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FINANCIAL  
MANAGEMENT

Thousands of Civilian  
Agency Contractors Abuse  
the Federal Tax System  
with Little Consequence

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## FINANCIAL MANAGEMENT

# Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence

Highlights of [GAO-05-683T](#), a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

### Why GAO Did This Study

Tax abuses by contractors working for the Department of Defense, which GAO previously reported on, have led to concerns about similar abuses by those hired by civilian agencies. GAO was asked to determine if similar problems exist at civilian agencies and, if so, to (1) quantify the amount of unpaid federal taxes owed by civilian agency contractors paid through the Financial Management Service (FMS), (2) determine whether there are indications of abusive or potential criminal activity by contractors with unpaid tax debts, and (3) identify any statutory or policy impediments and control weaknesses that impede tax collections under the Federal Payment Levy Program (FPLP).

### What GAO Recommends

In its report ([GAO-05-637](#)), on which this testimony is based, GAO makes recommendations to FMS to improve the FPLP and increase by tens of millions of dollars annually the amounts levied from payments to contractors with unpaid federal taxes. GAO also recommended that IRS review the 50 case study contractors identified in the report, and if warranted, pursue collection or criminal investigation. IRS agreed and FMS partially agreed. FMS did not agree that it should withhold payments to contractors without names or work with IRS to address challenges related to levying purchase card payments. GAO disagreed with FMS's assessment and reiterated support for its recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-05-683T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-683T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Greg Kutz at (202) 512-9095 or Steven Sebastian at (202) 512-3406.

### What GAO Found

FMS and IRS records showed that about 33,000 civilian agency contractors owed over \$3 billion in unpaid federal taxes as of September 30, 2004. GAO investigated 50 civilian agency contractors with abusive and potentially criminal activity. For example, businesses did not forward payroll taxes withheld from their employees to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Furthermore, several individuals owed multiple businesses with unpaid federal taxes—one owned about 20 businesses that did not fully pay taxes on over 300 returns. Some diverted payroll taxes for personal gain or to fund their businesses, such as building a house, purchasing other real property, and increasing the salary of the company's officer/owner. These contractors worked for a number of federal agencies including the Departments of Justice and Homeland Security, and the National Aeronautics and Space Administration.

#### Examples of Abusive and Potentially Criminal Activity

Business	Unpaid tax amount	Fiscal year 2004 FMS payments	Contractor activity
Health care	\$18 million	\$300,000	Purchased multimillion-dollar properties while not paying millions in payroll taxes
Consulting	\$1 million	\$200,000	Doubled salary of one officer/owner to over \$750,000 while not remitting payroll taxes
Temporary help	\$900,000	\$1 million	A pattern of over 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts
Security	\$400,000	\$200,000	Diverted payroll taxes to a foreign bank account to build a house overseas

Source: GAO's analysis of civilian agency, IRS, FMS, public, and other records.

If all tax debts owed by, and all payments made to, the 33,000 contractors were included in the FPLP, FMS could have collected hundreds of millions of dollars in fiscal year 2004. However, because only a fraction of all unpaid taxes and a portion of FMS payments were included in the levy program, FMS collected only \$16 million. For example, about \$171 billion of unpaid federal taxes was not sent to the levy program to be offset against payments because of statutory requirements or IRS policy exclusions such as claims of financial hardship or bankruptcy.

Tens of billions of dollars in federal payments were not matched against tax debts for potential levy because FMS did not proactively manage and oversee the levy program. Until GAO brought it to FMS's attention, FMS was unaware that \$40 billion of contractor payments had not been submitted for potential levy. FMS also did not identify payment files that lacked contractor taxpayer identification numbers, names, or both, resulting in another \$21 billion that could not be levied. FMS also excluded billions of dollars from levy because of what it considered limitations in its automated systems without taking steps to overcome those limitations. Furthermore, civilian agency purchase card payments to contractors totaling nearly \$10 billion could not be levied.

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Mr. Chairman, Members of the Subcommittee, Senator Collins, Senator Lieberman, and Senator Akaka:

Thank you for the opportunity to discuss payments to civilian agency contractors that abuse the federal tax system. Our related report, released today and developed at the request of this Subcommittee, and Senators Collins, Lieberman, and Akaka, describes problems we identified in the management of the Federal Payment Levy Program (FPLP), in particular the program's collection of levies from civilian agency contractors with unpaid taxes.<sup>1</sup> These problems illustrate the overall challenges the federal government experiences in managing the federal tax system in a way that contributes to taxpayers' perception of the tax system's fairness, i.e., their perception that their friends, neighbors, and business competitors are complying with the tax laws and actually paying their taxes. These challenges are exacerbated by our identification, in our testimony at a hearing on February 12, 2004, of fraud, waste, and abuse among certain Department of Defense (DOD) contractors that owed billions of dollars in unpaid taxes. Because of these problems, you asked us to perform an audit and related investigation of civilian agency contractors to determine whether, and to what extent, civilian agency contractors also have unpaid federal taxes.

With some exceptions, civilian agency contractors receive disbursements from the Department of Treasury's Financial Management Service (FMS).<sup>2</sup> FMS is also the federal government's central debt collection agency. Since July 2000, FMS has operated the FPLP in conjunction with the Internal Revenue Service (IRS) to collect unpaid federal taxes, including tax debt owed by businesses and individuals who contract with civilian agencies. Under the FPLP, specified payments to federal contractors are compared with tax debt data—updated on a weekly basis by IRS—using the Treasury Offset Program (TOP), a centralized debt collection program operated by FMS. When payment data are sent to TOP, it electronically compares the

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<sup>1</sup> GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005).

<sup>2</sup> A few civilian agencies, such as the U.S. Postal Service, have their own disbursing authority and do their own disbursements. Although DOD has its own disbursement authority, some DOD payments are made through FMS.

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names and taxpayer identification numbers (TINs)<sup>3</sup> on the payment files with the control names (first four characters of the names) and TINs of the debtors listed in TOP. If there is a match on a debt for which IRS has completed all legal notification requirements for levy, the federal payment is reduced (levied) to help satisfy the unpaid federal taxes. In fiscal year 2004, FMS collected \$16 million from levying payments to civilian agency contractors.

Today, we will summarize our work on why substantial payments that FMS made on behalf of civilian agencies to contractors with tax debt were not levied. Our testimony will provide a perspective on (1) the magnitude of unpaid federal taxes owed by civilian agency contractors, (2) the statutory and policy impediments and control weaknesses that impeded tax collections under the FPLP, and (3) abusive or criminal activity by civilian agency contractors related to the federal tax system. In addition, we will summarize our work covered in a separate draft report, which we have transmitted to FMS and IRS for their comments, on the progress FMS has made on obtaining reciprocal agreements with states so that payments to contractors made by the states could be levied for unpaid federal taxes.

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## Summary

Our analysis of FMS and IRS records showed that about 33,000 civilian agency contractors who owed over \$3.3 billion in unpaid federal taxes received payments from numerous federal agencies during fiscal year 2004. During the same period, the federal government missed many opportunities to collect some of the unpaid federal taxes owed by these civilian agency contractors. We estimate that if there were no legal or administrative provisions that excluded a significant amount of tax debt from the levy program, and if all contractor payments for which FMS maintains detailed information were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, IRS and FMS could

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<sup>3</sup> A TIN is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number assigned by IRS serves as the TIN. For individuals, the Social Security Number, assigned by the Social Security Administration, serves as the TIN.

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collect hundreds of millions of dollars annually.<sup>4</sup> However, during fiscal year 2004, FMS collected only \$16 million from the FPLP, leaving a tax levy collection gap totaling hundreds of millions of dollars.

A significant portion of the levy collection gap arises because only a fraction of unpaid tax debts is included in the levy program and matched against payments. Specifically, because of legal requirements and IRS policy provisions, only 37 percent of the unpaid tax debts are included in the FPLP. In addition, only about 30 percent of the debt included in the FPLP is actually ready for immediate levy. While the exclusion of unpaid federal taxes from the levy program is justified in some circumstances, it nevertheless results in significant losses in the collection of revenue from levies. In a later report, we will examine the accuracy and reasonableness of the IRS exclusions.

The remaining levy collection gap exists because of a lack of proactive oversight and management of the levy program by FMS. For example, FMS was not aware that it did not submit tens of billions of dollars in payments to the levy program for matching against tax debts. These included payments without payment type code and payments from certain agency paying units. Even when FMS was aware that many payments from agency payment files did not contain TINs, without which a match could not be made between the payment file and the tax debts, FMS did not address this deficiency. Consequently, these payments had no possibility of being levied. Furthermore, FMS decided to exclude tens of billions of dollars in payments from the levy program without determining whether the cost of making changes to its automated systems and other efforts necessary to include them in the levy program would exceed the potential benefits, specifically increased tax collections and improved compliance. We estimate that if FMS addresses its control and related weaknesses, it could collect an estimated \$50 million more from the FPLP annually. Furthermore, FMS has not addressed other challenges in the levy program that further limit its effectiveness at collecting unpaid taxes. These challenges include levying contractors paid with government purchase

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<sup>4</sup> Our estimate was derived by analyzing data from FMS's Payments, Claims, and Enhanced Reconciliation (PACER) system, which maintains detailed data on payments made via checks and Automated Clearing House. PACER payment data for fiscal year 2004 contained about 12.9 million contractor payments valued at \$247 billion. As will be discussed later, PACER does not maintain detailed information related to \$191 billion in payments made via Fedwire—payments requiring same-day settlement.

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cards and fully implementing, with IRS, the increased 100 percent levy provision authorized in 2004.<sup>5</sup> Furthermore, as will be communicated in a separate report, a draft of which was transmitted to FMS and IRS for comment on June 7, 2005, FMS and the states are not collecting debt, including unpaid taxes, on behalf of one another through the offset of contractor payments.<sup>6</sup> These mutually beneficial tax collection activities are not occurring because FMS has not actively pursued avenues to encourage states to enter into reciprocal agreements with the federal government to collect each other's taxes. Officials at the 17 states we contacted informed us that they were not aware that such a debt collection opportunity exists, but all expressed interest in pursuing this opportunity.

We also found numerous instances of abusive or potentially criminal activity related to the federal tax system during our audit and investigation of 50 civilian agency contractor case studies.<sup>7</sup> The 50 case studies involved mostly small companies—many of them closely held by the owners and officers—with unpaid payroll taxes. These payroll taxes included Social Security, Medicare, and individual income taxes withheld from employees' paychecks. We found that these contractors did not fulfill their role as "trustees" and forward these amounts to IRS. Rather, by diverting the money for personal gain or to fund their business, these contractors potentially committed a criminal felony. For example, one of the contractors used the payroll taxes not remitted to IRS to build a house overseas. A few contractors were involved in more than one business, all of which had unpaid tax debts. One case study contractor is one of a group of

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<sup>5</sup> The American Jobs Creation Act of 2004 contains a provision authorizing the federal government to levy up to 100 percent—up from a maximum of 15 percent—of specified payments for goods and services provided by contractors with unpaid federal taxes. Pub. L. No. 108-357, § 887(a), 118 Stat. 1418, October 22, 2004, to be codified at 26 U.S.C. § 6331 (h)(3).

<sup>6</sup> GAO, *Debt Collection: State and Federal Governments Are Not Taking Action to Collect Unpaid Tax Debt through Reciprocal Agreements*, [GAO-05-697R](#) (Washington, D.C.: to be issued).

<sup>7</sup> A case study consists in some cases of multiple related entities, some or all of which owe tax debts. When our audit and investigative work indicated that the 50 contractors we originally selected were related to other entities—defined as entities sharing the same owner or officer or common addresses—we performed work to determine whether the related entities and the owners owed tax debts as of September 30, 2004, and received other federal payments during fiscal year 2004.

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20 businesses that owed \$13 million in unpaid taxes covering over 300 tax periods.<sup>8</sup> Another case study contractor had a 20-year history of opening a business, failing to remit to IRS the taxes withheld from employees, and then closing the business, only to repeat the cycle again and incur additional tax debts almost immediately.

As discussed in our report released today, we are making 18 recommendations to FMS to improve collections under the FPLP and 1 recommendation to IRS to review the 50 case study companies and determine whether additional collection action or criminal investigation is warranted. IRS agreed and FMS partially agreed with our recommendations. FMS did not agree with our recommendations that it should withhold payments to contractors without a name or work with IRS to explore options to levy or otherwise collect from purchase card payments. FMS also disagreed with our characterization of its management of the levy program but did not dispute the factual basis on which we based our findings and recommendations. We disagree with FMS's assessment and reiterate support for our recommendations. In our related report on state participation in the levy program, a draft of which has been sent to FMS and IRS for comment, we are also making three additional recommendations to FMS to increase state participation in the collection of unpaid federal and state taxes.

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## Civilian Contractors Owe Billions of Dollars in Unpaid Federal Taxes

As was the case at the Department of Defense, thousands of civilian agency contractors throughout the federal government abused the federal tax system with little consequence. Our analysis of FMS and IRS records indicated that during fiscal year 2004, FMS made payments on behalf of civilian agencies to about 33,000 federal contractors with over \$3.3 billion in unpaid federal taxes as of September 30, 2004. This amount is likely understated because, first, we intentionally limited the population of contractors with unpaid tax debts to debts and payments that were

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<sup>8</sup> A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is one-quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, although payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year.

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significant and agreed upon,<sup>9</sup> and second, because the disbursement files we received from FMS were not complete, i.e., they did not always contain the information we needed to determine whether the contractors owed federal taxes. For example, contractors receiving \$17 billion in payments from FMS could not be identified because of blank or obviously erroneous TINs in the payment files submitted to FMS by the civilian agencies. Without an accurate TIN, we could not determine whether the contractor had unpaid federal taxes and, if so, the amount of unpaid taxes owed by the contractor. Similarly, as we have seen from our annual audits of IRS's financial statements, the taxpayer account database we received from IRS reflects only the amount of unpaid taxes either reported by the taxpayer on a tax return or assessed by IRS through its various enforcement programs.<sup>10</sup> The IRS database does not reflect the amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed the tax amounts due.

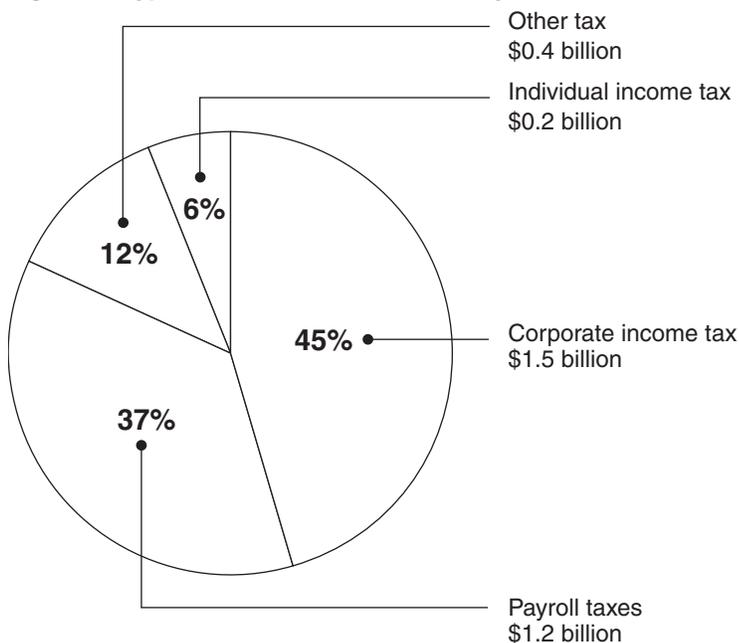
The over \$3.3 billion in unpaid taxes owed by these civilian agency contractors ranged from a small amount owed by an individual for a single tax period to a group of related businesses owing about \$13 million for over 300 tax periods. The type of unpaid taxes varied and consisted of payroll, corporate income, individual income, and other types of taxes. As shown in figure 1, over a third of the total tax amount owed by civilian contractors was for unpaid payroll taxes, and over 40 percent was for corporate income taxes.

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<sup>9</sup> Our initial matches of civilian contractor payments made during fiscal year 2004 with IRS tax debt as of September 30, 2004, identified about 63,000 contractors that had tax debt totaling \$5.4 billion. We excluded from our preliminary estimates tax debts that had not been agreed to by the tax debtor or affirmed by the court, tax debts from calendar year 2004, tax debts of \$100 or less, and fiscal year 2004 FMS payments of \$100 or less to arrive at our estimate of about 33,000 contractors with \$3.3 billion in tax debts.

<sup>10</sup> GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, [GAO-05-103](#) (Washington, D.C.: Nov. 10, 2004).

**Figure 1: Type of Federal Tax Debt Owed by Civilian Contractors**



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Unpaid payroll taxes include amounts that an employer withholds from an employee’s wages for federal income taxes, Social Security, and Medicare—but does not remit to IRS—and the related matching contributions of the employer for Social Security and Medicare. Employers who do not remit payroll taxes to the federal government are subject to civil and criminal penalties. Because employers are responsible for holding payroll taxes withheld from employees “in trust” for the federal government and making a federal tax deposit in that amount,<sup>11</sup> the employer is liable for the amounts not forwarded to the federal government, as well as the employer’s matching Social Security and Medicare contributions. Willful failure to remit payroll taxes is a criminal felony offense punishable by imprisonment of not more than 5 years,<sup>12</sup>

<sup>11</sup> The law further provides that withheld income and employment taxes are to be held in a separate bank account considered to be a special fund in trust for the federal government. 26 U.S.C. § 7512(b).

<sup>12</sup> 26 U.S.C. § 7202.

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while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense punishable by imprisonment of up to a year.<sup>13</sup> The law imposes no penalties upon an employee for the employer's failure to remit payroll taxes, since the employer is responsible for submitting the amounts withheld. However, individuals may be held personally liable for the withheld amounts not remitted to IRS and assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).<sup>14</sup>

A substantial amount of the unpaid federal taxes shown in IRS records as owed by civilian contractors has been outstanding for several years. As reflected in figure 2, over half of the unpaid taxes owed by civilian contractors was for tax periods prior to calendar year 2000.<sup>15</sup>

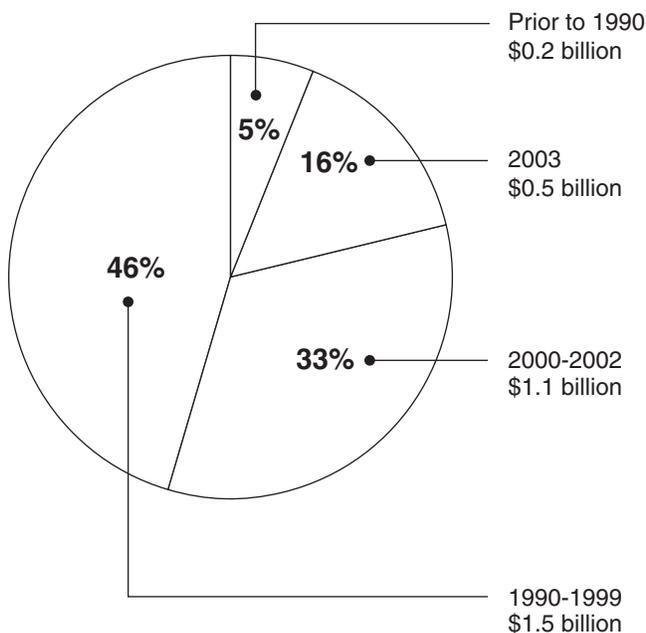
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<sup>13</sup> 26 U.S.C. § 7215 and 26 U.S.C. §7512 (b).

<sup>14</sup> 26 U.S.C. § 6672.

<sup>15</sup> The tax period may not always correspond to the age of the tax debt, as when a tax form is filed years after the due date or when IRS assesses additional taxes to earlier tax periods.

**Figure 2: Civilian Contractors' Unpaid Federal Taxes by Tax Periods through 2003**



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Prompt collection of unpaid taxes is vital because, as our previous work has shown, as unpaid taxes age, the likelihood of collecting all or a portion of the amount owed decreases.<sup>16</sup> This is due, in part, to the continued accrual of interest and penalties on the outstanding federal taxes, which, over time, can dwarf the original tax obligation. Furthermore, there is generally a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect tax debt.<sup>17</sup> Consequently, if the contractors owed federal taxes beyond the 10-year statutory collection period, the older tax debt typically would not be available for collection

<sup>16</sup> GAO, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, [GAO/AIMD/GGD-99-211](#) (Washington, D.C.: Aug. 2, 1999).

<sup>17</sup> The 10-year time period may be suspended, including for periods during which the taxpayer is involved in a collection due process appeal, a litigation, a pending offer in compromise or an installment agreement. Accordingly, figure 2 includes unpaid federal taxes that are for tax periods prior to 1995.

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because the debt would have been removed from IRS's records. We were unable to determine the amount of unpaid tax debts of federal contractors that had been removed because of the statutory collection period's expiration.

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## Millions in Unpaid Federal Taxes Are Not Collected

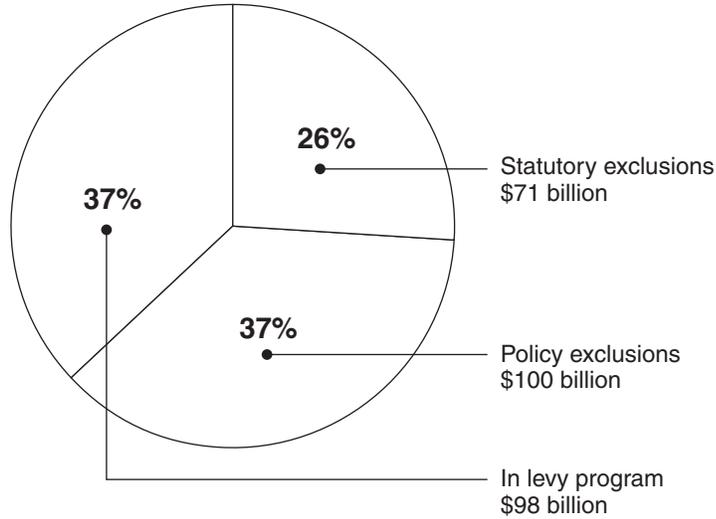
A large levy collection gap exists between the potential levy amount we estimated and the amount FMS actually collected under the FPLP. According to our estimate, if there were no legal or administrative provisions that removed a substantial amount of tax debt from the levy program, and if all contractor payments for which FMS maintained detailed information were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, FMS could have collected as much as \$350 million in fiscal year 2004. However, during fiscal year 2004, FMS collected about \$16 million from civilian contractors—or about 4 percent of the maximum levy collection we estimated. Because almost two-thirds of unpaid federal taxes are excluded from the FPLP because of statutory requirements and IRS policies, FMS and IRS will never be able to completely close the levy collection gap. Additionally, FMS's lack of oversight and proactive management of the levy program further impeded the government's ability to close the levy collection gap, leading to at least \$50 million in lost levy collections from civilian agency contractors during fiscal year 2004. Until FMS corrects the deficiencies in its oversight and management of the levy program, the federal government will continue to miss opportunities to collect unpaid taxes through the FPLP.

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## Billions of Dollars in Unpaid Taxes Excluded from Levy Program

According to IRS records, as of April 2005, IRS had coded about \$71 billion of unpaid federal taxes as being legally excluded from the levy program and \$100 billion as being excluded because of policy decisions. As shown in figure 3, this leaves only 37 percent (\$98 billion out of \$269 billion) in unpaid taxes that IRS sent to FMS to be included in the FPLP for potential collection. Furthermore, IRS had completed all legal notification requirements for immediate levy on only 30 percent the amount of unpaid tax debts in the FPLP as of September 30, 2004. Consequently, 70 percent of those tax debts sent over for levy were still not eligible to have payments levied.

**Figure 3: Levy Status of Unpaid Federal Taxes**



Source: GAO analysis of unaudited IRS data as of April 2005.

According to IRS records, bankruptcy and taxpayer agreements, including installment or offer in compromise agreements,<sup>18</sup> each account for about a quarter of the \$71 billion in statutory exclusions. Another 38 percent—\$27 billion—is due to IRS not having completed all initial taxpayer notifications required by law before a tax debt could be referred to the FPLP. These are cases that IRS refers to as being in notice status.

For tax debt in notice status—the first phase of IRS’s collection process—IRS sends a series of up to four separate notices to the tax debtor demanding payment of the tax debt. Upon receipt of each notice, the debtors have a minimum of 30 days to respond and have a number of different options, including appealing the tax debt if they disagree with the tax assessment, entering into a payment arrangement, applying for a hardship determination,<sup>19</sup> or paying the tax debt in full. Each time the debtor responds to a notice, IRS must make a determination on how to

<sup>18</sup> Installment agreements allow for payments on the debt in smaller, more manageable amounts. An offer in compromise approved by IRS allows a tax debtor to settle unpaid tax debt for less than the full amount due.

<sup>19</sup> In these instances, the tax debtors demonstrate to IRS that making any payments at all would result in a significant financial hardship.

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dispose of the response, for example, whether to accept or reject an installment agreement if one is offered, before proceeding further with another notice or collection action. The process of notification, response, disposition, and further notification could occur up to four times. Until the series of notifications is complete, the tax debt is excluded from the levy program.

In addition to legal restrictions, \$100 billion in tax debts is excluded because of IRS policy decisions. According to IRS data as of April 2005, slightly over half (\$51 billion) of all policy exclusions were due to IRS's determination that the tax debtor was in financial hardship.<sup>20</sup> Other policy exclusions include debts belonging to debtors who are working with IRS to voluntarily comply and debtors under active criminal investigation, among others. The amount excluded for policy reasons remained substantial even after IRS added more than \$28 billion to the levy program by reducing the number of policy exclusions in response to recommendations we made in our previous report on DOD contractors.<sup>21</sup>

In addition to the above, our past financial audits have indicated that IRS's records contain coding errors that affect the accuracy of taxpayers' account information, resulting in lost opportunities to collect outstanding taxes. The effective management of these codes is critical because if the codes used to exclude tax debts from the levy program (such as codes identifying a contractor as being in bankruptcy or having an installment agreement) erroneously remain in the system for long periods, tax debts may be needlessly excluded from the levy program.

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## Billions More in Tax Debts Referred to FMS Were Not Leviable

FMS's records indicate that as of September 30, 2004, about 70 percent of the tax debt in the FPLP was still not immediately leviable because IRS had not completed all the legal notification requirements necessary for levying to begin. Before levying a payment or any other asset, IRS is required to send the debtor an additional notice of intent to levy—known as a collection due process notice—that notifies the debtor of the impending levy. IRS gives the debtor up to 10 weeks to either resolve the debt or file

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<sup>20</sup> According to IRS, financial hardship can be either a statutory exclusion (under 26 U.S.C. 6343(e)) or policy exclusion, depending on when and who makes the determination. For reporting on the FPLP, IRS categorizes hardship cases as policy exclusions.

<sup>21</sup> GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-95](#) (Washington, D.C.: Feb. 12, 2004).

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an appeal. The debtor has the same response options as in the initial notice phase. In addition, the taxpayer can file a collection due process appeal. Once IRS completes action on the response or if the tax debtor does not respond, IRS codes the tax debt in the FPLP for immediate levy. Payments cannot be levied until this process is complete.

Prior to 1998, IRS was authorized to levy a payment immediately upon matching a tax debt with a federal payment as long as the collection due process notice had been sent. However, the IRS Restructuring and Reform Act of 1998 requires that debtors be afforded an opportunity for a collection due process hearing before a levy action can take place. To comply with this provision, IRS currently waits a minimum of 10 weeks for the tax debtor to respond to the collection due process notice before it proceeds with levy, thereby causing the federal government to miss levying some contractor payments. The joint task force established after our previous audit<sup>22</sup> has supported making the due process for the federal payment levy program a postlevy process.<sup>23</sup> This would allow IRS to levy payments when first identified and provide contractors with procedural due process remedies afterward. To further reduce the payments lost to levy because of the time required for the collection due process to run its course, IRS officials stated that they had begun matching new DOD contracts valued at over \$25,000 against tax debt and sending out collection due process notifications at that time rather than waiting until payments are made. The task force is also exploring avenues to combine the collection due process notice with the last of its initial notification letters sent to tax debtors.

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<sup>22</sup> In response to recommendations made in our audit of DOD contractors with unpaid federal tax debt, the Federal Contractor Tax Compliance Task Force was established with representatives from DOD, the Defense Finance and Accounting Service, IRS, FMS, the General Services Administration, the Office of Management and Budget, and the Department of Justice. The joint task force agreed to work together to ensure that federal contractors pay their taxes and that appropriate enforcement actions, including levies, are taken to collect delinquent tax accounts.

<sup>23</sup> Federal Contractor Tax Compliance Task Force, *Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations* (Washington, D.C.: Oct. 26, 2004).

## FMS's Management and Oversight of FPLP Resulted in Missed Opportunities to Levy Billions in Contractor Payments

We found that FMS disbursed tens of billions of dollars in payments without subjecting them to the levy process because of a lack of proactive oversight. As shown in table 1, the reasons for payments not being subjected to the levy process were that (1) agency payment station codes were not loaded into TOP, (2) payments contained blank or obviously inaccurate TINs, (3) payments contained blank or invalid names, and (4) payments contained invalid payment types. In general, FMS was not aware of these omissions until we brought them to its attention.

**Table 1: Payments Submitted to TOP That Could Not be Levied**

Dollars in billions	
Types of payments	Amount
Payments where the agency payment station has not been loaded in TOP	\$40
Payments containing blank or obviously inaccurate TINs	17
Payments containing blank or invalid names	4
Payment containing invalid payment types	5

Source: GAO's analysis of FMS data.

Notes: The categories above cannot be added together to derive the total amount of excluded payments because many payments had multiple deficiencies, each of which would have prevented the payment from being levied. For example, some payments without TINs also have invalid names.

First, we found that FMS did not update the TOP database to accept \$40 billion in payments from about 150 agency paying stations.<sup>24</sup> If a paying station is not in the TOP database, that location is excluded from the levy program; thus payments from that location are not matched against unpaid federal taxes for potential levy. Of the \$40 billion not sent to TOP, we determined that approximately \$9 billion in payments was made to civilian contractors with tax debts, none of which could be or were levied.

<sup>24</sup> These stations are generally referred to by their Treasury Agency Location Codes (ALC). The ALC is used to identify transactions, documents, and reports processed through the Treasury Department by a specific accounting point or station within an agency or bureau of a federal department or independent agency. Using the ALC enables Treasury to reconcile deposits and disbursements.

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Second, FMS disbursed over \$17 billion to civilian agency contractors without TINs or with obviously inaccurate TINs in the payment files submitted to it by civilian agencies. Valid TIN information is critical to the levy program because payments lacking this information cannot be matched against tax debts. The Debt Collection Improvement Act of 1996<sup>25</sup> requires executive agencies to obtain TINs from contractors and to include TINs on certified payment vouchers submitted to the Treasury Department for payment.<sup>26</sup> While Treasury has exempted as a matter of policy a limited number of vendors from the TIN requirements, the exemptions are rare and are generally limited to foreign companies providing goods and services for federal agencies in a foreign country or companies performing classified work. According to FMS officials, FMS tabulates certain payment records with obviously inaccurate TINs by agency and encourages agencies to send payment files with valid TINs in case of noncompliance.<sup>27</sup> However, FMS does not enforce the TIN requirement by rejecting agency payments with blank or obviously inaccurate TINs or requiring the agencies to certify that such payments meet one of the TIN exclusion criteria. As a result, agencies continue to submit payment requests without TINs, and consequently, these payments cannot be levied to collect unpaid federal taxes.

Third, FMS disbursed nearly \$3.8 billion in fiscal year 2004 to contractors whose name was not properly contained in the agency-submitted payment files. Instead, the name field in the payment file was either blank or contained numeric characters only.<sup>28</sup> The lack of a proper name could have been detected if FMS had conducted a cursory review of the payment files

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<sup>25</sup> Pub. L. No. 104-134, 110 Stat. 1321-358, Apr. 26, 1996.

<sup>26</sup> 31 U.S.C. §7701(c) and (d).

<sup>27</sup> Tabulation is performed for the standard payment types sent through the levy program, that is, payments known as type B. Type A and Fedwire payments are not tabulated or monitored. Type A payments are payments where the agency certifies the payment in the same file that contains detailed payment information. For type B payments, agencies send FMS the certification for the payment separately from the detailed payment information. ACH-CTX payments (a specific kind of type B payment) are payments whereby agencies can pay multiple invoices to a single contractor using a single ACH-CTX payment. Fedwire is a processing system designed for high-dollar, low-volume payments that must be received by payees the same day as originated by the agency.

<sup>28</sup> In addition, we identified numerous payee names that contained only a single alphabetic character in the name field. We did not include these in our analysis of payments with improper name fields.

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submitted by the agencies. For example, our review readily identified that most of the payment files submitted by the Department of State (State) did not contain valid contractor names. About \$3.2 billion of the nearly \$3.8 billion we identified as payments made to contractors without names in the payment files were made on behalf of State. According to a State Department official, State likely had names on its payment files since the 1980s, but a programming error had resulted in the names not being in the disbursement file sent to FMS. While disbursements could be made without a name—as disbursements are made electronically via direct deposit into the contractor’s bank account—valid name information is critical because the levy program requires a match between both the name and TIN for a levy to occur.

Last, during fiscal year 2004, FMS disbursed about \$5 billion via checks to civilian agency contractors on the basis of agency-submitted payment files that did not contain data in the payment-type field. FMS uses the payment-type field to determine if the payment is subject to the levy program. If the payment-type field is blank, FMS does not attempt to match the payment to unpaid tax debts for potential levy. As a result, none of the \$5 billion in payments we identified as having a blank payment-type field could have been levied to collect the contractors' unpaid federal taxes. After we brought this to FMS’s attention, an official stated that FMS planned to establish a new centralized program to monitor the completeness of agency information.

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## Management Decisions Excluded Tens of Billions More in Payments from the Levy Program

In addition to payments not included in the levy program because oversight was lacking, FMS and IRS also made decisions that caused tens of billions of dollars more in contractor payments not to be subject to potential levy collection. Specifically, we found that while FMS disbursed funds using a number of payment mechanisms—including payments known as type A, type B (including ACH-CTX), and Fedwire—FMS has taken actions to include only disbursements made via type B in the levy program. Even then, ACH-CTX—a specialized type B payment—is excluded from the levy program. We also found that FMS does not levy payments to collect the unpaid federal taxes owed by individuals because a small possibility exists that an individual TIN and name may be the same as the TIN and name of an unrelated business. Consequently, IRS instructed FMS not to levy contractor payments to individuals because it did not want to mistakenly levy payments of individuals to pay the debt of an unrelated business.

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Although it is responsible for administering the levy program, FMS could not quantify the magnitude of federal contractor payments excluded from the levy program, nor could FMS estimate the amount of levy collections it was missing because it had not included all payment categories in the program. Our work, based on limited data, indicates that at a minimum, \$26 billion in payments was made via type A and ACH-CTX that were not subject to the levy process. The \$26 billion, although likely understated, represents almost 11 percent of all contractor disbursements recorded in FMS's PACER database. In addition, FMS disbursed approximately \$191 billion in Fedwire payments,<sup>29</sup> but was not able to identify the value of payments made to contractors via Fedwire that it did not send to the levy program.

FMS excluded these payments from the levy program because including them would require programming changes to its automated systems or other efforts. Although FMS had performed some preliminary studies in 2001 regarding how to send type A payments to TOP, officials were unable to provide information regarding the cost of making system corrections.<sup>30</sup> At that time, FMS was developing a new payment system that it estimated would be completed as early as 2003 and therefore decided not to make the system changes. However, at the time of our audit, the new system was still not fully deployed. Consequently, over the last 4 years, the federal government has lost an unknown amount of collections that could have been levied from those payments. FMS officials stated that FMS is continuing to focus on completing the deployment of a new disbursement system, which it now estimates will be fully operational in 2006, rather than including type A payments in its current system. FMS tentatively plans to incorporate type A payments into TOP in calendar year 2006 when its new system is scheduled to be operational.

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<sup>29</sup> This amount does not include \$66 billion in certain benefit payments.

<sup>30</sup> FMS officials stated that it could take additional programming time to prepare TOP to receive type A payment information from other systems. For example, FMS conducted a study in 2001 and estimated that it would take about 6 hours of programming and 1 to 3 days of testing to make the system changes necessary to one system to include type A payments in TOP for levy.

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## FMS Faces Challenges in Addressing Other Program Limitations

FMS faces other management challenges in matching TINs and names, levying purchase cards, and implementing the 100 percent levy provision of the American Jobs Creation Act of 2004. Specifically, almost \$2 billion of contractor payments could not be levied because the TIN and payee name in the payment files did not match with the TIN and “control name” with which IRS provided TOP. In general, the control name is the first four characters of an individual’s last name or the first four characters of the business name. If TOP finds a TIN match between the payment file and the file provided by IRS, but cannot find the control name (first four characters of the IRS name) anywhere within the name field of the payment file, TOP reports only the mismatch to IRS, but does not levy payments to collect delinquent tax debts. After we brought this to FMS’s and IRS’s attention, IRS began working with FMS to increase the number of control names—up to 10 additional control names per business—it sends to TOP. IRS officials believed that this should increase the number of matches available under the levy program. IRS is also evaluating additional changes to increase the number of name controls that it sends to FMS for matching with payments to individuals.

We also found that nearly \$10 billion in federal payments made via purchase cards to contractors in fiscal year 2004 are not subject to levy because the government payment is made to the bank that issues the purchase card instead of the contractor doing business with the government. FMS officials have acknowledged the need to address this challenge but stated that FMS faces both operational and legal issues to incorporate such payments into TOP and that the process of paying the purchase-card-issuing bank may prevent FMS from using TOP to collect from contractors paid with a purchase card. In the meantime, the use of purchase cards for federal acquisition purposes continues to increase. Until this challenge is thoroughly examined by FMS and IRS and until solutions are identified, the federal government will continue to be unable to levy or otherwise collect from tens of billions of dollars in payments made to civilian contractors through this mechanism.

Finally, FMS has not fully implemented a new provision, authorized by Congress in October 2004, which increased the maximum levy percentage from 15 percent to 100 percent of payments to contractors with unpaid taxes. Our analysis indicated that if no legal or procedural provisions excluded tax debts from the levy program, a levy of up to 100 percent on all contractor payments would result in FMS’s collecting as much as

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\$800 million<sup>31</sup> annually from civilian contractors. However, because the provision provides for increasing the levy percentage on payments to vendors for “goods and services” sold or leased to the government, IRS has determined that the legal language excluded real estate, such as rent payments, from the new levy requirement. This exclusion presents significant implementation challenges for FMS because the civilian agencies’ payment systems at present do not separately identify real estate transactions from other contractor payments. Without the ability to distinguish between these payments, FMS could not implement the new law for civilian payments in such a way as to exempt real estate transactions from the 100 percent levy. FMS officials stated they had recently been able to implement the 100 percent levy provision for certain DOD payments but were unable to do so for disbursements made directly by FMS. According to FMS and IRS officials, a specific legislative change is being sought to subject real estate payments to the new 100 percent levy requirement.

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### FMS Has Not Taken Action to Establish Reciprocal Agreements with States

As discussed in a separate product,<sup>32</sup> developed at the request of this committee and transmitted to FMS for review and comment on June 7, 2005, FMS has not pursued agreements with the states that could result in the federal and state government’s collecting—through the offset of contractor payments—unpaid tax debts on behalf of each other. The Debt Collection Improvement Act of 1996 authorizes these collections if a state enters into a reciprocal agreement with FMS that allows the state and FMS to collect unpaid debt from each other’s payments, including payments to their contractors. Despite the potential benefits, the federal government has not yet established any reciprocal agreements with states to offset contractor payments. According to FMS officials, states have not expressed interest in executing such agreements. In fact, the state debt collection officials we contacted,<sup>33</sup> and officials at the Federation of Tax Administrators and at the National Association of State Auditors,

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<sup>31</sup> This assumes that the tax debts and payment amount remain constant in future years.

<sup>32</sup> [GAO-05-697R](#).

<sup>33</sup> We contacted debt collection officials of the following 17 states: California, Connecticut, Georgia, Illinois, Hawaii, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Virginia. Collectively, the 17 states received over 75 percent of FMS’s collections from the federal tax refund offset program as well as over 75 percent of the federal collections from the State Income Tax Levy Program.

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Comptrollers, and Treasurers, informed us that they had not pursued reciprocal agreements because they were not aware that this debt collection avenue exists. The state officials all expressed interest in obtaining more information on potential agreements and in assessing the potential benefits of such agreements.

Our review indicated that many federal contractors paid through FMS have unpaid state tax debt. Our analysis of FMS's payment records found that FMS disbursed a total of about \$1.8 billion to over 4,600 federal contractors with state tax debt—primarily tax debt owed by individuals—in fiscal year 2004. These contractors owed approximately \$17 million in state tax debt. According to our analysis, if states had reciprocal agreements with FMS, the states could have collected over half of the outstanding state tax debt from these federal contractors in a single year.

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## Civilian Agency Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

We found abusive and potentially criminal activity related to the federal tax system for all 50 cases that we audited and investigated. The 50 case-study contractors typically operate in wage-based industries, providing security, building maintenance, professional services, health care, and personnel services for the Departments of Homeland Security, Justice, and Veterans Affairs, and the National Aeronautics and Space Administration, to name a few. The contractors are mostly small—many of them, closely held by the owners and officers. In table 2, and on the following pages, we summarize 10 of these businesses. The amount of unpaid taxes associated with these 10 case studies ranged from nearly \$400,000 to over \$18 million. We found that some case-study contractors had large amounts of unpaid taxes because they were “multiple abusers,” i.e., they were one of a group of related companies that owed taxes. Several “multiple abusers” among these 10 cases studies owed taxes for more than 50 tax periods; in one case, a group of about 20 related businesses owed nearly \$13 million over more than 300 tax periods. It was also not surprising to find that a few of the business owners among these case studies also owed individual income taxes. Furthermore, we determined that 9 of the 10 case studies had unpaid state and local taxes significant enough that state and local tax taxing authorities had filed tax liens against them.

Our investigations revealed that some owners had substantial personal assets—including commercial real estate, a sports team, or multiple luxury vehicles—yet their businesses failed to remit the payroll taxes withheld from employees' salaries. Several owners owned homes worth over \$1 million—one owner had over \$3 million and another had over

\$30 million in real estate holdings. Others informed our agents that they diverted payroll taxes they had not remitted to IRS for personal gain or to fund their business, while others were engaged in activities that also indicated that they might have diverted payroll taxes for personal gain. For example, one owner transferred the payroll taxes he withheld from employees to a foreign bank account and was using the money to build a home in that country, while another contractor doubled the salary of an officer in a 5-year period to over \$750,000 at the same time that the business failed to remit payroll taxes and declared losses for income tax purposes of more than \$2 million. In one case, even though the business owed IRS for unpaid payroll taxes withheld from employees' salaries, the business was involved in a joint venture to spend millions on additional facilities and new technologies, some of which will take place outside the United States. In addition, we found that 3 of the 50 case studies involved owners or officers who had been either convicted or indicted for non-tax-related criminal activities or were under IRS investigation. We are referring the 50 cases detailed in our report to IRS so that it can determine whether additional collection action or criminal investigation is warranted.

**Table 2: Civilian Agency Contractors with Unpaid Federal Taxes**

Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments <sup>a</sup>	Unpaid federal tax amount <sup>b</sup>	Comments
1	Health-care-related services to Departments of Veterans' Affairs and Health and Human Services	Over \$300,000	Over \$18 million	<ul style="list-style-type: none"> <li>• Business is affiliated with many other health-care-related facilities, including nursing and convalescent homes.</li> <li>• Taxes owed by related entities cover over 80 tax periods.</li> <li>• Since failing to fully remit all the taxes withheld from employees' paychecks starting in the late 1990s, the owner purchased               <ul style="list-style-type: none"> <li>• multimillion-dollar properties,</li> <li>• an unrelated business, and</li> <li>• a number of luxury vehicles.</li> </ul> </li> <li>• Other real estate holdings include residential and commercial properties valued in the tens of millions.</li> </ul>
2	Waste collection services to the Department of Justice	Over \$700,000	Over \$2 million	<ul style="list-style-type: none"> <li>• Company and several other entities share the same address or executives.</li> <li>• Taxes owed by related entities cover over 40 tax periods and include individual income tax debt of one owner.</li> <li>• Since the late 1990s, about the same time that the company failed to pay all of its payroll taxes, the company regularly withdrew cash from its bank accounts. These withdrawals totaled several million dollars.</li> <li>• Since failing to fully remit all the payroll taxes withheld from employees' paychecks, one owner sold his residence for more than \$1 million.</li> </ul>

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Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments <sup>a</sup>	Unpaid federal tax amount <sup>b</sup>	Comments
3	Health-care-related services to the Department of Veterans Affairs	Nearly \$250,000	Over \$9 million	<ul style="list-style-type: none"> <li>• Business is affiliated with three other related companies.</li> <li>• Taxes owed by related entities cover over 60 tax periods and include the owner's individual income tax debt, totaling hundreds of thousands.</li> <li>• One entity is under IRS investigation. In addition, owner suspected of fraudulent banking activity.</li> <li>• Since failing to pay taxes               <ul style="list-style-type: none"> <li>• officer spent tens of thousand of dollars on gambling and</li> <li>• one of the three companies had multiple withdrawals of cash from bank accounts—each totaling tens of thousands of dollars.</li> </ul> </li> </ul>
4	Waste collection services to the Department of Veterans Affairs	Over \$10,000	Nearly \$13 million	<ul style="list-style-type: none"> <li>• Company is one of almost 20 related entities, all of which owed unpaid taxes—primarily payroll taxes.</li> <li>• Taxes owed by related entities cover over 300 tax periods.</li> <li>• The owner also owns               <ul style="list-style-type: none"> <li>• a residential property located near a golf course and</li> <li>• other commercial properties in several states with an assessed value of over \$2 million.</li> </ul> </li> </ul>
5	Payroll and temporary employment services to the Department of Housing and Urban Development	Over \$1 million	Nearly \$900,000	<ul style="list-style-type: none"> <li>• Business related to three other entities.</li> <li>• Taxes owed by two related entities cover over 20 tax periods.</li> <li>• Some tax debts of remaining entities were not paid for so long that IRS is now legally prohibited from seeking collection.</li> <li>• The owner's history of delinquency stretches nearly 20 years and covered multiple businesses. Specifically, the owner typically               <ul style="list-style-type: none"> <li>• incurs payroll taxes for one company,</li> <li>• is assessed trust fund penalty on that company but makes no or little payments,</li> <li>• closes company,</li> <li>• starts another company, and</li> <li>• repeats the same pattern.</li> </ul> </li> <li>• For example, the owner filed for bankruptcy protection in the late 1990s. In the early 2000s, after the court denied the owner's request for bankruptcy protection, the owner closed the company and immediately established a new business with a similar name at the same address that provides the same services.</li> <li>• The owner               <ul style="list-style-type: none"> <li>• rents office space in an expensive area of a major metropolitan city and</li> <li>• purchased a luxury automobile at the same time the company had filed for bankruptcy protection and was not remitting all of the payroll taxes.</li> </ul> </li> </ul>
6	Health-care-related services to Department of Veterans Affairs	Nearly \$300,000	Over \$10 million	<ul style="list-style-type: none"> <li>• The company's delinquent taxes—primarily payroll taxes—cover 20 tax periods from the late 1990s.</li> <li>• IRS is investigating the company for potential criminal activity.</li> <li>• Since failing to pay payroll taxes in the late 1990s, the officer who had been assessed the trust fund violation purchased several vehicles totaling nearly \$200,000.</li> <li>• Since the late 1990s, the company reported cumulative losses on its tax returns totaling about \$5 million.</li> <li>• Despite these continued losses and accumulated tax debt, the company is involved in a multimillion-dollar joint venture.</li> </ul>

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Case study	Goods, services, or nature of work and agencies to whom they were provided	Fiscal year 2004 FMS payments <sup>a</sup>	Unpaid federal tax amount <sup>b</sup>	Comments
7	Security guard services to Departments of Homeland Security and Veterans Affairs	Over \$200,000	Over \$400,000	<ul style="list-style-type: none"> <li>The company had not filed all required tax returns since the early 2000s, and had been delinquent in payroll taxes almost continuously since the late 1990s.</li> <li>Delinquent tax debts cover over 25 tax periods and include the owner's individual income taxes totaling tens of thousands. In addition, the owner repeatedly failed to file personal income tax returns.</li> <li>The owner diverted unpaid payroll taxes to a foreign bank account to build a house overseas.</li> </ul>
8	Consulting services to the Smithsonian Institution	Over \$200,000	Over \$1 million	<ul style="list-style-type: none"> <li>The business's unpaid federal taxes are primarily payroll taxes incurred in late 1990s and early 2000s.</li> <li>Unpaid tax debt balance covers more than 20 tax periods and includes hundreds of thousands of dollars in individual income tax debts owed by two officers.</li> <li>During the same period that tax debt was incurred, the company also declared large losses but doubled the salary of one officer to over \$750,000.</li> <li>Officers own several luxury vehicles and multimillion-dollar properties in exclusive areas of a major metropolitan area.</li> <li>The company is making payments on current installment agreement.</li> </ul>
9	Armed security guard services to several agencies, including the Department of Justice and the Environmental Protection Agency	About \$500,000	Nearly \$400,000	<ul style="list-style-type: none"> <li>Tax debt balance includes over \$200,000 in payroll taxes owed for almost 10 tax periods.</li> <li>In the early 2000s, company did not file income tax returns.</li> <li>In the mid-2000s, an officer of the company was convicted for stealing hundreds of thousands of dollars from the company.</li> <li>The owner is under indictment for embezzlement and money laundering.</li> </ul>
10	Building maintenance, lawn and garden, and sanitary services to Department of Transportation	Over \$300,000	Nearly \$400,000	<ul style="list-style-type: none"> <li>This business did not make any payroll tax deposits for several years from the late 1990s through the early 2000s.</li> <li>Tax debt balance covers more than 30 tax periods and includes nearly \$100,000 in personal tax debt of the officer.</li> <li>The company is a chronic nonpayer of corporate tax debts and has not made any voluntary income tax payments since the mid-1990s.</li> <li>The officer is also a chronic nonfiler of his individual income taxes. In one of those years, the officer reported net income of about \$100,000 but paid no taxes.</li> </ul>

Source: GAO's analysis of civilian agency, IRS, FMS, public, and other records.

Notes: Dollar amounts are rounded for the tax debt, estimated maximum levy, and government payments. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes.

<sup>a</sup> Civilian agency vendor payments provided by FMS from its PACER system.

<sup>b</sup> Unpaid tax amount as of September 30, 2004.

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The following provides illustrative detailed information on several of these cases.

**Case 1:** This case includes many related companies that provide health care services for the Department of Veterans Affairs, for which they received over \$300,000 in payments during fiscal year 2004. The related companies have different names, operate in a number of different locations, and use at least several other TINs. However, they share a common owner and contact address. The businesses collectively owed more than \$18 million in tax debts—of which nearly \$17 million is unpaid payroll taxes dating back to the mid-1990s. IRS has assessed a multimillion-dollar trust fund penalty for willful failure to remit payroll taxes on each of two officers. During the early 2000s, at the time when the owner's business and related companies were still incurring payroll tax debts, the owner purchased a number of multimillion-dollar properties, an unrelated business, and a number of luxury vehicles. Our investigation also determined that real estate holdings registered to the owner totaled more than \$30 million.

**Case 2:** This case comprises a number of related entities, all of which provide waste collection and recycling services. These entities received fiscal year 2004 payments from the Department of Justice totaling over \$700,000, about half of which is from purchase card payments, while owing in aggregate over \$2 million in tax debt. These taxes date to the late 1990s and consist primarily of payroll taxes. Despite the fact that the company reportedly used legally available means to repeatedly block federal efforts to file liens against the company, liens totaling more than \$1 million exist against the company. IRS has also assessed trust fund penalties against the two officers. At the same time that the entities were incurring the tax debt, cash withdrawals totaling millions of dollars were made against the business's bank account. Furthermore, since the company started owing taxes, the owner had sold real estate valued at over \$1 million. The executives of these entities drive late-model luxury or antique automobiles. Recently, the company started to make payments on its taxes.

**Case 3:** This case includes several nursing care facilities, three of which owed taxes—primarily payroll—totaling nearly \$9 million. In addition, the owner's individual income tax debt totaled more than \$400,000, bringing the total tax debt of this case study contractor to over \$9 million. One business provides nursing care services for the Department of Veterans Affairs, for which it was paid over \$200,000 during fiscal year 2004. An officer of the company has been assessed a multimillion-dollar trust fund

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penalty for willful failure to remit payroll taxes and was recently arrested on fraud charges. Our investigative work indicates that an owner made multiple cash withdrawals, each valued at tens of thousands of dollars, in the early 2000s while owing payroll taxes and that these cash withdrawals were used for gambling. We further determined that cash transfers totaling over \$7 million were made in a 7-month period in the early 2000s.

**Case 7:** This contractor provided guard and armed security services for the Department of Homeland Security and the Department of Veterans Affairs, for which it was paid over \$200,000 during fiscal year 2004. This business has a history of noncompliance with federal tax laws. Specifically, the business was consistently delinquent in paying its taxes since the late 1990s and has not filed all its income and payroll tax returns for a number of years in the late 1990s. In the last 1-year period that the business made payroll tax deposits, the business reported that it owed nearly \$80,000 in payroll taxes but made payments totaling less than \$4,000—about one-twentieth of the taxes owed. At the same time that the owner withheld but failed to remit payroll taxes, the owner diverted the money into a foreign bank account to build a house overseas.

**Case 8:** During fiscal year 2004, this company provided consulting services for the Smithsonian Institution, for which it received over \$200,000. Starting in the late 1990s, the company did not remit to the government all the money it withheld from its employees' salaries. However, at about the time the company was failing to remit the taxes, it nearly doubled one officer's salary to over \$750,000. IRS assessed a trust fund penalty on the officers of this company for willfully failing to remit payroll taxes withheld from their employees' salaries. Those officers own homes valued at millions of dollars in exclusive neighborhoods in a large metropolitan area and several late-model luxury vehicles.

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## Concluding Comments

In the current environment of federal deficits and rising obligations, the federal government cannot afford to leave hundreds of millions of dollars in taxes uncollected each year. However, this is precisely what has been occurring with respect to the FPLP. The levy program has thus far been inhibited from achieving its potential primarily because substantial tax debt is not subject to levy and because FMS, the nation's debt collector, has not exercised effective and proactive oversight and management of the program. Overall, the problems we discuss throughout our companion report issued today paint a picture of a program badly in need of management overhaul. Until FMS takes decisive actions to improve

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oversight and management of the program, there will be a persistent loss of collections and contractors will continue to be able to abuse the tax system with little consequence.

Furthermore, by failing to pay taxes on their income or diverting the payroll taxes withheld from their employee's salaries to fund business operations or their own personal lifestyles, contractors with unpaid tax debts effectively decrease their operating costs. The lower operating costs provide these individuals and their companies with an unfair competitive advantage over the vast majority of companies that pay their fair share of taxes. Over time, this could lead to further erosion in taxpayers' confidence in the fairness of the nation's tax system, leading to increased rates of noncompliance with the nation's tax laws. Federal contractors should be held to a high degree of responsibility to pay their fair share of taxes owed because they are being paid by the government, and the failure to effectively enforce the tax laws against them encourages noncompliance among other contractors as well. The federal government will continue to lose hundreds of millions of dollars in tax collections annually until actions are taken to send all payments to the levy program, ensure that all payments have the information necessary to allow them to be levied, and establish a proactive approach toward managing the levy program.

Our companion report includes 18 recommendations to FMS and one to IRS. Our recommendations to FMS address the need to improve implementation of the FPLP so that FMS can increase by tens of millions of dollars annually the amount levied from payments to contractors with unpaid federal taxes, including the need to identify and correct payments made to contractors without valid taxpayer identification numbers and implement procedures to provide reasonable assurance that all eligible payments are submitted for levy. Our recommendation to IRS calls for it to investigate and, if warranted, pursue collection or criminal investigation of the 50 case study contractors identified in the report. In written comments on a draft of the companion report, IRS agreed with our findings and recommendations, and pointed to efforts that it has taken to deal with contractors who abuse the federal tax system. FMS partially agreed with our recommendations. However, while not disputing the substance of our findings, FMS disagreed that its management of the program was ineffective. FMS stated that it believed that it had provided excellent leadership of the levy program, that the weaknesses we cited in the companion report were the result of difficult management choices, and that the responsibility for managing the levy program rests with IRS. FMS also disagreed with our conclusion that it had not fully implemented the

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100 percent levy provision. FMS also did not agree with two of our recommendations, specifically, that it should withhold payments to vendors without names in the agency payment files and that it work with IRS to explore options to levy payments or otherwise collect outstanding tax debt from contractors paid by purchase card vendors.

We continue to believe that the problems we discuss throughout the companion report paint a picture of a program badly in need of management overhaul. Although IRS has a key responsibility to refer tax debts, FMS has an equally key responsibility to make all payments available for levy. We continue to believe that all of our recommendations constitute valid and necessary courses of action, especially in light of the identified weaknesses and the slow progress that FMS has made to maximize collections since the passage of the Debt Collection Improvement Act more than 8 years ago.

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Mr. Chairman; Members of the Subcommittee; and Senators Collins, Levin, and Akaka, this concludes our prepared statement. We would be pleased to answer any questions you may have.

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## Contacts and Acknowledgment

For future contacts regarding this testimony, please contact Gregory D. Kutz at (202) 512-9095 or [kutzg@gao.gov](mailto:kutzg@gao.gov), Steven J. Sebastian at (202) 512-3406 or [sebastians@gao.gov](mailto:sebastians@gao.gov), or John J. Ryan at (202) 512-9587 or [ryanj@gao.gov](mailto:ryanj@gao.gov). Individuals making key contributions to this testimony included, Ray Bush, Richard Cambosos, William Cordrey, Francine Delvecchio, F. Abe Dymond, Paul Foderaro, Alison Heafitz, Kenneth Hill, Aaron Holling, Jason Kelly, John Kelly, Rich Larsen, Tram Le, Mai Nguyen, Kristen Plungas, Rick Riskie, David Shoemaker, Sid Schwartz, Esther Tepper, Tuyet-Quan Thai, Wayne Turowski, Matt Valenta, Scott Wrightson, and Mark Yoder.

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