Collection Actions for In-Business Trust Fund Accounts Closed as Currently Not Collectible Need Improvement

August 24, 2010

Reference Number: 2010-30-095

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Phone Number | 202-622-6500
Email Address | inquiries@tigta.treas.gov
Web Site | http://www.tigta.gov

COLLECTION ACTIONS FOR IN-BUSINESS TRUST FUND ACCOUNTS CLOSED AS CURRENLY NOT COLLECTIBLE NEED IMPROVEMENT

Highlights

Final Report issued on August 24, 2010

Highlights of Reference Number: 2010-30-095 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The large number of in-business taxpayers that are accumulating trust fund tax liabilities is a major tax compliance problem for the Internal Revenue Service (IRS). Overall, TIGTA determined that the Collection Field function needs to improve collection actions for in-business trust fund accounts closed as currently not collectible. Because not all required collection actions were taken, taxpayers continued to accumulate additional trust fund taxes. Taxpayers who do not voluntarily pay their share of taxes create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

WHY TIGTA DID THE AUDIT

This audit was initiated as part of our Fiscal Year 2009 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives. The overall objective was to determine whether the IRS Collection Field function appropriately evaluates and monitors in-business trust fund accounts closed as currently not collectible.

WHAT TIGTA FOUND

The Collection Field function did not take all appropriate collection actions prior to closing in-business taxpayer accounts as currently not collectible. In 20 (33 percent) out of 61 cases reviewed, revenue officers did not always secure, verify, and/or analyze information to determine taxpayers' current financial condition and/or determine whether the taxpayers were current with filing requirements. When all required collection actions are not performed while a revenue officer is determining collectability of an in-business trust fund account, additional liabilities may accrue. TIGTA estimates that improving controls to ensure required collection actions are pursued could potentially prevent approximately $84 million in liabilities from accruing per year, which is approximately $420 million over the next 5 years.

Mandatory followup reviews were not always requested and performed after in-business trust fund accounts were closed as currently not collectible. In 45 (49 percent) of 92 cases reviewed, mandatory followup reviews were not performed. These accounts were not available for further collection actions. TIGTA estimates that improving controls to ensure mandatory followup reviews are performed would make approximately $46 million of in-business trust fund liabilities available for collection each year, which is about $230 million for the next 5 years.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) provide training to Collection Field function managers and revenue officers with additional emphasis on the importance of securing, verifying, and analyzing financial information; 2) ensure the Integrated Collection System and Internal Revenue Manual are updated to include verification of income and expense requirements; 3) continue development and implementation of a systemic process within the Integrated Collection System to require the scheduling of mandatory followup reviews; and 4) update Centralized Case Processing function procedures to clarify mandatory followup review procedures and require periodic monitoring prior to mandatory followup review dates.

In their response to the report, IRS officials agreed with the recommendations and outcome measures. The IRS has taken steps to implement several corrective actions and plans to take additional steps to address TIGTA's concerns.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

August 24, 2010

MEMORANDUM FOR COMMISSIONER SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Collection Actions for In-Business Trust Fund Accounts Closed as Currently Not Collectible Need Improvement (Audit # 200930015)

This report presents the results of our review to determine whether the Internal Revenue Service Collection Field function appropriately evaluates and monitors in-business trust fund accounts closed as currently not collectible. This audit was included as part of our Fiscal Year 2009 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.

Table of Contents

Abbreviations

BMF	Business Master File
CCP	Centralized Case Processing
CFf	Collection Field function
IBTF	In-Business Trust Fund
ICS	Integrated Collection System
IDRS	Integrated Data Retrieval System
IRS	Internal Revenue Service
RO	Revenue Officer
TRCAT	Taxpayer Service and Return Processing Categorization

Background

The Internal Revenue Service (IRS) defines a trust fund[1] tax as money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the United States Department of the Treasury. Employers are required to:

- Withhold amounts (trust fund tax) from their employees' salaries to cover individual Federal income, Social Security, and Medicare taxes.
- Make matching contributions for the amounts for Social Security and Medicare taxes.
- Deposit these amounts with the Department of the Treasury.
- File employment tax returns.

The collection of taxes with employment tax returns is a significant source of revenue for the Federal Government. According to IRS data, approximately $1.8 trillion (67 percent) of the $2.7 trillion in revenue collected in Fiscal Year 2008 was from individual income and employment taxes withheld.[2] A 2008 Government Accountability Office report indicated that "*while most businesses fulfill their fiduciary responsibility to the government to withhold taxes from their employee's salaries, make matching contributions, and remit these sums to the government, a significant number do not. As of September 30, 2007, IRS's records showed that over 1.6 million businesses owed over $58 billion in unpaid payroll taxes, including interest and penalties.*"[3]

The large number of in-business taxpayers who are pyramiding trust fund tax liabilities is a major compliance problem for the IRS. Accordingly, one of the highest work priorities in the Collection Field function (CFf) is in-business trust fund (IBTF) accounts. Generally, collection assignments for these liabilities go directly to the CFf, where a revenue officer (RO) will seek to get the taxpayer to become compliant with current deposit[4] and payment requirements and request full payment of taxes owed. In those instances where the taxpayer cannot fully pay the

[1] See Appendix V for a glossary of terms.
[2] IRS Data Book Fiscal Year 2008, Table 5. Individual income and employment taxes withheld include Individual income taxes and Federal Insurance Contributions Act taxes. Federal Insurance Contributions Act taxes include Old-Age, Survivors, and Disability Insurance (referred to as Social Security) and Hospital Insurance (referred to as Medicare Part A) taxes.
[3] *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes* (GAO-08-617, dated July 2008). The number reported by the GAO is total unpaid payroll taxes. This includes all balance due accounts where collection statutes (generally 10 years) have not expired (i.e., accounts in notice status, accounts in active collection, and accounts in suspense status such as currently not collectible).
[4] Employers are generally required to pay payroll taxes periodically through the Federal Tax Deposit system.

back taxes, the RO may explore other collection alternatives such as an installment agreement. However, in some instances, the in-business taxpayer may not have the ability to pay his or her back taxes, and enforcement actions cannot be taken because the business has no equity in assets. In these cases, the RO can close the business taxpayer's account as currently not collectible. However, prior to doing so, the RO must:

- Ensure the taxpayer is in compliance with current filing, deposit, and payment requirements, which may include the use of Letter 903 to inform the taxpayer of the consequences of not depositing Federal employment taxes.
- File Notice of Federal Tax Lien, where applicable.
- Obtain a collection information statement (financial information).
- Conduct a Trust Fund Recovery Penalty investigation and make a recommendation of whether or not the penalty is to be assessed.

Unlike a number of other currently not collectible dispositions, subsequent liabilities on these taxpayer accounts must be investigated by the CFf to verify the taxpayer's financial condition and to make a Trust Fund Recovery Penalty recommendation. Also, because these cases will not be systemically re-activated if a taxpayer's financial status improves, the RO must request a mandatory followup review of the taxpayer's account within 18 to 24 months after closing the account as currently not collectible.

The Centralized Case Processing (CCP) function maintains the closed case files to monitor followup review dates and generates assignments through what are known as Other Investigations. These assignments can result in the RO taking enforcement actions to collect the outstanding balance due or returning the account to currently not collectible status. At a minimum, the RO should:

As of September 30, 2009, in-business taxpayers, with accounts declared currently not collectible, owed about $1.1 billion in unpaid employment taxes.

- Secure a new collection information statement.
- Conduct a full compliance check.
- Review the taxpayer's latest income tax return.

The IRS' data for Fiscal Years 2006 through 2008 shows that more than 649,000 business taxpayers owing more than $20.4 billion in tax, penalties, and interest were declared currently not collectible for various reasons.[5] Of these, more than 402,000 business taxpayers owed more than $12.5 billion in employment taxes. In-business taxpayers represent about $604 million

[5] Accounts can be declared currently not collectible for various reasons including bankruptcy, defunct corporation, hardship, in-business, and shelved accounts.

(5 percent) of the $12.5 billion owed by business taxpayers. As of September 30, 2009, the total IRS inventory of currently not collectible accounts included almost $20.7 billion of unpaid employment taxes from business taxpayers with $1.1 billion (approximately 5 percent) from in-business taxpayers.[6] While the in-business taxpayers represent a relatively small portion of the business accounts declared currently not collectible, there is an increased risk that additional trust fund liabilities will accumulate.

This review was performed at the IRS Small Business/Self-Employed Division CFf offices in Seattle, Washington, and Detroit, Michigan, during the period April 2009 through February 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[6] IRS Collection Report 5000-149 (Recap of Accounts Currently Not Collectible Report). The report does not provide a breakdown of the number of taxpayers by the various currently not collectible closing codes. The majority of business accounts closed as currently not collectible were due to the IRS shelving process, but defunct corporations accounted for about 67 percent of the dollar amounts.

Results of Review

The Collection Field Function Did Not Take All Appropriate Collection Actions Prior to Closing In-Business Taxpayer Accounts as Currently Not Collectible

When working an IBTF account, the RO will seek to get the taxpayer to become compliant with current deposit and payment requirements and will request full payment of taxes owed. In those instances where the taxpayer cannot fully pay the back taxes, the RO performs additional collection actions. These collection actions generally include having taxpayers file delinquent returns, filing tax liens, and determining collectability by securing and verifying financial information to identify the financial condition of the taxpayer. Managers are required to review collection actions taken by ROs to determine whether the proposed case resolution supports the currently not collectible closure.

To determine whether the CFf took appropriate actions to maximize collections, we reviewed a statistical sample of 61 in-business taxpayer accounts closed as currently not collectible in Calendar Year 2008. These cases had a total outstanding balance of $4 million. We selected our sample from a population of 3,248 cases of in-business taxpayers with a total outstanding IBTF balance of $245 million.

Overall, we determined the CFf did not take all appropriate collection actions prior to closing in-business taxpayers' accounts as currently not collectible. In 20 (33 percent) of 61 cases, ROs did not secure, verify, and/or analyze financial information to determine ability to pay and/or did not ensure that the taxpayers were current with all tax return filing requirements. Specifically, our analysis of the 20 cases[7] showed:

- Six cases in which the RO did not secure financial information to determine the taxpayer's ability to pay.
- Ten cases in which the RO did not verify the financial information provided by the taxpayer to adequately determine the taxpayer's current financial condition. Also, in 6 of these 10 cases, the RO did not document and/or analyze the financial information to determine the taxpayer's ability to pay.
- Six cases in which the RO did not ensure the taxpayers were in compliance with all tax return filing requirements.

[7] Two of the compliance cases also had a verification issue. Therefore, the cases reported will not add up to the 20 cited.

ROs did not always secure financial information

ROs are required to secure financial information when full payment is not received. This financial information is later used to determine the taxpayer's financial condition and ability to pay his or her tax liabilities. In addition, CFf managers are required to conduct an independent review of the financial information secured by the ROs to determine if procedures have been followed and the collection actions taken support the proposed case resolution. However, ROs did not secure financial information in 6 of the 20 exception cases. Our analysis of these cases showed that the CFf manager did not ensure the RO secured the necessary financial information to support the proposed case resolution as currently not collectible. Without securing financial information, the RO has not properly documented the decision to close the case as currently not collectible and the managers are unable to validate whether the RO case resolution decision was appropriate.

ROs did not always verify income and expenses

Financial information secured from the taxpayer or his or her representative should be complete, and the ROs should verify income and expenses to determine the taxpayer's financial condition. However, the ROs did not verify income and expense information provided by the taxpayers in 10 of the 20 exception cases.

In December 2007, the IRS provided financial analysis training to CFf managers. The training provided was based on IRS focus group dialogues with the ROs and managers which revealed a lack of consistency following established Internal Revenue Manual procedures when cases were being closed as currently not collectible. In particular, securing, verifying, and analyzing financial data on the cases was the greatest area of concern of the focus group. During this training, CFf managers received a training guide entitled, *Financial Analysis Training for Collection Field Group Managers*. IRS management explained that they encouraged the CFf managers to use this Guide to train the ROs within their groups during staff meetings to ensure consistency in the performance of collection actions for analyzing financial data. However, the IRS did not require the CFf managers to report if this training was completed.

The ROs use the Integrated Collection System (ICS) to manage their workload and identify collection actions to complete while they are working their cases. The ICS has action items the ROs must check off as they progress through their casework. The ICS does not include a requirement to verify income and expense information as an action item for the ROs to complete when full payment is not secured from the taxpayer. Without the verification of income and expense information as an ICS requirement, this collection item is not being completed.

We reviewed the Field Compliance Embedded Quality Guide,[8] Financial Analysis Training Guide, and Internal Revenue Manual to determine whether they contained requirements for verification of income and expense information. We found the Field Compliance Embedded Quality Guide and the Financial Analysis Training Guide had a requirement for verification of income and expenses. However, the Internal Revenue Manual procedures need to be strengthened to include the verification of income and expense requirement.

The ROs did not ensure taxpayers were in compliance with filing requirements

The ROs should monitor filing and payment responsibilities of the taxpayer prior to closing a case. Prior to case closure, the RO must address all modules regardless of status, especially if the taxpayer has pyramided trust fund liabilities. However, the ROs were not verifying and addressing compliance prior to closing the in-business accounts as currently not collectible. We found that six cases were closed when the taxpayer was not in compliance with his or her filing requirements. Because delinquent returns exist on the taxpayer account, these cases may be reassigned into the field due to the delinquency or subsequent liabilities may be incurred.

When all required collection actions are not performed while an RO is determining collectability of an IBTF account, additional liabilities may accrue. ROs did not take adequate collection action to prevent pyramiding of IBTF liabilities. In 16 of the 20 exception cases, the taxpayer continued to accumulate additional trust fund liabilities while the cases were assigned to an RO. For these 16 cases, a total of $658,326 in liabilities pyramided, increasing the assigned outstanding liabilities from $925,300 when the case was assigned to $1,583,626 prior to the cases being closed as currently not collectible. This resulted in an average increase of $41,145 per case. Based on our statistically valid sample, we project that improving controls to ensure required collection actions are pursued could potentially prevent approximately $84 million[9] of IBTF liabilities from accruing per year, or approximately $420 million over the next 5 years.

Recommendations

The Director, Collection, Small Business/Self-Employed Division, should ensure:

Recommendation 1: Training is provided to CFf managers and ROs with additional emphasis on the importance of securing, verifying, and analyzing financial information.

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[8] *Field Compliance Embedded Quality Guide*, April 2008, contains guidelines for CFf managers and National CFf quality reviewers to follow when reviewing cases using the Embedded Quality Program. Embedded Quality is designed to place more emphasis on significant case actions (attributes) and to concentrate less on process steps.
[9] This projection is potential total outstanding liabilities of the taxpayer as originally assigned plus additional accruals, all of which may not be accrued. In addition, not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the RO. See Appendix IV for details on the computation of the outcome measure.

Management's Response: IRS management agreed with this recommendation and will issue a memo to reinforce the Internal Revenue Manual guidance for closing accounts as in-business currently not collectible. In addition, a training class is scheduled that will provide more detailed guidance for CFf managers and ROs working in-business accounts

Recommendation 2: The ICS and Internal Revenue Manual are updated to include verification of income and expense requirements.

Management's Response: IRS management agreed with this recommendation and has requested a change to the ICS to address the requirement for verification of income and expenses. In addition, the Internal Revenue Manual will be updated to clarify that ROs must analyze and verify income and expenses prior to reporting accounts as currently not collectible.

Mandatory Followup Reviews Were Not Always Requested and Performed After In-Business Trust Fund Cases Were Closed as Currently Not Collectible

Followup reviews are conducted to determine whether the taxpayer's financial condition has changed or whether the account should remain currently not collectible and be scheduled for an additional mandatory followup review. If the taxpayer's financial condition has improved, collection actions are resumed. IRS procedures require the CFf to conduct a mandatory followup review 18 to 24 months after the IBTF accounts are determined to be not collectible. The RO should initiate and schedule mandatory followup reviews when the cases are closed.

To determine whether the CFf took timely and appropriate mandatory followup review actions on the IBTF accounts, we reviewed a statistical sample of 92 cases closed as currently not collectible during Calendar Year 2006. These cases had a total outstanding balance of almost $7 million. We selected our sample from a population of 2,011 cases of IBTF taxpayers with a total outstanding balance of $161 million.

Scheduled mandatory followup reviews were conducted in 16 (17 percent) of the 92 cases. Our analysis showed the ROs followed IRS procedures when conducting these reviews. Specifically, they properly secured new financial information, conducted compliance checks, and reviewed the latest income tax returns for these case reviews. In addition, 31 (34 percent) of the 92 cases incurred subsequent delinquencies (i.e., additional liabilities, unfiled tax returns) after they were closed. These cases reached the IRS inventory assignment criteria and were assigned back to the field for additional collection actions. However, in 45 (49 percent) cases, neither a mandatory followup review nor other subsequent collection action occurred. Specifically, we found:

- In 34 of the 45 cases, the RO did not request a mandatory followup review when the case was closed as currently not collectible.

- In 11 of the 45 cases, the RO did request a mandatory followup review within the ICS; however, no mandatory followup review was conducted because the case was not assigned back to the field to work when the followup review date arrived.

Mandatory followup reviews were not always conducted

The IRS process for requesting a mandatory followup review requires the RO to select a followup review box in the currently not collectible section of the ICS when the case is closed. This initiates and schedules the mandatory followup review. The ROs should be familiar with this requirement. We found 34 cases where the ROs did not request mandatory followup reviews when they closed the cases.

The IRS was aware the ROs were not requesting mandatory followup reviews. The IRS explained that if the RO is unfamiliar with the procedures, the case currently can be closed within the ICS without a mandatory followup review being scheduled. At the time we conducted our review, IRS management was in the process of implementing a systemic process within the ICS that will require the ROs to schedule a mandatory followup review when an IBTF account is closed as currently not collectible. When this new process is implemented, the ICS will not allow the case to be closed without the mandatory followup review being scheduled. The scheduled implementation date is January 2011. We believe the implementation of a systemic requirement for mandatory followup review within the ICS will address this concern.

The CCP function did not assign all cases to the field when the mandatory followup review date arrived

If the RO schedules a followup review within the ICS, the case is then assigned systemically to the CCP function for monitoring. When the followup review date arrives, if the case still has a balance due account, the CCP function should assign the case back to the field to work

We identified 11 cases where, although the ROs requested mandatory followup reviews within the ICS, mandatory followup reviews were not conducted. The cases were not assigned back to the field to work when the followup review date arrived. The IRS determined CCP function procedures needed to be clarified to outline the actions the CCP function should take when the mandatory followup review date arrives. In February 2010, the IRS issued a CCP alert[10] to identify the problem while it establishes procedures in this area. We agree that procedures need to be developed to clarify and strengthen the process for ensuring cases are assigned back to the field if balance due and/or delinquent returns exist on the account when the mandatory followup review date arrives.

[10] CCP alerts are issued to notify employees of a procedural problem and actions they should take while procedures are being established to address the problem.

When the IRS does not follow up on accounts closed as currently not collectible, there is no way to verify the taxpayer's financial condition for ability to pay his or her tax liabilities. In 17 of the 45 exception cases, the taxpayer incurred subsequent delinquencies (i.e., additional liabilities, unfiled tax returns) after the cases were closed in Calendar Year 2006. However, as of July 2009, these cases had not reached the IRS inventory assignment criteria to be assigned back to the field and were not available for further collection actions.

Based on the 45 exception cases identified in our statistically valid sample, we estimate that improving controls to ensure mandatory followup reviews are performed would make approximately $46 million[11] of IBTF liabilities available for collection per year, or approximately $230 million over the next 5 years.

Recommendations

Recommendation 3: The Director, Collection, Small Business/Self-Employed Division, should coordinate with the Modernization and Information Technology Services organization to ensure continued development and implementation of a systemic process within the ICS to require the mandatory scheduling of followup reviews for IBTF accounts closed as currently not collectible.

> ***Management's Response:*** IRS management agreed with this recommendation and is in the process of updating the ICS to require ROs to schedule a mandatory followup when closing in-business cases as currently not collectible.

***Recommendation 4*:** The Director, Campus Compliance Services, Small Business/Self-Employed Division, should ensure CCP function procedures are updated to clarify mandatory followup review procedures and require periodic monitoring prior to mandatory followup review dates.

> ***Management's Response:*** IRS management agreed with this recommendation. The CCP function issued an alert on February 22, 2010, clarifying the mandatory followup review procedures. The CCP function plans to issue a second alert after the CFf is notified of new CCP function procedures to perform periodic reviews of in-business currently not collectible cases being monitored by the CCP function.

[11] This projection represents tax liabilities potentially accrued and were not available for collection action. Not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the revenue officer. See Appendix IV for details on the computation of the outcome measure.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS CFf[1] appropriately evaluated and monitored IBTF accounts closed as currently not collectible. This audit was initiated as part of our Fiscal Year 2009 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives. During the review, we relied on data from the Business Master File (BMF), the ICS, and the Taxpayer Service and Return Processing Categorization (TRCAT) file. We evaluated the reasonableness of the data through comparison with selected information from the Integrated Data Retrieval System (IDRS). We determined that the data were sufficiently reliable to meet our objective. To accomplish our audit objective, we:

I. Determined whether the CFf takes appropriate actions to maximize collections from IBTF accounts prior to classifying them as currently not collectible.

   A. Discussed with Collection management expectations for working IBTF accounts and actions required prior to closing these accounts as currently not collectible.

   B. Determined whether timely and appropriate actions were taken prior to closing IBTF accounts as currently not collectible.

      1. Selected a statistically valid sample of 61 IBTF liability accounts considered currently not collectible as of December 27, 2008, that were closed as currently not collectible by the CFf between January 1 and December 17, 2008. This sample was randomly selected from a population of 3,248 taxpayers identified from the TRCAT file where the in-business currently not collectible transactions (i.e., transaction code 530 with a closing code 13) were input during this time period. The dates of the transaction input were obtained from an extract of the BMF. The statistical sample was based on a 95 percent confidence level, a precision level of ±10 percent, and an expected error rate of 20 percent.[2] This period was chosen to provide a current basis for evaluating case actions. We validated the reliability of the downloaded data by comparing the data to the

[1] See Appendix V for a glossary of terms.
[2] We determined the sample sizes based on a 20 percent error rate and 50 percent error rate. We used the 50 percent error rate sample size and used a random number generator to select 93 cases, based on a population of 3,248 taxpayers, in case we would need to expand our review based on preliminary audit results. We started the case reviews with the first 61 cases as determined by the 20 percent error rate. The actual error rate of 33 percent did not require expansion or review of the additional 32 cases preselected. Because all 93 cases were randomly selected at the same time, reviewing the first 61 cases does not affect the validity of the sample.

information available through research of the IDRS. We selected a statistical sample to be able to quantify and project our results to the population.

2. Evaluated the sample of closed case files to determine whether required enforcement actions were taken or attempted prior to closing the account as currently not collectible.

II. Determined whether timely and appropriate actions were taken after IBTF accounts were classified as currently not collectible.

A. Discussed with Collection management expectations for conducting followup reviews on IBTF accounts.

B. Discussed with CCP function management methods used to ensure mandatory followup review dates are monitored and followup reviews are initiated as required. We evaluated the adequacy of the CCP function's control over monitoring and initiating required followup reviews.

C. Determined whether timely and appropriate mandatory followup review actions were taken on IBTF accounts closed as currently not collectible.

1. Selected a statistically valid sample of 92 IBTF accounts[3] considered currently not collectible as of December 23, 2006, that were closed as currently not collectible by the CFf between January 1 and December 12, 2006. This sample was randomly selected from a population of 2,011 taxpayers identified from the TRCAT Business File where the in-business currently not collectible transactions (i.e., transaction code 530 with a closing code 13) were input during this time period. The dates of the transaction input were obtained from an extract of the BMF. The statistical sample was based on a 95 percent confidence level, a precision level of ±10 percent, and an expected error rate of 50 percent.[4] This period was chosen because followup reviews should be scheduled 18 to 24 months after disposition and it provides a basis for evaluating the adequacy of the followup reviews. We validated the reliability of the downloaded data by comparing the data to the information available through research of the IDRS. We selected a statistical sample to be able to quantify and project our results to the population.

[3] The population may include some business taxpayers without trust fund filing requirements and/or liabilities based on limitations with extracts.

[4] We determined the sample sizes based on a 20 percent error rate and 50 percent error rate. We used the 50 percent error rate sample size and used a random number generator to select 92 cases, based on a population of 2,011, in case we would need to expand our review based on preliminary audit results. We started the case reviews with the first 60 cases as determined by the 20 percent error rate, experienced a higher error rate than expected, and expanded our audit to review the additional 32 cases preselected. Because all 92 cases were randomly selected at the same time, expansion of the audit does not affect the validity of the sample.

2. Evaluated the sample cases to determine whether the CFf effectively evaluated the taxpayer's current financial condition and took appropriate actions based on the results of the review.

D. Evaluated the sample cases identified in Step II.C.1. to determine whether the CFf takes appropriate actions when taxpayers accrued subsequent trust fund tax liabilities.

III. Determined the reliability of the ICS currently not collectable data extract.

A. On randomly selected taxpayer accounts, evaluated the reliability of data by comparing the RO case closed date from the Data Center Warehouse with the IRS IDRS currently not collectible transaction code date and the ICS module balance amount with the IDRS assessed balance amount.

B. Evaluated completeness of the data by comparing the ICS currently not collectable file to a data extract of BMF transaction code 530 with closing code 13 (i.e., the transaction code and closing code that indicates a currently not collectible in-business account).

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: CFf and CCP function policies, procedures, and practices for case actions taken prior to closing in-business accounts as currently not collectible and case actions taken for mandatory followup reviews. We evaluated these controls by interviewing management, reviewing source materials, and analyzing closed case actions on accounts closed as currently not collectible during Calendar Years 2006 and 2008.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Carl L. Aley, Director
Amy Coleman, Audit Manager
Glen Rhoades, Audit Manager
Christina Dreyer, Lead Auditor
Darryl Roth, Lead Auditor
Lynn Rudolph, Senior Auditor
Richard Viscusi, Senior Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
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Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

The IRS can potentially increase revenue by approximately $130 million per year ($84 million of accrued IBTF[1] liabilities for cases closed in Calendar Year 2008 and $46 million of IBTF liabilities not available for collection action for cases closed in Calendar Year 2006) or $650 million over the next 5 years. These benefits can potentially be achieved if the CFf takes all appropriate collection actions prior to closing IBTF taxpayer accounts as currently not collectible and performs mandatory followup reviews after the cases are closed.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $84 million in additional accruals[2] per year or $420 million for 5,325 taxpayers over the next 5 years (see page 4).

Methodology Used to Measure the Reported Benefit:

We identified 3,248 IBTF[3] accounts from the TRCAT business file where the in-business currently not collectible transactions (i.e., transaction code 530 with closing code 13) were input during January through December 2008. We obtained the dates of the transaction input from an extract of the BMF. From this population, we selected a statistical sample of 61 cases using a confidence level of 95 percent, a precision level of ±10 percent, and an expected error rate of 20 percent.

We determined that, in 20 cases, the ROs did not secure, verify, and/or analyze financial information to determine the ability to pay and/or did not ensure that the taxpayers were current with all tax return filing requirements. These 20 cases had accrued a total of $1,583,627 in tax liabilities. For the sample, this resulted in an average of $25,961 per case ($1,583,627/61). Projecting this average potential tax liability per case over the population of 3,248 cases, we estimate that improving controls to ensure required collection actions are pursued could

[1] See Appendix V for a glossary of terms
[2] This projection is potential total outstanding liabilities of the taxpayers as originally assigned plus additional accruals, all of which may not be accrued. In addition, not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the RO.
[3] The population may include some business taxpayers without trust fund filing requirements and/or liabilities based on limitations with extracts.

potentially prevent approximately $84 million ($25,961 x 3,248) of IBTF liabilities from pyramiding per year, which is approximately $420 million over the next 5 years.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $46 million available for collection[4] per year or $230 million for 4,920 taxpayers over the next 5 years (see page 7).

Methodology Used to Measure the Reported Benefit:

We identified 2,011 IBTF[5] accounts from the TRCAT business file where the in-business currently not collectible transactions (i.e., transaction code 530 with closing code 13) were input during January through December 2006. We obtained the dates of the transaction input from an extract of the BMF. From this population, we selected a statistical sample of 92 cases using a confidence level of 95 percent, a precision level of ±10 percent, and an expected error rate of 50 percent.

We determined that in 45 cases the CFf did not conduct a mandatory followup review because these cases were not assigned to the field for collection. These 45 cases had accrued a total of $2,092,796 in tax liabilities. For the sample, this results in an average of $22,748 per case ($2,092,796/92). Projecting this average potential tax liability per case over the population of 2,011 cases, we estimate that improving controls to ensure mandatory followup reviews are performed would make approximately $46 million ($22,748 x 2,011) of IBTF liabilities available for collection per year, which is about $230 million over the next 5 years.

[4] This projection represents tax liabilities potentially accrued and were not available for collection action. In addition, not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the RO.
[5] The population may include some business taxpayers without trust fund filing requirements and/or liabilities based on limitations with extracts.

Appendix V

Glossary of Terms

Business Master File – The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

Centralized Case Processing – The unit that works requests from the Collection Field function.

Collection Field function – The unit in the Area Offices consisting of ROs who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled returns.

Data Center Warehouse – An architecture used by the Treasury Inspector General for Tax Administration to maintain critical historical data that have been extracted from IRS operational data storage and transformed into accessible formats.

Embedded Quality Program – A measurement system for reporting organizational quality performance and is comprised of two distinct systems: the Embedded Quality Review System and the National Quality Review System. The Embedded Quality Review System provides a structured context for evaluating employee performance. The National Quality Review System provides independent collection review information from which management may draw inferences regarding overall case quality for a given operational segment.

Full Compliance Check – Involves determining whether the taxpayer is current with his or her Federal tax deposit requirements and current with tax return filing requirements.

In-Business – A business with ongoing business activity.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Integrated Collection System – An information management system designed to improve revenue collections by providing ROs access to the most current taxpayer information using laptop computers for quicker case resolution and improved customer service.

Integrated Data Retrieval System – IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Letter 903 – Alerts a taxpayer of the seriousness of noncompliance and explains more fully the alternatives that can be taken if the taxpayer is still not in compliance with the trust fund tax requirements. Subsequent noncompliance subjects the taxpayer to special filing and deposit requirements, and further noncompliance subjects the taxpayer to potential criminal charges or civil injunctions.

Pyramiding – The incurring of future additional tax liabilities.

Revenue Officer – An employee in the Collection Field function who attempts to contact taxpayers and resolve collection matters that have not been resolved through notices sent by the IRS campuses or the Automated Collection System.

Taxpayer Service and Return Processing Categorization file – A part of the Accounts Receivable Dollar Inventory. These files are generated on a quarterly basis from both the Individual Master File and Business Master File.

Trust Fund – Money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the United States Department of the Treasury.

Trust Fund Recovery Penalty – A penalty assessed against any person required to collect, account for, and pay taxes held in trust who willfully fails to perform any of these activities. The penalty is equal to the amount of tax evaded, not collected, or not accounted for and paid. The RO must establish responsibility and willfulness when determining whether to proceed with assertion of the Trust Fund Recovery Penalty.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

July 26, 2010

RECEIVED
JUL 26 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner Faris R. Fink for
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Collection Actions for In-Business Trust Fund Accounts Closed as Currently Not Collectible Need Improvement (Audit # 200930015)

We have reviewed your draft report, "Collection Actions for In-Business Trust Fund Accounts Closed as Currently Not Collectible Need Improvement." We agree with the findings of the report and the recommendations.

In-business taxpayers that are accumulating trust fund tax liabilities are a major compliance problem for the IRS. We need to take appropriate action to bring these taxpayers into compliance with their filing and paying requirements. The Collection Field function (CFf) must appropriately evaluate a taxpayer's ability to pay prior to reporting an account currently not collectible (CNC). In addition, accounts closed as in-business CNC must be monitored to prevent taxpayers from accumulating additional tax liabilities.

The IRS recognizes the need to improve collection actions on in-business trust fund accounts closed as CNC. We previously identified some of the issues included in this report and have already taken steps to implement several corrective actions to improve performance in this area.

In December 2007, we conducted face-to-face training for collection group managers. We addressed the criteria for review of completed work including in-business CNC cases. We specifically addressed verification of compliance, equity in assets, ability to pay, and mandatory follow-ups. In November 2008, we submitted a request for a change to the Integrated Collection System (ICS) to require revenue officers (ROs) to schedule mandatory follow-ups on cases closed as in-business CNC. In addition, a new monitoring tool that will enhance in-business compliance monitoring for users of the ICS is scheduled for implementation in 2011. It will alert ROs, on a monthly basis, of possible non-compliance and potentially prevent taxpayers from accumulating additional tax liabilities. On February 22, 2010, Centralized Case Processing (CCP) issued an alert clarifying the mandatory follow-up review procedures for CCP employees monitoring the in-business CNC cases.

We concur with the calculation of the outcome measures presented in Appendix IV of the report given the acknowledgement that "this projection is potential total outstanding liabilities of the taxpayer as originally assigned plus additional accruals, all of which may not be accrued" and that "not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the RO." Many taxpayers whose accounts were closed as in-business subsequently go out of business and the liabilities cannot be collected.

Attached is a detailed response outlining our corrective actions. If you have questions, please contact me, or a member of your staff may contact Frederick W. Schindler, Director, Collection Policy at (202) 283-7650.

Attachment

Attachment

RECOMMENDATION 1:
The Director, Collection, Small Business/Self-Employed Division, should ensure training is provided to CFf managers and ROs with additional emphasis on the importance of securing, verifying, and analyzing financial information.

CORRECTIVE ACTION:
We agree with this recommendation. 1.) A Director, Collection Policy memo to reinforce the Internal Revenue Manual (IRM) guidance for closing accounts as in-business Currently Not Collectible (CNC) will be issued by July 30, 2010. 2.) A training class, "Resolving Business Liabilities," is scheduled for FY 2011, and will provide more detailed guidance for Collection Field function (CFf) managers and revenue officers (ROs) working in-business accounts.

IMPLEMENTATION DATE:
1.) August 15, 2010
2.) October 15, 2011

RESPONSIBLE OFFICIAL:
Director, Collection Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:
The Director, Collection Policy SB/SE will advise the Director, Collection SB/SE of any delays in implementing this corrective action.

RECOMMENDATION 2:
The Director, Collection, Small Business/Self-Employed Division, should ensure the ICS and Internal Revenue Manual are updated to include verification of income and expense requirements.

CORRECTIVE ACTION:
We agree with this recommendation. 1.) We have requested a change to the Integrated Collection System (ICS) to address the requirement for verification of income and expenses that will be included on the next Work Request for ICS changes. 2.) IRM 5.16.1, Currently Not Collectible, will be updated to clarify that ROs must analyze and verify business income and expenses prior to reporting accounts CNC. We will include a cross-reference to the detailed information provided in IRM 5.16.1.13, Financial Analysis - Business Expenses and IRM 5.16.1.14, Determining Business Income.

IMPLEMENTATION DATE:
1.) February 15, 2012
2.) April 15, 2011

2

RESPONSIBLE OFFICIAL:
Director, Collection Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:
The Director, Collection Policy, SB/SE will advise the Director, Collection, SB/SE of any delays in implementing this corrective action.

RECOMMENDATION 3:
The Director, Collection, Small Business/Self-Employed Division, should coordinate with the Modernization and Information Technology Services organization to ensure continued development and implementation of a systemic process within the ICS to require the mandatory scheduling of follow-up reviews for IBTF accounts closed as currently not collectible.

CORRECTIVE ACTION:
We agree with this recommendation and this change is already in development. The ICS will be updated to require ROs to schedule a mandatory follow-up when closing a case as in-business CNC. The ICS will not allow the case to be closed as in-business without a follow-up.

IMPLEMENTATION DATE:
February 15, 2011

RESPONSIBLE OFFICIAL:
The Director, Collection Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:
The Director, Collection Policy, SB/SE will advise the Director, Collection, SB/SE of any delays in implementing this corrective action.

RECOMMENDATION 4:
The Director, Campus Compliance Services, Small Business/Self-Employed Division should ensure CCP procedures are updated to clarify mandatory follow-up review procedures and require periodic monitoring prior to mandatory follow-up review dates.

CORRECTIVE ACTION:
We agree with this recommendation. Centralized Case Processing (CCP) issued an alert on February 22, 2010, clarifying the mandatory follow-up review procedures. A second alert will be issued after CFf is notified of new CCP procedures to perform periodic reviews of in-business CNC cases being monitored by CCP.

IMPLEMENTATION DATE:
October 15, 2010

3

RESPONSIBLE OFFICIAL:
The Director, Campus Compliance Services, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.