRS's financial statements. While our financial statement audits have identified some data reliability problems associated with the coding of some of the fields in IRS's tax records, including errors and delays in recording taxpayer information and payments, we determined that the data were sufficiently reliable to address this report's objectives. Our financial audit procedures, including the reconciliation of the value of unpaid taxes recorded in IRS's master file to IRS's general ledger, identified no material differences.

Appendix II: Comments from the Internal Revenue Service

Note: Subsequent to providing the draft report to IRS, numbered GAO-06-743, we renumbered the report to [GAO-07-26](#).



COMMISSIONER

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

September 29, 2006

Mr. Steven J. Sebastian
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Sebastian:

I have reviewed your draft GAO report titled "Procedural Changes Could Enhance Tax Collections" (GAO-06-743). We appreciate your recognition of our success with the Federal Payment Levy Program (FPLP). In part due to numerous improvements made to the program, this year the IRS collected more money than ever before through FPLP while ensuring taxpayer rights were protected. Through August 2006 we collected \$260 million through FPLP, compared to \$197 million collected through the program for all of FY 2005.

Among the improvements to the FPLP, as of January 2006, 18 of the 20 Defense Finance and Accounting Service (DFAS) payment systems have been added to the program. In addition, General Services Administration salary payments were added in March of this year, and we are currently working with the Financial Management Service (FMS) and DFAS to include salary payments from military retirees, Department of Defense civilians, and the Departments of Health and Human Services, Veterans Affairs, and Energy.

Your report acknowledges the significant strides made by the Federal Contractors Tax Compliance Task Force (FCTC) in identifying and including contractors in the FPLP. The FCTC maximized the number of delinquent tax debts the IRS makes available for matching, increased the frequency of data exchanges between DFAS and FMS, improved the timing of the Collection Due Process (CDP) notices that are required to be issued to taxpayers before a levy can be made, and established a process for validating Taxpayer Identification Numbers (TINs) of federal contractors through the Central Contractor Registration (CCR). The effectiveness of the FPLP depends on maximizing both the number of debts provided by the IRS and the number of payments for which the debts are successfully matched.

We have recently undertaken several initiatives to improve our Currently Not Collectible (CNC) program, as we continually strive to enhance program execution under our existing policies. These initiatives include a joint SB/SE and W&I team charged with assessing the overall effectiveness of the CNC reactivation process, and a study to determine whether changes to our Allowable Living Expense tables would be appropriate given the availability of additional economic data.

2

We share your opinion that IRS should only place an account in CNC status after rigorous financial analysis. We also agree that accounts suspended for reasons of hardship should be subject to an accurate reactivation system if the taxpayer's income rises. The CNC income thresholds provide a wide range of reactivation points that, when coupled with the use of the IRS' allowable living expenses, can accurately determine the amount of income at which a taxpayer's financial situation may have changed enough for the IRS to reevaluate their ability to pay.

When standard allowance amounts are applied against an individual's income, IRS employees can make a reasonable assessment of their ability to pay. Each case is carefully considered to ensure requiring payments would not cause a taxpayer to experience an undue financial hardship. When an IRS employee determines collection of an account should be suspended, an appropriate threshold that best matches the taxpayer's current expenses is selected and notated systemically. Income on subsequent returns in excess of the threshold triggers IRS to reassess the taxpayer's financial situation.

Imposing a more rigid national median amount instead of an individually determined threshold amount would disregard circumstances such as family size, medical needs, and geographic variations in average income. We place a high priority on avoiding undue burden on taxpayers while helping them meet their tax responsibilities. Protecting taxpayer rights and being sensitive to individual situations is an area we focus on and work closely with the Taxpayer Advocate Service to achieve.

We believe a range of threshold amounts that IRS employees can select from based on the knowledge they have attained about the taxpayer's situation is much fairer to taxpayers and provides a more accurate determination. It also prevents premature reactivation of accounts which is an unproductive use of IRS's limited resources.

Responses to your specific recommendations are enclosed. We will continue to work on enhancing the FPLP and appreciate your acknowledgement of IRS' accomplishments to date. If you have any questions, please contact Floyd Williams, Director, Legislative Affairs, at (202) 622-3720.

Sincerely,



Mark W. Everson

Enclosure

Enclosure

Recommendation for the Commissioner

Monitor the timely termination of defaulted installment agreements to help ensure tax debt is made available to the FPLP as soon as possible.

Response

We agree with this recommendation and will identify how many accounts are in an installment agreement without payments within the last 60 days and determine if a programming correction is warranted.

Recommendation for the Commissioner

Place tax debt in the notice phase into the FPLP as soon as legally possible.

Response

We disagree with this recommendation. In the interest of cost-effective tax administration, the IRS sends a series of notices to taxpayers before resorting to levy as a means of collection. The vast majority of taxpayers – 77.6 percent – full pay their accounts after the initial first notice. While we have taken action to accelerate the CDP and levy issuance on federal contractors that owe taxes, we do not believe this is the appropriate action for individual taxpayers who have a high payment rate during the notice process. We include cases in the FPLP program following the notice stream to allow time for taxpayers to self correct before levy is attempted. We continue to believe that this is the most cost-effective way to resolve the greatest number of cases early in the process, while still promoting voluntary compliance and not causing undue hardship.

Recommendation for the Commissioner

Consider adding language to IRS' first communication in the notice process stating that the tax debtor's income and assets can be levied to collect the unpaid tax debt, including federal payments to them through the FPLP.

Response

We disagree with the recommendation to change the first notice. As noted above, a significant number of taxpayers satisfy their liability after first notification of their balance due. Some balances due are a result of tax adjustments or math errors identified during return processing that are explained to taxpayers in the first notice. We have received criticism in the past for early aggressiveness and not affording taxpayers an opportunity to voluntarily satisfy their liability. As a result these notices have been carefully created jointly with the Taxpayer Advocate Service to ensure that we adhere to taxpayer rights. We will consider stronger language regarding possible enforcement activity in subsequent collection notices.

2

Recommendation for the Commissioner

Modify FPLP exclusion policy to allow tax debt in Automated Collection System (ACS) subcategories R-5 and I-6 that is being considered for a levy on financial assets through paper levies to be concurrently included in the FPLP.

Response

We agree all appropriate debts should be included in the FPLP to facilitate the collection process. However, we disagree with the recommendation that ACS subcategories R-5 (Initial Levy Action) and I-6 (Levy follow-up) should be included. These inventories are excluded because ACS issues levies on these cases which could attach more than the 15 percent that is subject to FPLP.

Of greater concern is that including these cases in FPLP may result in duplicate levies which could create unanticipated hardships for taxpayers. Therefore, we do not agree that these subcategories should be included in the FPLP.

Recommendation for the Commissioner

Reevaluate whether the dollar ranges for existing financial hardship income thresholds, especially those that exceed the national median income are appropriate or reasonable.

Response

We agree that we should validate the effectiveness of our current CNC reactivation thresholds in connection with our project to evaluate whether changes to the Allowable Living Expense (ALE) tables are warranted. However, imposing a rigid national median amount instead of an individually determined threshold amount would disregard circumstances such as family size, medical needs, and geographic variations in average income. It would also cause the IRS to expend resources handling prematurely reactivated, unproductive cases. The range of reactivation thresholds must take into account a wide variety of financial circumstances, and must work in concert with the ALE.

Recommendation for the Commissioner

Consider changing the financial hardship closing codes for tax debtors designated as being in financial hardship prior to the 2004 income threshold increases to a closing code that most closely corresponds to the originally designated income threshold – for example, tax debtors who were in the threshold of \$50,000 prior to the change would be given a different subcode (closing code) so that the tax debtor's income ceiling stays as close to the original \$50,000 ceiling as possible under the new income thresholds.

Response

We cannot agree with this recommendation until we determine how many Currently Not Collectible (CNC) accounts would be affected by it. Execution of the recommendation would require significant programming and system changes which we may not be able

to implement. This fact, coupled with a reduction in the number of accounts that would be subject to this action over time, may reduce the cost effectiveness of the recommended change.

Recommendation for the Commissioner

Establish a policy so that in implementing future financial hardship income threshold changes, tax debtors financial hardship subcodes (closing codes) are changed to ones that maintain the tax debtor's income ceiling as close as possible to the ceiling prior to the change.

Response

We agree with this recommendation in concept, and will take it into consideration while reviewing any future changes to the financial hardship closing codes. However, we are concerned about the potential programming costs of this recommendation, and will weigh the possible benefits against these costs prior to deciding whether to implement it.

Recommendation for the Commissioner

Establish a policy to review tax debtor's financial condition every 3 years to verify the continued validity of the financial hardship designation.

Response

We disagree with the recommendation to institute a mandatory financial review process at a set time interval for every financial hardship CNC case since this would involve a significant resource commitment with limited, if any, increase in collection potential. Currently, when declaring a case CNC under financial hardship, we have the opportunity to choose a closing code that takes into consideration the taxpayer's known future financial circumstances. Instituting a mandatory review every 3 years would add approximately 180,000 to 200,000 taxpayer cases into the collection work stream each year¹. In considering this change, we would have to balance account reactivations against the opportunity cost of the same resources being applied to working newer accounts. Since we are currently evaluating our CNC reactivation process and investigating opportunities for improvement, we will consider including a time factor in our study as part of the cost benefit analysis discussed in the corrective action above.

Recommendation for the Commissioner

Evaluate the ongoing validity of the financial hardship designations whenever tax debtors fail to file their annual tax returns by comparing third-party income information to the tax debtors' designated financial hardship income threshold ceilings.

¹ CAR report 5000-149 (recap of CNC Accounts) for the cumulative period ending September 30, 2003, September 30, 2004, and September 30, 2005. Line 2.14 total IMF CNC modules closed with cc 24-32 divided by line 2.0 Total number of IMF TC 530 modules multiplied by line 1.0 total number of IMF CNC Taxpayers.

4

Response

We agree with this recommendation. During Fiscal Year (FY) 2006, Small Business/Self-Employed and Wage and Investment formed a team, which is now in the analysis phase, to look at the effectiveness of the reactivation process for CNC. We currently review income sources reported by third parties for all taxpayers who fail to file returns, and place the account in the delinquent return notice process if a taxable return filing requirement appears likely. If the taxpayer fails to file the returns during this notice process, a Taxpayer Delinquency Investigation (TDI) is generated. The TDI is placed in the inventory stream for further investigation by contact employees based on current inventory priorities. The team will continue to work in FY2007 to study the impact of future non-filing compliance on the CNC financial hardship reactivation.

Recommendation for the Commissioner

Refer tax debtors with a financial hardship designation to IRS' withholding compliance program for special attention if those tax debtors do not pay their current income tax obligations.

Response

We agree that this recommendation has merit. In FY2006, the IRS initiated a withholding compliance program that identifies individuals who incur tax debt due to under-withholding. The program, which is still in its initial stages, requires the individual's employer to increase the employee's federal tax withholdings. We are currently assessing the effectiveness of the program and our ability to expand it as our resources allow. We will continue research in this area to determine the feasibility of implementing this type of process in conjunction with the corrective action above.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

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

Acknowledgements

The following individuals made major contributions to this report: William J. Cordrey, Amy Bowser, Ray Bush, Kenneth Hill, Inna Livits, Dave Shoemaker, Sidney Schwartz, and Mark Yoder.

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