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TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



*Designated Payment Codes Are  
Inaccurate and Ineffective*

**March 28, 2012**

**Reference Number: 2012-30-026**

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.

**Redaction Legend:**

1 Tax Return/Return Information

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## HIGHLIGHTS

### DESIGNATED PAYMENT CODES ARE INACCURATE AND INEFFECTIVE

## Highlights

### Final Report issued on March 28, 2012

Highlights of Reference Number: 2012-30-026 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### IMPACT ON TAXPAYERS

The IRS established Designated Payment Codes (DPC) to identify IRS enforcement actions or other events that result in taxpayers submitting subsequent payments on their balance due accounts. However, the IRS is not consistently or accurately applying DPCs, which reduces the IRS's ability to assess the effectiveness of its collection actions. Ineffective use of IRS collection resources can unnecessarily burden the majority of taxpayers who fully and timely pay their taxes.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS is consistent and accurate in applying DPCs to subsequent payments received on balance due accounts. The audit is included in TIGTA's Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

### WHAT TIGTA FOUND

TIGTA reviewed a statistical sample of 138 subsequent payments that posted to taxpayer balance due accounts. TIGTA determined that 106 (77 percent) of the 138 subsequent payments were processed without the required DPC. In addition, 11 (34 percent) of the 32 subsequent payments that had a DPC were not accurate. DPCs are not consistently or accurately applied in the majority of cases because: 1) the IRS has not established DPCs to account for all types of subsequent payments, including those made in response to an IRS notice; 2) DPC procedures on how to process subsequent payments submitted directly to an IRS campus are inconsistent; and 3) the format, instructions, and

processing of the form used to submit subsequent payments do not ensure that DPCs are applied. As a result, DPC data cannot be used to determine the effectiveness of collection actions, and some IRS reports used to monitor and report collection activities are not accurate.

TIGTA also reviewed a random sample of subsequent payments made after the IRS filed Letter 3172, *Notice of Federal Tax Lien Filing and Your Rights to a Hearing under IRC 6320*, and determined that DPCs were not always used. After liens were filed, it was not always clear why the taxpayer made the payment. In addition, DPC procedures do not address partial subsequent payments resulting from liens.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) ensure there is a DPC for all IRS actions that are primarily responsible for taxpayers submitting a payment; 2) establish controls to ensure DPCs are applied consistently and accurately; 3) revise Form 3244, *Payment Posting Voucher*, and its instructions to clarify the DPC requirement for all listed transaction codes; 4) revise Letter 3172 to allow the taxpayer to send in the notice with any subsequent payment; and 5) establish a DPC for partial subsequent payments and installment agreement payments made in response to the filing of a lien.

IRS management plans to conduct an expanded review of DPCs, which agrees with the intent of our first three recommendations. IRS management did not agree with Recommendations 4 and 5, stating that Recommendation 4 places undue burden on the taxpayer, while Recommendation 5 would not accurately measure the target metric.

TIGTA believes Recommendation 4 makes the procedures for Letter 3172 consistent with those for Form 8519, *Taxpayer's Copy of Notice of Levy*, which instructs the taxpayer to include a copy of the notice with the payment. Recommendation 5 is intended to allow the IRS to measure the impact of filing liens by identifying specific subsequent payments made by the taxpayer due to the filing of a lien.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

June 12, 2012

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

**FROM:** Michael E. McKenney  
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Designated Payment Codes Are Inaccurate and Ineffective (Audit # 201130015)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) is consistent and accurate in applying Designated Payment Codes (DPC) to subsequent payments received on taxpayer balance due accounts. This audit was conducted based on the National Taxpayer Advocate's 2009 Report to Congress and at the request of the IRS Oversight Board. This audit is included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

IRS management provided an updated response, dated May 28, 2012, which has been incorporated in this revision of the report. IRS management included some general comments and assertions about DPCs and our report that we believe warrant additional comment. We have included portions of management's response and our related comments below.

Management's Response:

- DPCs are intended to identify some of the collection activities that precede the payment received. While DPCs can be useful, there are limitations to the scope of their utility. In fact, as pointed out in your report, procedures between field and campus employees differ. Therefore, we will use the review mentioned above to determine the appropriate use of DPCs and take actions accordingly.



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### Office of Audit Comment:

The purpose of DPCs, verbatim from the Internal Revenue Manual,<sup>1</sup> is to “identify the event (e.g., lien, levy, seizure) that was primarily responsible for the subsequent payment being made. DPCs are used at the time the subsequent payment is processed. Data from this type of input are congressionally mandated and should be accumulated on a national basis to determine the revenue effectiveness of specific collection activities.” We believe the inconsistent IRS procedures for applying DPCs are “limiting the scope of their utility.” Our recommendations will expand the scope of the DPCs’ utility by including subsequent payments submitted due to IRS notices, liens, and payments received for installment agreements established in response to a lien.

### Management’s Response:

- Care must be taken in the use of DPC data because the taxpayer’s motivation for making a payment can rarely be isolated to a single factor.

### Office of Audit Comment:

The Internal Revenue Manual requires the IRS to record the “event” that was “primarily responsible” for the subsequent payment being made. It does not require the identification of taxpayer motivation or an exclusive single factor. The proper use of DPCs would allow IRS management to better assess the effectiveness of specific collection actions by associating them with payments.

### Management’s Response:

- The draft audit report cited DPC accuracy findings. The audit steps did not include review of the payment source documents, making the determination of accuracy open for further analysis. Based on available information, we do not concur with the accuracy findings outlined in the report.

### Office of Audit Comment:

The types of errors we identified are not subjective. For example, many of the errors involved the use of a DPC indicating a subsequent payment submitted with an amended return, but there was no amended return associated with the taxpayer. A review of source documentation would not change the nature of the mistakes we identified, but could be helpful in determining who made them.

Management’s complete response to the draft report is included as Appendix VIII.

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<sup>1</sup> Internal Revenue Manual 5.2.8.1 (August 15, 2008).



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Copies of this report are also being sent to the IRS 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.



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*Abbreviations*

DPC	Designated Payment Code
IDRS	Integrated Data Retrieval System
IRS	Internal Revenue Service
TC	Transaction Code



## *Designated Payment Codes Are Inaccurate and Ineffective*

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### *Background*

The Internal Revenue Service (IRS) receives taxpayer payments for several reasons and through various methods. For example, some payments are voluntary, such as payments submitted with a timely filed tax return. Other payments are submitted in response to IRS collection actions, such as receipt of an IRS notice or the filing of a lien,<sup>1</sup> when the taxpayer has a balance due account. The IRS established two-digit Designated Payment Codes (DPC)<sup>2</sup> to identify the event (*e.g.*, lien, levy, seizure, *etc.*) that was primarily responsible for the subsequent payment being made. The DPCs are used at the time the subsequent payment is processed. Data from this type of input are congressionally mandated and should be accumulated on a national basis to determine the revenue effectiveness of specific collection activities.

The IRS requires employees to assign the appropriate DPC to subsequent payments on the payment voucher documents:

- Form 809, *Receipt for Payment of Taxes*.
- Form 3244, *Payment Posting Voucher*.

These forms are then forwarded to an IRS submission processing center, where the payment is applied to the taxpayer's balance due account.

Subsequent payments made electronically by taxpayers using the Electronic Federal Tax Payment System are systemically assigned a DPC based on the IRS tax form number. However, electronic payments are not accepted for all types of collection actions. For example, a taxpayer cannot submit an electronic payment for an offer in compromise.

This review was performed at the Small Business/Self-Employed Division Headquarters in New Carrollton, Maryland, during the period May through August 2011. 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.

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<sup>1</sup> See Appendix VII for a glossary of terms.

<sup>2</sup> See Appendix V for a list of DPCs used by the Collection Field function.



## Designated Payment Codes Are Inaccurate and Ineffective

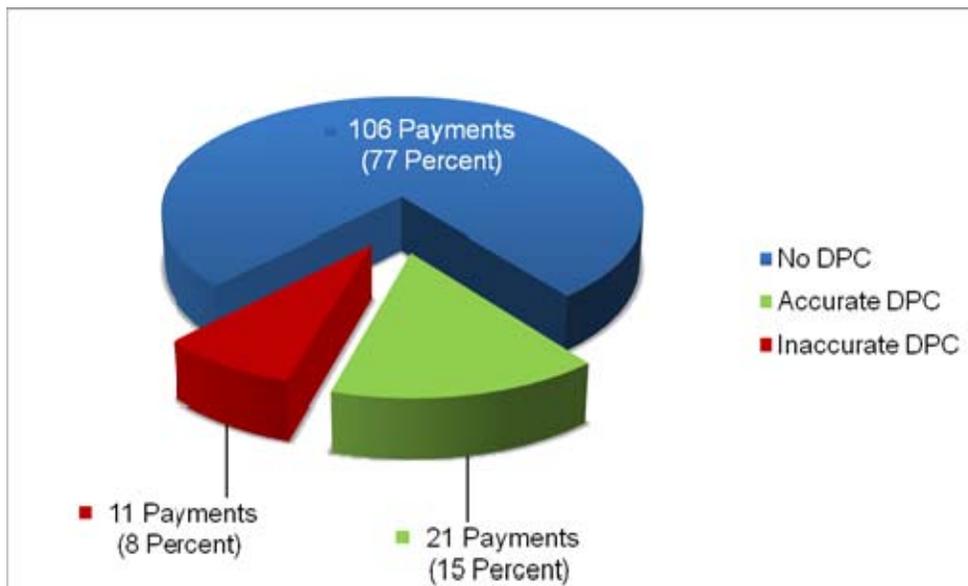
### Results of Review

#### **Designated Payment Codes Are Not Consistently or Accurately Applied**

The Collection Field function and the Automated Collection System are required to apply a DPC to all subsequent payments received. In addition, IRS procedures require that a DPC be applied to subsequent payments received by Taxpayer Assistance Centers and Examination field offices. Accordingly, the IRS is required to notate the DPC on all posting documents/vouchers (e.g., Form 3244) used to process and post subsequent payments on balance due accounts.

We reviewed a statistical sample of 138 subsequent payments that posted to taxpayer balance due accounts during the week ending April 3, 2010. These subsequent payments represent payments taxpayers submitted on their balance due accounts because of a collection action taken by the IRS. Our results showed that DPCs were not consistently or accurately applied in the majority of cases. Figure 1 shows that only 15 percent of the subsequent payments reviewed contained an accurate DPC.

**Figure 1: Accuracy of DPCs for Sampled Subsequent Payments**



Source: Treasury Inspector General for Tax Administration analysis of a sample of subsequent payments requiring DPCs.



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**DPCs are not consistently applied to subsequent payments**

The IRS is not coding all subsequent payments on taxpayer balance due accounts with the appropriate DPC when required. Of the 138 sampled subsequent payments reviewed, 106 (77 percent) were processed without a DPC. For these 106 cases, there was no DPC (the DPC field was blank) in 104 cases and the other two cases were processed with a DPC of “00,” which indicates that the payment voucher did not have a DPC. For these 106 cases, our analysis showed:

- 76 subsequent payments (72 percent) were submitted after a collection action for which there is no DPC available.
  - 69 subsequent payments were submitted after a statutory notice was issued.
  - 7 subsequent payments were submitted after an IRS Underreporter Program notice was issued.
- 21 subsequent payments (20 percent) were submitted after a Form 8519, *Taxpayer’s Copy of Notice of Levy* (hereafter referred to as notice of intent to levy), was issued, for which a DPC is available.
- 9 subsequent payments (8 percent) were submitted for reasons we could not determine (miscellaneous).

We estimate that 676,593 subsequent payments were processed with no DPC during the week we selected our sample. We are 90 percent confident the number of subsequent payments processed without a DPC is between 624,356 and 728,831. We assume the other weeks during Fiscal Year 2010 should be similar and, based on the results of our sample, estimate that more than 37 million subsequent payments were processed without the required DPC during Fiscal Year 2010. We determined that DPCs were missing because:

- DPCs were not available for all types of subsequent payments.
- DPC procedures are inconsistent.
- The format, instructions, and processing of Form 3244 do not ensure DPCs are applied.

**DPCs were not available for all types of subsequent payments**

Although the IRS established DPCs to identify the event that was primarily responsible for the subsequent payment being made, it has not established DPCs to identify all of the collection actions that are responsible for subsequent payments. We determined that an IRS notice (statutory and Underreporter Program notices) preceded 76 (72 percent) of the 106 subsequent payments processed without a DPC. The subsequent payments were submitted for an installment agreement which, in many cases, the taxpayers established in response to notices. However, DPCs have not been established for subsequent payments made in response to statutory or Underreporter Program notices.



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Management advised us that DPCs should be used according to IRS procedures, which includes cases assigned to the Automated Collection System, the Collection Field function, and those awaiting assignment in the queue. IRS procedures also state that DPCs are not to be used on routine balance due notices. However, because taxpayers make subsequent payments after receiving notices, we believe there should be a corresponding DPC to meet the objective of identifying the event that was primarily responsible for the subsequent payment being made.

### **DPC procedures are inconsistent**

IRS procedures are inconsistent on when DPCs are required. Specifically, IRS procedures do not require a DPC for subsequent payments directly submitted to an IRS campus. For example, no DPC is required if a taxpayer receives a Notice of Intent to Levy and responds by sending a payment directly to an IRS campus. In contrast, a DPC is required if that same taxpayer sends the payment to a revenue officer. We were advised that the IRS does not require DPCs on certain submission processing center subsequent payments because the event that was primarily responsible for the subsequent payment cannot be determined by a submission processing center employee. However, DPCs were established to identify the event that was primarily responsible for the subsequent payment being made, regardless of where the payment is made.

### **The format, instructions, and processing of Form 3244 do not ensure that DPCs are applied**

The IRS uses Form 3244 to transmit subsequent payments received from taxpayers to the submission processing centers for deposit and posting. However, the format of Form 3244 may be confusing when applying the appropriate DPC for the respective transaction code (TC).<sup>3</sup> For example, the form is preprinted with only three of the six TCs for which a DPC is mandatory. However, there is only one preprinted space for a DPC, and it is aligned with the box pertaining to TC 670. Figure 2 shows the layout of Form 3244.

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<sup>3</sup> See Appendix VI for a list of TCs requiring a DPC.



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**Figure 2: Form 3244 – Payment Posting Voucher**

Payment Posting Voucher <i>(Not a taxpayer receipt)</i>			DLN										
N M F	U L C	DLN Status	SSN/EIN	Form number/ MFT	Tax Period	Plan/Report Number	Transaction/ Received date						
Taxpayer name, address, and ZIP code <i>(Please print legibly or use typewriter)</i>						List, in the column below, payments to be posted to the taxpayer's account. A maximum of two <i>Credit</i> transactions may be shown.							
Remarks			List, in the column below, any <i>Debit</i> amount to be assessed. A maximum of one debit transaction may be shown.			<b>Transaction Data</b>							
						Amount	Code	Description	Amount	Code	Description	Sub Payment	DPC
						670							
						610		Remittance with return					
						620		Payment for Form 7004					
						640		Advance payment on Deficiency					
						430		Est. tax payment Form 1040-ES					
						660		Est. tax payment Form 1041-ES					
						680		Designated interest					
Trace ID Number						360		Fees and collection cost					
Prepared by <i>(Name and unit symbol)</i>						570		Additional liability pending					
								Other debit					
								Total payment					

Form **3244** (Rev. 9-2009)      Cat. No. 22215N      Department of the Treasury—Internal Revenue Service

Source: Internal Revenue Manual<sup>4</sup> pertaining to DPCs.

There are no detailed Internal Revenue Manual instructions on how to complete the form, and the job aid pertaining to Form 3244 does not mention DPCs. In addition, Form 3244 processing instructions do not require employees to determine an appropriate DPC. We were advised that revenue officers use the Integrated Collection System to generate Form 3244, and the Integrated Collection System will not generate Form 3244 without a DPC. However, the Integrated Collection System will generate Form 3244 when DPC 00 is applied.

Further, Forms 3244 without DPCs are not considered critical errors,<sup>5</sup> and the forms are processed whether or not a DPC is provided. When there are critical errors identified on Form 3244, IRS submission processing centers send Form 5919, *Submission Processing Center Teller's Error Advice*, to the originator of the Form 3244. However, IRS procedures specifically state not to issue a Form 5919 for missing DPCs on Forms 3244. Therefore, the originators are not getting feedback about the missing DPCs. This policy may have contributed to the large number of subsequent payments that were processed with no DPC.

**DPCs are not always accurately applied**

Even when DPCs are used, they are often inaccurate. Our results showed that an incorrect DPC was used in 11 (34 percent) of the 32 cases in which a DPC had been applied. Specifically, cases were processed with the DPC in:

<sup>4</sup> Internal Revenue Manual 3.11.10 (January 1, 2012).

<sup>5</sup> Critical errors include alterations (of any kind), markovers, or erasures in critical fields. Critical fields are all money amounts, date of issue, employee signature, taxpayer name, and identification number.



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- \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.
- 7 instances indicating remittance with an amended return, but there was no amended return on these balance due accounts.
- \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.

We estimate that 70,213 subsequent payments were processed with an inaccurate DPC during the week we selected our sample. We are 90 percent confident the number of inaccurate DPCs is between 36,689 and 103,736. We assume other weeks during Fiscal Year 2010 should be similar and, based on the results of our sample, estimate that 4 million subsequent payments were processed with an inaccurate DPC during Fiscal Year 2010.

IRS procedures for the Collection Field function and the Automated Collection System do not include any quality review of Form 3244 or payment vouchers to ensure the proper DPC is used. In addition, the IRS submission processing function is responsible for processing subsequent payments, and its procedures do not provide for a quality review for the accuracy of DPCs. While the submission processing centers conduct quality reviews in the functions that receive and sort subsequent payments before they are processed, this quality review does not include assessing the accuracy of DPCs.

Because DPCs were not consistently or accurately applied, some of the information on collection activity reports, which are used to monitor and report on collection activities, was also inaccurate. Based on our sample, we estimate that the Fiscal Year 2010 Collection Activity Report reflected 676,593 subsequent payments with no DPC and 70,213 subsequent payments with an inaccurate DPC. In addition, the Fiscal Year 2011 Collection Activity Report showed \$16 billion (73 percent) of \$22 billion collected with no DPC. As a result, the data are incomplete and these reports are not useful for determining the effectiveness of specific collection activities, as required by Congress.

Without consistent and accurate application of DPCs, the Collection function, Small Business/Self-Employed Division, cannot fully understand the revenue effectiveness of specific collection activities that cause taxpayers to make subsequent payments on their balance due modules. In addition, the IRS is unable to assess the cost/benefit and effectiveness of certain collection activities. Collection management agrees the potential exists to improve the usefulness of DPCs and had already initiated a study of this issue. The IRS had not completed the study at the time of our review.



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## **Recommendations**

To reduce the number of subsequent payments processed without a DPC, the Director, Collection Policy, Small Business/Self-Employed Division, and the Director, Submission Processing, Wage and Investment Division, should:

**Recommendation 1:** Ensure all IRS actions that are primarily responsible for taxpayers submitting subsequent payments on their balance due accounts have an associated DPC.

**Management's Response:** The IRS's planned corrective action agrees with the intent of our recommendation. The IRS agreed it is important to use associated DPCs correctly for payments when required by established procedures and plans to conduct an expanded DPC review. The review will determine which IRS actions primarily responsible for taxpayers submitting subsequent payments on their balance due accounts may be appropriate to have an associated DPC. The review plan includes an analysis of DPC source documents at Wage & Investment and Small Business/Self-Employed Division's payment processing campuses, a DPC accuracy control review, process analysis of DPC selection, and program analyst and employee interviews. It also includes a review of the use of DPC data for collection program evaluation and cost accounting classification. The IRS will finalize and execute the review plan with assistance of the Research Analysis and Statistics Division, Office of Program Evaluation and Risk Analysis. Upon analysis of the review results, the IRS will determine additional appropriate actions to take related to the recommendation.

**Recommendation 2:** Ensure DPCs are applied consistently and accurately to subsequent payments that require a DPC.

**Management's Response:** The IRS's planned corrective action agrees with the intent of our recommendation. The IRS plans to conduct an expanded DPC review to determine which DPCs are effective and can be used consistently and accurately. IRS management will utilize the review results to make any necessary changes to the use and procedures governing DPCs and will communicate the procedures to their staff to ensure the DPCs are being used appropriately.

**Recommendation 3:** Revise Form 3244 and its instructions to clarify that a DPC is required for all listed TCs.

**Management's Response:** The IRS's planned corrective action agrees with the intent of our recommendation. As part of the analysis of its expanded DPC review, the IRS plans to assess the use, instructions, and effectiveness of the current Form 3244, focusing on identifying changes to improve the clarity and effectiveness of the use of Form 3244.



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## **Designated Payment Code Data Are Insufficient to Measure the Effectiveness of Lien Filings**

The filing of a Federal tax lien is an enforcement action available to the IRS. For all delinquent accounts assigned to the Collection Field function or the Automated Collection System, a determination must be made on whether or not to file a lien to protect the interests of the Federal Government. In the 2009 Annual Report to Congress, the National Taxpayer Advocate suggested the IRS's use of liens may not be furthering the agency's revenue collection objective and the IRS has shown very little interest in evaluating the effectiveness of liens. The report further stated that the IRS's failure to accurately code and track the source of payments precludes it from drawing useful conclusions about the effectiveness of its lien filings. As part of our review of DPCs, we included a test of DPC information to determine the effectiveness of liens. Our analysis showed that DPC information cannot be used to measure the effectiveness of liens.

For the 12-month period ending June 30, 2009, the IRS filed more than 948,000 liens on the assets of taxpayers with a balance due module. From this population, we selected a random sample of 120 balance due modules. Because one lien can be filed for more than one taxpayer's balance due module, we included an additional 116 balance due modules to the sampled modules. Overall, we reviewed 236 balance due modules. For 75 modules (32 percent), the taxpayers submitted 596 subsequent payments after the lien was filed. Our results showed that for these 596 subsequent payments:

- 360 subsequent payments (60 percent) had an appropriate DPC (other than lien). For example, 187 of the subsequent payments had a DPC indicating that the payments were the result of levy action taken against the taxpayer.
- 30 subsequent payments (5 percent) had no DPC, and we determined that these subsequent payments were not due to the filing of the lien.
- 203 subsequent payments (34 percent) had no DPC, and we determined that the subsequent payments could have been due to either the filing of the lien or the filing of a levy.
- 3 subsequent payments (1 percent) had an appropriate DPC that indicated the subsequent payments were the result of the lien.

We identified two conditions that contributed to the poor reliability of DPC data with respect to lien filings:

- Taxpayer motivation was uncertain.
- DPC procedures do not provide for partial subsequent payments resulting from liens.



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**Taxpayer motivation was uncertain**

For the 203 subsequent payments that did not have a DPC, we determined the subsequent payments could have been due to a lien or a levy. It is routine practice to file both a lien and issue a Form 8519 for the same balance due account. Because of the timing of both actions in relation to the subsequent payments, we could not determine which of the enforcement actions was responsible for the taxpayers submitting the subsequent payments. There is also the possibility the taxpayers made the subsequent payments for some other unrelated reason.

After the IRS files a lien, it sends the taxpayer Letter 3172, *Notice of Federal Tax Lien Filing and Your Rights to a Hearing under IRC 6320* (hereafter referred to as a lien notice). The lien notice advises the taxpayer of the lien filing and informs the taxpayer of his/her rights to appeal. The lien notice does not instruct the taxpayer to include the notice with any subsequent payments sent to the IRS. For this reason, the DPC pertaining to liens (DPC 07) is not assigned to subsequent payments received after receipt of a lien notice. When the IRS takes levy action against a taxpayer, it sends the taxpayer Form 8519. However, Form 8519 instructs the taxpayer to include a copy of the notice with the payment. For this reason, DPC 15 (Payments Received With Form 8519, *Taxpayer Copy of Notice of Intent to Levy*) should be applied when a subsequent payment is received with Form 8519 included. This practice allows the IRS to determine that the Notice of Intent to Levy motivated the taxpayer to submit the payment. It is unclear why the IRS makes a distinction between subsequent payments received in response to lien notices and subsequent payments received in response to Notices of Intent to Levy.

**DPC procedures do not provide for partial subsequent payments resulting from liens**

We determined that 150 (74 percent) of 203 subsequent payments with no DPC were installment agreement payments. These installment agreements were established after the filing of the lien, and the lien could have influenced the taxpayer to enter into the installment agreement. However, IRS procedures provide for crediting the influence of liens only to those subsequent payments specifically made to secure release, discharge, withdrawal, or subordination of the lien. The procedures do not allow the use of the DPC that applies to a lien when subsequent payments are made for installment agreements, even if the installment agreement was established because of the lien notice. As a result, DPC data do not provide complete information about liens, which limits the IRS's ability to determine lien effectiveness.



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## **Recommendations**

To improve the reliability of DPC data in measuring the effectiveness of filing liens, the Director, Collection Policy, Small Business/Self-Employed Division, and the Director, Submission Processing, Wage and Investment Division, should:

**Recommendation 4:** Revise Letter 3172 to allow taxpayers to send in the notice with any subsequent payments.

**Management's Response:** IRS management disagreed with this recommendation and stated that it places undue burden on the taxpayer, can potentially confuse procedures relative to Notice of Federal Tax Lien appeals, and replicates the procedures for the IRS's use of Letter 3640, *Lien Payoff Letter*, when a taxpayer requests the balance due on a Notice of Federal Tax Lien. Management stated the primary function of Letter 3172 is to advise the taxpayer of collection due process rights in relation to the Notice of Federal Tax Lien. Expanding the letter to provide specific payoff and release information would make the letter cumbersome for the taxpayer to read and would compromise its effectiveness in explaining the appeal process. Requiring the taxpayer to submit additional paperwork each time they make a payment places an unnecessary burden on the taxpayer.

**Office of Audit Comments:** The primary functions of Letter 3172 are to notify the taxpayer that the IRS filed a lien against the taxpayer and the taxpayer is entitled to a hearing in response to that filing. We did not recommend expanding Letter 3172 to provide specific payoff and release information. Our proposed recommendation makes the procedures for Letter 3172 consistent with those for Form 8519, which instructs the taxpayer to include a copy of the notice with the payment. This process would allow the IRS to associate payments made in response to lien notices in the same manner that it can associate payments made in response to levies. Also, this additional instruction would not be cumbersome for the taxpayer to read or compromise the letter's effectiveness in explaining the appeal process. Notably, Letter 3640, which IRS management refers to in their response, also instructs the taxpayer to send his or her payment with a copy of Letter 3640 to the IRS. Based on the IRS's response to our recommendation, it does not appear IRS management is concerned with the burden Form 8519 or Letter 3640 adds to the taxpayer. Therefore, it is not clear why the IRS has concerns with adding similar instructions to Letter 3172.

**Recommendation 5:** Establish DPCs to account for partial subsequent payments and installment agreement payments made in response to the filing of a lien.

**Management's Response:** IRS management disagreed with this recommendation. Management believes the data yielded by the proposed recommendation would not accurately measure the target metric (*i.e.*, the motivating factor for the payment). The



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IRS, recognizing the limitation of using DPC data to measure the effectiveness of lien filing, has used research studies to measure the impact of lien filing.

**Office of Audit Comments:** IRS management's prior review of DPC results also showed that the DPC for liens was applied only when a taxpayer fully paid a liability expressly to obtain a lien release. A unique DPC for installment agreements established as a result of a lien filing would allow the IRS to associate the payments with the lien filing. The prior IRS research studies that we reviewed during this audit measure the impact of lien filing by focusing on the change in the taxpayer's balance due account amount over time. Any changes over time could have been caused by different factors not related to the filing of the lien. Our recommendation is intended to allow the IRS to measure the impact of filing liens by identifying specific subsequent payments made by the taxpayer due to the filing of a lien.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

Our objective was to determine whether the IRS is consistent and accurate in applying DPCs to subsequent payments received on balance due accounts.<sup>1</sup> To accomplish the objective, we:

- I. Evaluated IRS controls, policies, and procedures pertaining to DPCs.
  - A. Reviewed IRS procedures.
  - B. Reviewed management information system reports on DPCs to assess their reliability in showing the effectiveness of specific collection activities.
  - C. Assessed the effectiveness of payment voucher documents (Form 809, *Receipt for Payment of Taxes*, and Form 3244, *Payment Posting Voucher*) in determining the appropriate DPC to apply to subsequent payments.
- II. Determined whether the IRS consistently and accurately applied DPCs to subsequent payments that were processed using TCs 640, 670, 680, 690, 694, and 700.
  - A. Analyzed data from an Individual Master File extract of TCs 640, 670, 680, 690, 694, and 700 posted during the week ending April 3, 2010. We also determined the frequency of use for DPCs “00” and “99” or where the DPC field was blank.
  - B. Selected a statistically valid sample of 271 transactions with TCs 640, 670, 680, 690, 694, and 700 from the extract in Step II.A. from a population of 880,848 transactions posted during the week ending April 3, 2010. The sample was selected using a random number generator. We used a statistical sample because we wanted to project the number of cases with errors. Based on an error rate of 85 percent for the first 120 cases, we revised our sample size to 138:
    - Population – 880,848
    - Confidence Level – 90 percent
    - Expected Rate of Occurrence – 85 percent
    - Precision Rate –  $\pm 5$  percent.
  1. Validated the computer-processed data in our sample by comparing the sample information to that found on the Integrated Data Retrieval System (IDRS) using command codes. We determined the data were sufficiently reliable for this audit.

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<sup>1</sup> See Appendix VII for a glossary of terms.



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2. Determined whether a DPC was applied consistently and accurately when TCs 640, 670, 680, 690, 694, and 700 were used to post the subsequent payment.
  3. Using various IDRS command codes, researched the applicable taxpayer balance due module to determine if the applied DPC accurately described why the taxpayer submitted the payment on the balance due account.
  4. For cases where the DPC was not accurate, blank, or contained "00" or "99," researched the IDRS to determine the DPC that best described why the taxpayer submitted the payment.
  5. Analyzed data from an Individual Master File extract to determine that there were 48,554,415 subsequent payments that posted with TCs 640, 670, 680, 690, 694, and 700 during Fiscal Year 2010. We multiplied the 48,554,415 by the point estimate for a two-sided 90 percent confidence interval exception rate of 76.81 percent to calculate the 37 million subsequent payments we estimate were processed with no DPC during Fiscal Year 2010.
  6. Analyzed data from an Individual Master File extract to determine that there were 48,554,415 subsequent payments that posted with TCs 640, 670, 680, 690, 694, and 700 during Fiscal Year 2010. We multiplied the 48,554,415 by the point estimate for a two-sided 90 percent confidence interval exception rate of 7.97 percent to calculate the 4 million subsequent payments we estimate were processed with an inaccurate DPC during Fiscal Year 2010.
- III. Determined whether the IRS consistently and accurately applied DPCs to subsequent payments submitted because of a Federal tax lien.
- A. Selected a random sample of 120 balance due modules on which the IRS filed a lien. We selected the sample from an Automated Lien System extract of 948,051 liens filed by the IRS nationwide between July 1, 2008, and June 30, 2009. The sample was selected using a random number generator. We used a random sample to ensure every lien case had an equal chance of being selected from the entire population.
    1. The Automated Lien System data used to select our sample were validated as part of the Fiscal Year 2010 statutory review of liens and we determined the data were sufficiently reliable for this audit.
    2. Using various IDRS command codes, researched the applicable taxpayer tax module to determine:
      - a. The status of the Federal tax lien.
      - b. The status of the unpaid tax liability pertaining to the Federal tax lien.
      - c. The DPCs applied to all subsequent payments.



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3. Determined whether a DPC was applied consistently and accurately when TCs 640, 670, 680, 690, 694, and 700 were used to post the subsequent payment submitted because of a Federal tax lien.
4. Using various IDRS command codes, researched the applicable tax module and determined if the applied DPC accurately described why the taxpayer submitted the payment on the balance due account.
5. For cases where the DPC is not accurate, blank, or contained “00” or “99,” researched the IDRS to determine the DPC that best described why the taxpayer submitted the payment.

**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: the Small Business/Self-Employed Division collection policies, procedures, and practices for appropriately applying DPCs to subsequent payments received. We evaluated these controls by interviewing management and reviewing samples of subsequent payments requiring DPCs.



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**Appendix II**

*Major Contributors to This Report*

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Carl Aley, Director  
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Meaghan Tocco, Lead Auditor  
Nicole DeBernardi, Auditor  
Joel Weaver, Auditor  
Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant



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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Commissioner, Wage and Investment Division SE:W  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Deputy Commissioner, Wage and Investment Division SE:W  
Director, Collection Policy, Small Business/Self-Employed Division SE:S:C  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaisons:  
    Commissioner, Small Business/Self-Employed Division SE:S  
    Commissioner, Wage and Investment Division SE:W



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## Appendix IV

### *Outcome Measure*

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

#### **Type and Value of Outcome Measure:**

- Reliability of Information – Potential; 676,593 subsequent payments<sup>1</sup> reported on the Fiscal Year 2010 Collection Activity Report with no DPC and 70,213 subsequent payments included on the Fiscal Year 2010 Collection Activity Report with an inaccurate DPC (see page 2).

#### **Methodology Used to Measure the Reported Benefit:**

From a statistically valid sample of 138 transactions from an Individual Master File extract of transaction codes posted during the week ending April 3, 2010, for which a DPC was required, we found 104 (75 percent) subsequent payments that were processed without a DPC and 11 (8 percent) that were processed with an inaccurate DPC. The sample was selected based on a confidence level of 90 percent, a precision rate of  $\pm 5$  percent, and an expected rate of occurrence of 85 percent. We projected the findings to the total population of 880,848 subsequent payments with TCs for which a DPC is required that posted during the week ending April 3, 2010.

- We estimate 676,593 subsequent payments were processed with no DPC and are 90 percent confident the number of subsequent payments processed without a DPC is between 624,356 and 728,831.
- We estimate 70,213 subsequent payments were processed with an inaccurate DPC and are 90 percent confident the number of subsequent payments processed with an inaccurate DPC is between 36,689 and 103,736.

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<sup>1</sup> See Appendix VII for a glossary of terms.



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**Appendix V**

*List of Designated Payment Codes  
Used by the Collection Field Function*

<b>DPC</b>	<b>Definition</b>
00	Designated payment indicator is not present on posting voucher
01	Non-Trust Fund payment (alternate definition for Master File Tax Code 55 only: Payment applied to penalty other than Trust Fund Recovery Penalty)
02	Trust Fund payment (alternate definition for Master File Tax Code 55 only: Payment applied to Trust Fund Recovery Penalty)
03	Bankruptcy, undesignated payment
04	Levy on State income tax refund (prior to 07/22/1998)
05	Notice of levy
06	Seizure and sale
07	Federal tax lien
08	Suit
09	Offer in compromise
10	Manually monitored installment agreement
11	Bankruptcy payment, designated to trust fund
12	Cash bond credit (allowed with Transaction Code 640 only)
13	Payment in response to reminder notice, deferred taxes
14	Authorization given by taxpayer to apply payment to expired Collection Statute Expiration Date account
15	Payments received with Form 8519, <i>Taxpayer's Copy of Notice of Levy</i>
24	Payment with amended return
31	Exclude payment from systemic cross-reference processing to allow treatment of each spouse differently on a joint return (Master File Tax Code 31)



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<b>DPC</b>	<b>Definition</b>
33	Offer in compromise \$150.00 application fee
34	Offer in compromise 20% lump sum/initial periodic payment
35	Offer in compromise subsequent payments made during the offer investigation
99	Miscellaneous payment other than above

*Source: Internal Revenue Manual<sup>1</sup> pertaining to the application of DPCs.*

<sup>1</sup> Internal Revenue Manual 5.1.2.8.1.4 thru 5.1.2.8.1.6 (July 13, 2010).



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**Appendix VI**

*List of Transaction Codes Requiring  
Designated Payment Codes*

TC	Description	Required DPCs
640	Advanced Payment of Determined Deficiency or Underreporter Proposal	00, 01, 02, 12, or 99
670	Subsequent Payment	00 through 11, or 99
680	Designated Payment of Interest	00, 01, 02, 06, 07, or 99
690	Designated Payment of Penalty	00, 01, 02, 06, 07, 09, or 99
694	Designated Payment of Fees and Collection Costs	00, 01, 03, 06, or 07
700	Credit Applied	00 or 06

Source: Internal Revenue Manual<sup>1</sup> pertaining to the application of DPCs.

<sup>1</sup> Internal Revenue Manual 3.11.10.5.10(1) (January 1, 2012).



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## Appendix VII

### *Glossary of Terms*

**Area Office** – A geographic organizational level used by IRS business units and offices to help specific types of taxpayers understand and comply with tax laws and issues.

**Automated Collection System** – A telephone contact system through which telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

**Automated Lien System** – The system that stores Federal tax lien and collection due process document data; uses information and provides the tools for users to create, release, refile, and withdraw liens; revokes releases; processes collection due process letters; and prints lien and collection due process letter facsimiles.

**Balance Due Account** – A balance due account occurs when the taxpayer has an outstanding liability for taxes, penalties, and/or interest.

**Campus** – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

**Collection Activity Reports** – A group of reports providing management information to field and Headquarters Collection officials. The reports reflect activity associated with taxpayer delinquency accounts; the issuance of taxpayer delinquency inquiries; and the issuance, disposition, and inventories of installment agreements, as well as collection-related payments.

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

**Command Code** – A five-character abbreviation for a particular inquiry or action requested through the IDRS. Each command code is used for a specific purpose.

**Electronic Federal Tax Payment System** – The system that processes electronic Federal tax deposits and all other types of business and individual payments submitted electronically.

**Examination Field Office** – Area offices consisting of revenue agents who handle office examinations of individuals, partnerships, and corporations.

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

**Installment Agreement** – Arrangements by which the IRS allows taxpayers to pay liabilities over time.



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

**Integrated Data Retrieval System** – The IRS computer system that is capable of retrieving and updating stored taxpayer information. It works in conjunction with a taxpayer's account records.

**IRS Oversight Board** – A nine-member independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the Internal Revenue laws and to provide experience, independence, and stability to the IRS so it may move forward in a cogent, focused direction.

**Job Aid for Form 3244** – Guidelines for Collection Field function personnel to follow when completing Form 3244, *Payment Posting Voucher*. These guidelines were created to align with current Collection function procedures.

**Levy** – A method used by the IRS to collect outstanding taxes from sources such as bank accounts and wages.

**Lien** – An encumbrance on property or rights to property as security for outstanding taxes.

**Module** – Refers to each tax return filed by the taxpayer for a specific period (year or quarter) during a calendar year for each type of tax.

**Notice of Intent to Levy (Form 8519)** – Notice advising the taxpayer that the IRS intends to levy on certain assets, and what steps the taxpayer needs to take within 30 days to prevent the IRS from taking this action.

**Offer in Compromise** – An agreement between a taxpayer and the IRS that settles the taxpayer's tax liabilities for less than the full amount owed.

**Queue** – An automated holding file for unassigned inventory of delinquent cases for which the Collection function does not have enough resources to assign immediately for contact.

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

**Seizure** – The taking of a taxpayer's property to satisfy his or her outstanding tax liability.

**Statutory Notice** – A notice of deficiency that explains the purpose of the notice, the amount of the deficiency, the taxpayer's options, a waiver to allow the taxpayer to agree to the additional tax liability, and a statement showing how the deficiency was computed.



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**Submission Processing Center** – The data processing arm of the IRS. The sites process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

**Subsequent Payment** – A payment on a taxpayer account for a tax return that was filed but not fully paid.

**Taxpayer Assistance Center** – IRS offices with employees who provide face-to-face assistance to taxpayers by answering questions and resolving account-related issues. These offices include walk-in sites where taxpayers can obtain answers to both account and tax law questions, as well as receive assistance in preparing their tax returns.

**Transaction Code** – Three-digit codes used to identify a processed transaction and to maintain a history of actions posted to a taxpayer's account on the Master File.

**Underreporter Program** – The system that matches items reported on an individual's income tax return to information supplied to the IRS from outside sources (such as employers, banks, and credit unions) to determine whether the taxpayer's tax return reflects the correct amounts, ensuring the tax amount is correct.



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**Appendix VIII**

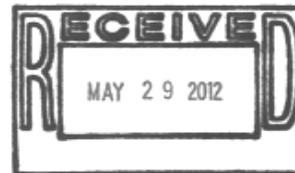
*Management's Response to the Draft Report*



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

MAY 28 2012



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink *Faris R Fink*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Designated Payment Codes Are Inaccurate  
and Ineffective (Audit # 201130015)

Thank you for the opportunity to review your draft audit report, "Designated Payment Codes Are Inaccurate and Ineffective." We recognize that improvements can be made in the use of Designated Payment Codes (DPC). As noted in your report, IRS had already initiated a review, which will be expanded, to assist in this regard. The IRS will use results from this review to make appropriate changes to the use of DPC codes. We agree that it is important to improve our understanding of why taxpayers make payments and we will use information from the review to identify and implement actions that will achieve this goal without unnecessarily increasing taxpayer burden.

DPCs are intended to identify some of the collection activities that precede the payment received. While DPCs can be useful, there are limitations to the scope of their utility. In fact, as pointed out in your report, procedures between field and campus employees differ. Therefore, we will use the review mentioned above to determine the appropriate use of DPCs and take actions accordingly.

Care must be taken in the use of DPC data since the taxpayer's motivation for making a payment can rarely be isolated to a single factor. The draft audit report cited DPC accuracy findings. The TIGTA audit steps did not include review of the payment source documents, making the determination of accuracy open for further analysis. Based on available information, we do not concur with the accuracy findings outlined in the report.

As stated above, the IRS is conducting an in-depth review to determine the most effective use of DPCs and how DPCs can assist the IRS in performing additional analyses and breakouts below the summary program levels of collection activities. Among other data and analysis, this review will include an analysis of payment source documents. The IRS expects to complete the review by December 31, 2012. We will utilize the review results to make any necessary changes to the use and procedures



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governing DPCs and will communicate any changes to the staff at that time to ensure accurate and appropriate use. Any changes will ensure that the necessary balance between the IRS' need for accurate data and the burden placed on the taxpayer is maintained. We will further consider your recommendations as we complete this study and analyze the results. Because we believe further study of the source documents and the appropriate use of DCPs is warranted, we cannot concur with the stated Outcome Measures at this time.

The attachment provides detailed responses to the recommendations. If you have any questions, please contact me, or a member of your staff may contact Scott Reisher, Director, Collection Policy at (202) 283-7361.



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**Attachment**

**RECOMMENDATION 1:**

Ensure that all IRS actions that are primarily responsible for taxpayers submitting subsequent payments on their balance due accounts have an associated DPC.

**CORRECTIVE ACTION:**

We agree it is important to use associated DPCs correctly for payments when required by established procedures. As stated in our response memorandum, IRS will conduct an expanded DPC review. The review will determine which IRS actions, primarily responsible for taxpayers submitting subsequent payments on their balance due accounts, may be appropriate to have an associated DPC. The review plan includes an analysis of DPC source documents at Wage & Investment and Small Business/Self Employed payment processing campuses, a DPC accuracy control review, process analysis of DPC selection, program analyst and employee interviews, and a review of the use of DPC data for collection program evaluation and cost accounting classification. IRS will finalize and execute the review plan with assistance of the Research Analysis and Statistics Division, Office of Program Evaluation and Risk Analysis. Upon analysis of the review results, we will determine additional appropriate actions to take related to your recommendation.

**IMPLEMENTATION DATE:**

April 15, 2013

**RESPONSIBLE OFFICIAL:**

The Director, Collection Policy, Enterprise Collection Strategy, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION(S) MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 2:**

Ensure DPCs are applied consistently and accurately to subsequent payments that require a DPC.

**CORRECTIVE ACTION:**

We agree that the consistent and appropriate application of DPCs are important. As explained in detail in the corrective action for recommendation 1 above, the IRS will conduct an expanded DPC review to determine which DPCs are effective and can be used consistently and accurately. We will utilize the review results to make any necessary changes to the use and procedures governing DPCs and will communicate the procedures to our staff to ensure the DPCs are being used appropriately.



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**IMPLEMENTATION DATE:**

April 15, 2013

**RESPONSIBLE OFFICIAL:**

The Director, Collection Policy, Enterprise Collection Strategy, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION(S) MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 3:**

Revise Form 3244 and its instructions to clarify that a DPC is required for all listed TCs.

**CORRECTIVE ACTION:**

As part of the analysis of our expanded DPC review (explained above), we will assess the use, instructions, and effectiveness of the current Form 3244, focusing on identifying changes to improve the clarity and effectiveness of the use of Form 3244.

**IMPLEMENTATION DATE:**

April 15, 2013

**RESPONSIBLE OFFICIAL:**

The Director, Collection Policy, Enterprise Collection Strategy, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION(S) MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 4:**

Revise Letter 3172, *Notice of Federal Tax Lien Filing and Your Rights to a Hearing under IRC 6320* to allow taxpayers to send in the notice with any subsequent payments.

**CORRECTIVE ACTION:**

We do not agree with the recommendation as it places undue burden on the taxpayer, can potentially confuse procedures relative to Notice of Federal Tax Lien (NFTL) appeals, and replicates the procedures for the Service's use of Letter 3640, Lien Payoff Letter, when a taxpayer requests the balance due on an NFTL.



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The primary function of Letter 3172 is to advise the taxpayer of the Collection Due Process rights in relation to the NFTL. Expanding the letter to provide specific payoff and release information would make the letter cumbersome for the taxpayer to read and would compromise its effectiveness in explaining the appeal process. Requiring the taxpayer to submit additional paperwork each time they make a payment places an unnecessary burden on the taxpayer.

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION(S) MONITORING PLAN:**

N/A

**RECOMMENDATION 5:**

Establish DPCs to account for partial subsequent payments and installment agreement payments made in response to the filing of a lien.

**CORRECTIVE ACTION:**

We do not agree with this recommendation because we believe the data yielded by the proposed recommendation would not accurately measure the target metric (i.e., the motivating factor for the payment). The Service, recognizing the limitation of using DPC data to measure the effectiveness of lien filing, has used research studies to measure the impact of lien filing.

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION(S) MONITORING PLAN:**

N/A