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Report to the Secretary of the Treasury

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TAX ADMINISTRATION

Changes Are Needed to Improve Federal Agency Tax Compliance

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The Honorable Nicholas F. Brady
Secretary of the Treasury

Dear Mr. Secretary:

On October 18, 1990, we testified on the Internal Revenue Service's (IRS) accounts receivable from federal agencies for employment taxes before the Subcommittee on Oversight of the House Committee on Ways and Means. The Subcommittee had previously requested that we determine whether federal agencies were negligent in meeting their federal employment tax obligations and the extent and causes of any delinquent tax payments. This report summarizes (1) the results of our analysis and (2) various options discussed at the hearing to improve federal agencies' compliance with employment tax laws and regulations. It also includes recommendations to you on how compliance with employment tax laws and regulations can be improved. The Department of the Treasury and two of its agencies—IRS and the Financial Management Service (FMS)—each have responsibilities for ensuring that improvements in federal employment tax compliance become a reality.

Results in Brief

IRS' records showed that federal agencies owed millions of dollars in unpaid employment taxes. After analyzing the records and other information, we concluded that in most instances, the records were inaccurate. The records contained many errors that showed up as accounts receivable on IRS' books and gave the appearance that agencies had not paid their taxes. We found that in fact, most agencies had paid their taxes on time and that most of the errors in the records were a result of the cumbersome paper-based process being used to make payments. This process is outdated and prone to errors, often resulting in payment processing and posting errors that show up as accounts receivable. Substantial changes are needed to avoid such errors. We believe that electronic interagency funds transfer, with the requirement that the funds transfer information be provided to IRS, would help reduce the numerous errors responsible for federal agency receivables.

Federal agency heads must be held accountable for ensuring that their agencies are in full compliance with tax laws and regulations. We found that federal managers appear to place insufficient priority on reporting their federal tax liability, and late filing of tax returns is widespread. Enhanced attention to agency tax deposit issues as part of (1) Financial Integrity Act reviews and (2) certifications of tax compliance by high level officials should help foster greater agency accountability. Improved communications between IRS and other federal agencies should also help. Specifically, the notices IRS sends to agencies when tax data do not reconcile and when returns have not been filed should be clarified to apply to the unique tax situation faced by federal agencies. IRS needs to inform agencies of adjustments it makes to their accounts. Also, IRS needs to provide assistance to agencies through training programs.

Improvements in these areas should greatly help to (1) reduce the number of erroneous assessments and misapplied payments in IRS' records and (2) increase federal agency compliance. An agenda for governmentwide action is needed. The Department of the Treasury, IRS, FMS, and the other federal agencies all have a role to play in implementing such an agenda.

Background

All employers, including federal agencies, are required to deposit withheld income and social security taxes through the Federal Tax Deposit (FTD) system and to file quarterly returns with IRS. Federal agencies' tax deposits are made to a Federal Reserve Bank and must be accompanied by manually prepared FTD coupons. The FTD coupons along with summary information are sent by the Federal Reserve Banks to IRS, and IRS uses this information to update taxpayers' accounts. However, the payment of taxes by federal agencies to IRS, unlike payments by private individuals and businesses, is essentially an intragovernmental transfer of money already in federal hands.

The role of Treasury in formulating economic, financial, tax, and fiscal policies and in serving as the financial agent for the government makes it the proper focal point to coordinate efforts for improving the process of collecting tax payments from federal agencies. Within Treasury, FMS is responsible for operating and maintaining systems for collecting government funds, including the FTD system currently used to collect business income and trust fund tax payments. FMS serves as the government's agent for issuing Treasury checks to cover various government payments, including agencies' employment tax payments to IRS.[1] IRS, also within Treasury, administers the nation's internal revenue laws, collects taxes, and maintains records of taxpayers' accounts.

[1]Department of Defense agencies may use Defense disbursing offices to issue checks.

On the basis of work we did for our October 18, 1990, congressional testimony, we determined that changes are needed in the procedures agencies use in making employment tax payments.[2] That work included an in-depth review of IRS' records and other information pertaining to 63 federal agency accounts that IRS reported as owing $178 million in back taxes as of February 1990.

We found that IRS' records were inaccurate because the vast majority of the $178 million in accounts receivable had already been paid. Most of the receivables from federal agencies were actually the result of payment processing or posting errors rather than an amount owed. Less than 3 percent—$4.3 million—of the $178 million was subsequently collected. Many IRS revenue officers expressed dim hopes of collecting much of the remaining amount because of the frequency of errors made by IRS, FMS, and the agencies. The process currently being used to make tax payments is partially responsible for the errors because it is outdated and ill-designed for intragovernmental fund transfers. The current process also depends on a high volume of paper documents that must be properly accounted for to prevent processing and posting errors.

Further, we testified that two-thirds of the agency accounts we reviewed had at least one quarterly employment tax return that was filed late. Late filing by agencies impairs IRS' early detection of late or insufficient payments because information concerning tax deposits is not fully processed until the quarterly tax return is filed. Also, late filing complicates the reconciliation of return information with tax payments.

Objectives, Scope, and Methodology

Our objectives were to present (1) options for improving the processing of federal agency employment tax payments and (2) strategies for improving federal agency compliance with employment tax laws and regulations. The data used in preparing this report were drawn from our recently completed review of accounts receivable from federal agencies.

To meet our objectives, we reviewed applicable IRS policies and procedures relating to accounts receivable in general and federal agency receivables in particular. We also discussed these policies and procedures with officials at IRS' National and Baltimore District offices. The

[2] IRS' Accounts Receivable Inventory (GAO/T-GGD-91-02,Oct. 18, 1990).

Baltimore District Office has revenue officers dedicated to working federal agency delinquent accounts.

To gain an understanding of problems agencies encounter under the current procedures for paying employment taxes, we judgmentally selected a sample from the 676 federal agency accounts IRS reported as owing $185 million in late February 1990. We selected the 63 accounts with balances of $100,000 or more. Using IRS' masterfile transcripts—the official record of taxpayers' accounts—we analyzed bookkeeping entries made in these accounts from February 1990 through late August 1990. We did so to help us determine whether the receivables resulted from errors caused by IRS or the agency, or from agency noncompliance. We also obtained information about each account from the IRS revenue officers and other IRS officials handling the account. In addition, we interviewed officials in 11 agencies to determine the reasons why their agencies appeared on IRS' records as owing back taxes. Only 6 agency accounts from our sample of 63 accounts made late tax payments to cover a tax delinquency during the period covered by our analysis. We interviewed officials in these six agencies. The remaining five agencies were randomly selected. At the same time, we obtained documentation to fully support the circumstances surrounding the agencies' tax situations with IRS.

We did our work from June 1990 through September 1990 in accordance with generally accepted government auditing standards.

An Agenda for Governmentwide Action

The problems experienced by federal agencies and IRS in properly accounting for federal taxes call for a governmentwide solution. Actions are needed to ensure that the Department of the Treasury, FMS, and IRS do all they can to simplify the payment process and provide appropriate and clear guidance to agencies on their tax responsibilities. At the same time, federal managers must be held accountable for agency compliance to ensure that they place the appropriate priority on paying taxes and filing their returns.

Simplifying the Processing of Federal Agency Tax Payments and Return Information

We believe certain changes in the payment requirements for federal agencies would help to avoid unnecessary administrative problems for IRS and the agencies. The current payment process requires FMS to issue checks for most agencies and mail them to a Federal Reserve Bank. At the same time, the FTD coupon must accompany the check through this process to ensure that proper credit is given to the agency. This type of payment system has great potential for errors. For example, officials we interviewed at one federal agency said the agency's checks for $2.4 million had been lost twice. This situation was made even more complex when IRS inappropriately applied another FTD payment against the delinquency caused by the lost checks. It took the agencies involved over 2 years to resolve the discrepancies and cost many staff hours.

Simpler procedures are needed for federal agencies to comply with their payment requirements, especially since federal agency tax payments are intragovernmental transfers of funds. We believe that agencies can meet their responsibilities by using electronic interagency funds transfer through bookkeeping entries in lieu of payments by check. This type of funds transfer process could also provide IRS with needed information and would reduce the number of error-prone paper documents currently needed to make tax deposits because FTD coupons and Treasury checks would no longer be needed. Electronic payroll and tax processing systems are increasingly being used in government and private industry to replace paper-based systems. We believe that considerable improvements would result if electronic data technologies and automated systems were used for federal agency tax payments.

Improve Communications Between IRS and Agencies

Improving communications between IRS and agencies will lessen the confusion agencies now experience when dealing with IRS in attempting to resolve tax data that does not reconcile. Officials in 6 of the 11 agencies we interviewed said IRS adjusted its accounts, sometimes erroneously, without informing them. Officials in three other agencies said IRS sent them refund checks without explanations. Such practices cause problems for both IRS and the agencies when they attempt to reconcile accounts, because the agency is not always aware of IRS' adjustments. IRS, for its part, should properly inform the agencies of its adjustments. If agencies are made aware of adjustments, they can more easily respond to IRS' requests for information that will help in reconciling their accounts.

Another factor causing confusion between IRS and agencies is the notices IRS sends to them. IRS' computer-generated notices regarding delinquent taxes were written to apply to private taxpayers, not federal agencies. Therefore, when these notices are sent to agencies, they may include penalties and interest as part of taxes allegedly owed. When interest and penalties are assessed against agencies, it complicates the resolution of the tax issue since agencies are not liable for them. Matters are further complicated when IRS sends agencies notices to which they are not subject, such as notices of IRS' intent to levy bank accounts and seize assets.

Finally, IRS can also help federal agencies by providing training specifically targeted to federal tax processing situations. Our interviews with agency officials indicated that training within agencies on tax processing is virtually nonexistent. In addition, many of the agencies experienced high turnover rates in payroll operations, partly because of low pay. We believe that this lack of training and continuity in staffing hinders the agencies' ability to comply with tax laws and regulations. Ultimately, IRS' training of agency staffs should pay off through improved communications between IRS and the agencies.

Making Federal Managers Accountable for Tax Compliance

Federal managers should be held accountable for complying with tax laws. Filing federal tax returns and responding to IRS notices and inquiries appear to have a low agency priority and suffer from a lack of management attention. This situation is illustrated by the fact that more than two-thirds of the 63 accounts we sampled filed late tax returns. In addition, we found that internal controls over matters pertaining to tax payments appear to be weak in some agencies. For example, an agency received from IRS an erroneous refund check, which was held by its disbursing office for almost a year. However, the payroll office, which determines the agencies' tax liability, was not notified of the refund until IRS started sending notices for the taxes owed.

In 1982, Congress passed the Federal Managers' Financial Integrity Act (FMFIA), which requires agencies to examine their internal controls and report all material weaknesses to the president and Congress annually. Even though internal controls over payroll activities are included in the agencies' FMFIA reviews, they may not get the attention they deserve. For example, three of the six agencies that made late tax payments identified payroll processing problems as material weaknesses several years ago in their FMFIA reviews. However, payroll problems affecting the accuracy of tax processing and reporting still persist in these agencies. We believe that the FMFIA process continues to be an appropriate process to focus management attention on federal tax compliance, but heightened attention to FMFIA reports is needed to ensure that the reviews cover tax compliance and promote management follow-up.

The recently enacted Chief Financial Officers' Act may furnish IRS with an additional avenue for ensuring that agencies comply with the tax laws. One option would be to have the chief financial officer in each agency certify to the Secretary of Treasury annually that the agency has fully met its federal tax obligations.

IRS' Six-Point Strategy

The strategy for reducing federal agency receivables outlined by the Commissioner of Internal Revenue at the October 18, 1990, hearing addresses many of the issues raised in this report. The strategy is a common-sense approach to dealing with the employment tax problems facing the government. IRS has already initiated some components of the strategy, but the success of the strategy depends on the cooperative efforts of Treasury, IRS, FMS, and other agencies.

The IRS strategy includes actions to improve its management and systems related to accounts receivable. These actions include

- continuing broad-based efforts in the accounts receivable area, including tax systems modernization projects related to collection activities, such as systems to verify certain return information before posting it to taxpayers' accounts to reduce erroneous FTD notices;
- developing a means to make federal tax deposits electronically rather than by check;
- providing better guidance to federal agencies on how to comply with employment tax laws and regulations by amplifying and updating the Treasury Financial Manual and other information used by agencies;
- sponsoring training programs for federal agencies;
- centralizing accountability for federal payroll tax matters within IRS and the agencies; and
- ensuring executive level accountability for compliance with federal employment tax laws in each agency.

Conclusions

IRS has experienced significant problems in properly accounting for employment tax payments. These problems are the result of numerous errors in transmitting and recording payments arising from the cumbersome nature of the tax deposit system. Significant quality improvement efforts by both IRS and the agencies undertaken as part of a governmentwide reform agenda are needed to reduce the cost of errors to all agencies involved. Treasury, FMS, and IRS together can help by simplifying the payment process and providing clearer communications, guidance, and training to the agencies.

The agencies themselves, of course, bear a major share of the responsibility. The widespread late filing of returns suggests that the agencies do not place sufficient priority on keeping their federal tax accounts and records current. Since agency tax delinquencies do not trigger interest and penalties, other tools must be relied upon to encourage the managerial attention this issue requires. The FMFIA internal control reviews appear well suited to serve as checks on agency tax compliance, but enhanced attention to FMFIA reports is needed to ensure that the reviews specifically cover tax compliance and promote appropriate management follow-up. Requiring top level agency officials, such as the chief financial officers established in recent legislation, to certify that agencies are complying with laws and regulations is another promising approach to fostering greater accountability.

The resolution of these problems must be accomplished as part of a governmentwide effort. We believe that Treasury, working in close coordination with IRS and FMS, must serve as the focal point for such an effort. In its capacity as the overseer of the nation's tax system, Treasury, along with IRS and FMS, has the knowledge and authority necessary to implement needed changes in the tax processing system. Further, as a major cabinet agency, Treasury may be in a better position than IRS to obtain cooperation and support from other federal agencies, such as the Office of Management and Budget, which helps to ensure the efficient implementation of FMFIA reviews throughout federal agencies.

Recommendations

We recommend that Treasury, in close coordination with IRS and FMS, undertake a governmentwide program to improve federal agency tax processing. Such a program should include

- streamlining agency tax payment processing through electronic interagency funds transfer and requiring that the funds transfer information be provided to IRS;
- enhancing the clarity of IRS communications with agencies in such ways as by developing notices tailored to the unique tax situation of federal agencies and informing agencies of adjustments to their accounts; and
- providing for an IRS training program for agencies' staff involved in making tax payments and filing tax returns.

We also recommend that Treasury develop methods to promote greater accountability by top agency management for compliance with tax laws and regulations by working with the agencies and the Office of Management and Budget. Treasury should consider, among other methods, enhancing agency tax compliance by (1) ensuring that agencies' FMFIA reviews adequately cover tax compliance and include management follow-up and (2) developing a process for top managers to certify their agencies' tax compliance.

Agency Comments

We did not obtain written comments on this report from Treasury, IRS, and FMS. Our findings and conclusions were in agreement with the testimony presented by the Commissioner of Internal Revenue at the October 18, 1990, hearing. Also, our recommendations are similar to the six-point strategy IRS said it may pursue to improve the compliance of federal agencies with employment tax obligations.

As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of this report. A written statement must also be submitted to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We are sending copies of this report to the Joint Committee on Taxation; the Subcommittee on Private Retirement Plans and Oversight of IRS, Senate Committee on Finance; the Subcommittee on Oversight, House Committee on Ways and Means; and other interested parties. We will make copies available to others on request.

Major contributors to this report are listed in the appendix. Please contact me on (202) 272-7904 if you have any questions concerning the report.

Sincerely yours,

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