

**GAO**

**Testimony**

Before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

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**TAX COMPLIANCE**

**Thousands of Federal Contractors Abuse the Federal Tax System**

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# TAX COMPLIANCE

## Thousands of Federal Contractors Abuse the Federal Tax System

Highlights of [GAO-07-742T](#), a testimony before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

### Why GAO Did This Study

Since 1990, GAO has periodically reported on high-risk federal programs that are vulnerable to fraud, waste, and abuse. Two such high-risk areas are managing federal contracts more effectively and assessing the efficiency and effectiveness of federal tax administration. Weaknesses in the tax area continue to expose the federal government to significant losses of tax revenue and increase the burden on compliant taxpayers to fund government activities. Over the last several years, the Senate Permanent Subcommittee on Investigations requested GAO to investigate Department of Defense (DOD), civilian agency, and General Services Administration (GSA) contractors that abused the federal tax system. Based on that work GAO made recommendations to executive agencies including to improve the controls over levying payments to contractors with tax debt—many of which have been implemented—and referred 122 contractors to IRS for further investigation and prosecution.

As requested, this testimony will highlight the key findings from prior testimonies and related reports. This testimony will (1) describe the magnitude of tax debt owed by federal contractors, (2) provide examples of federal contractors involved in abusive and potentially criminal activity related to the federal tax system, and (3) describe current law and proposed federal regulations for screening contractors with tax debts prior to the award of a contract.

[www.gao.gov/cgi-bin/getrpt?GAO-07-742T](http://www.gao.gov/cgi-bin/getrpt?GAO-07-742T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gregory Kutz at (202) 512-7455 or [kutzg@gao.gov](mailto:kutzg@gao.gov).

### What GAO Found

In our previous audits and related investigations, we reported that thousands of federal contractors had substantial amounts of unpaid federal taxes. Specifically, about 27,000 DOD contractors, 33,000 civilian agency contractors, and 3,800 GSA contractors owed about \$3 billion, \$3.3 billion, and \$1.3 billion in unpaid taxes, respectively. These estimates were understated because they excluded federal contractors that understated their income or did not file their tax returns; however, some contractors may be counted in more than one of these groups.

As part of this work, we conducted more in-depth investigations of 122 federal contractors and in all cases found abusive and potentially criminal activity related to the federal tax system. Many of these 122 contractors were small, closely held companies that provided a variety of goods and services, including landscaping, consulting, catering, and parts or support for weapons and other sensitive programs for many federal agencies including the departments of Defense, Justice, and Homeland Security. These contractors had not forwarded payroll taxes withheld from their employees and other taxes to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Furthermore, some company owners diverted payroll taxes for personal gain or to fund their businesses. A number of owners or officers of the 122 federal contractors owned significant personal assets, including a sports team, multimillion dollar houses, a high-performance airplane, and luxury vehicles. Several owners gambled hundreds of thousands of dollars at the same time they were not paying the taxes that their businesses owed.

#### Examples of Abusive and Potentially Criminal Activity

Type of business	Unpaid tax debt	Payments to contractor	Contractor activity
Custodial services for DOD	Over \$1 million	Over \$1 million	Owner bought a boat, several cars, and a home outside the country.
Temporary help for civilian agency	Nearly \$900,000	Over \$1 million	Owner followed pattern of over 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts.
Security under GSA contract	Over \$9 million	Over \$1 million	Owner made cash withdrawals to fund an unrelated business and purchase a men's gold bracelet worth over \$25,000.

Source: Previous GAO testimonies.

Federal law, as implemented by the Federal Acquisition Regulation (FAR), does not now require contractors to disclose tax debts or contracting officers consider tax debts in making contracting decisions. Federal contractors that do not pay tax debts could have an unfair competitive advantage in costs because they have lower costs than tax compliant contractors on government contracts. GAO's investigation identified instances in which contractors with tax debts won awards based on price differential over tax compliant contractors.

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss our past work on government contractors that have failed to pay their federal taxes. Our remarks today are based on work that we have performed over the last several years for the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs. In hearings held before that Subcommittee over the last several years,<sup>1</sup> we testified that federal contractors at the Department of Defense (DOD), selected civilian agencies, and the General Services Administration (GSA) abused the federal tax system with little consequence. As requested, this testimony highlights the key findings from those testimonies and related reports. Specifically, this testimony will (1) describe the magnitude of tax debts that were owed by federal contractors at the time of our previous testimonies and related reports, (2) provide examples of federal contractors involved in abusive and potentially criminal activity related to the federal tax system, and (3) discuss current law and proposed changes to the Federal Acquisition Regulation (FAR) concerning contractor tax debt.

To address our objectives, we reviewed prior findings from GAO audits of federal contractors that have abused the federal tax system. Our audit work was performed in accordance with U.S. generally accepted government auditing standards. We performed our investigative work in accordance with standards prescribed by the President's Council on Integrity and Efficiency.

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## Summary

In each of our audits and related investigations, we found thousands of federal contractors that had substantial amounts of unpaid federal taxes. Specifically, we testified that about 27,000 DOD contractors, 33,000 civilian agency contractors, and 3,800 GSA contractors owed about \$3

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<sup>1</sup> GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-414T](#) (Washington, D.C.: Feb. 12, 2004); *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-683T](#) (Washington, D.C.: June 16, 2005); and *Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System*, [GAO-06-492T](#) (Washington, D.C.: Mar. 14, 2006).

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billion, \$3.3 billion, and \$1.4 billion in federal taxes, respectively.<sup>2</sup> Much of the unpaid taxes were payroll taxes.<sup>3</sup> However, each estimate of contractors' unpaid federal taxes is understated because IRS data do not reflect all amounts owed. Specifically, our estimates do not include amounts owed by contractors who have not filed tax returns or that have failed to report the full amount of taxes due (referred to as nonfilers and underreporters) and for which Internal Revenue Service (IRS) has not determined the amount owed.

We conducted more in-depth case study investigations of 122 federal contractors that appeared to demonstrate abusive or potentially criminal activity related to the federal tax system. We found that, in fact, each of the 122 federal contractors was involved in abusive and potentially criminal activity related to the tax system. Many of these case-study contractors were small, closely held companies that operated in wage-based industries; such as security; building maintenance; computer services; and personnel services for GSA, DOD, and the Departments of Homeland Security, Justice, and Veterans Affairs. The types of contracts that were awarded to these federal contractors included products or services related to weapon components, space and aircraft parts, law enforcement, disaster relief, and national security. Many were established businesses (such as corporations) that owed payroll taxes that include amounts withheld from their employees. However, rather than fulfill their role as "trustees" of these funds and forward them to IRS as required by law, these federal contractors diverted the funds for other purposes.<sup>4</sup>

At the same time that they were not paying their federal taxes, many individuals associated with our 122 cases bought or owned significant personal assets, including a sports team, a high-performance airplane, commercial properties, multimillion dollar homes, and luxury vehicles. In one case, the owner of a federal contracting firm purchased a number of

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<sup>2</sup> Because federal contractors may do business with more than one federal agency, some federal contractors that owe tax debts may be included in more than one analysis concerning DOD, GSA, and civilian federal contractors that abuse the federal tax system. Because our analysis for each segment covered different time periods, we cannot provide an overall number of federal contractors with tax debts and the magnitude of such debts.

<sup>3</sup> Payroll taxes include amounts withheld from employee wages for Social Security, Medicare, and individual income taxes.

<sup>4</sup> Willful failure to remit payroll taxes is a criminal felony offense while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense. 26 U.S.C. §§ 7202, 7215 and 7512 (b).

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multimillion-dollar properties, an unrelated business, and a number of luxury vehicles while his business failed to remit to IRS a substantial amount of payroll taxes. Several owners also gambled hundreds of thousands of dollars at the same time they were not paying the federal taxes that their businesses owed. Further, several of the owners or officers of the businesses with unpaid federal taxes were investigated or indicted for nontax offenses such as embezzlement, fraud, and money laundering.

Federal law does not prohibit a contractor with unpaid federal taxes from receiving contracts from the federal government. Currently, regulations calling for federal agencies to do business only with responsible contractors do not require contracting officers to consider a contractor's tax delinquency. According to the FAR, a responsible prospective contractor is a contractor that meets certain specific criteria,<sup>5</sup> including having adequate financial resources and a satisfactory record of integrity and business ethics. However, the FAR does not currently require contracting officers to take into account a contractor's tax debt when assessing whether a prospective contractor is responsible. As a result, the FAR does not currently require contracting officers to determine if federal contractors have federal unpaid taxes at the time a contract is awarded. Further, federal law generally prohibits the disclosure of taxpayer data to contracting officers. Thus, contracting officers do not have access to tax data directly from IRS unless the contractor provides consent. In March 2007, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council proposed to amend the FAR to require prospective contractors to disclose whether they have, within a 3-year period preceding their offer, been notified of any delinquent taxes that remain unsatisfied or whether they have received notice of any tax lien filed against them that remains unsatisfied or has not been released.<sup>6</sup> The proposed rule also includes, among other things, delinquent taxes and unresolved liens as causes for suspension or debarment.

Finally, we also reported that for wage-based businesses that provide goods and services, federal contractors with unpaid federal taxes have an unfair advantage in price competition when competing against other businesses for federal contracts. Companies that do not pay their payroll tax, which is typically over 15 percent of the employees' wages, would

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<sup>5</sup> FAR 2.101; 9.104-1

<sup>6</sup>Representations and Certifications – Tax Delinquency, 72 Fed. Reg. 15093 (proposed Mar. 30, 2007) (to be codified at 48 C.F.R. pts. 9 and 52).

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have a significantly lower costs advantage and therefore have a substantive competitive advantage over their competitors. For example, we identified instances in which companies that had unpaid payroll taxes were competitively awarded contracts over companies that had paid their federal taxes.

As result of the work we performed for the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs we made numerous recommendations to executive agencies to improve the controls over levying payments to contractors with tax debt, many of which the agencies have implemented. We also referred 122 contractors to IRS for further investigation and prosecution.

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

In each of our audits and related investigations, we found thousands of federal contractors that owed billions of dollars of federal taxes. Specifically,

- In February 2004, we testified that DOD and IRS records showed that about 27,000 DOD contractors owed nearly \$3 billion in federal taxes. About 42 percent of this \$3 billion represented unpaid payroll taxes.
- In June 2005, we testified that about 33,000 civilian agency federal contractors owed over \$3.3 billion in federal taxes. Over a third of the \$3.3 billion represented unpaid payroll taxes.
- In March 2006, we testified that over 3,800 GSA contractors owed about \$1.4 billion in federal taxes. About one-fifth of the \$1.4 billion represented unpaid payroll taxes.

Because federal contractors may do business with more than one federal agency, some federal contractors that owe tax debts may be included in more than one analysis concerning DOD, GSA, and civilian federal contractors that abuse the federal tax system.

In each of our audits, we found that government contractors owed a substantial amount of unpaid payroll taxes. Employers are subject to civil and criminal penalties if they do not remit payroll taxes to the federal government. When an employer withholds taxes from an employee's wages, the employer is deemed to have a fiduciary responsibility to hold these funds "in trust" for the federal government until the employer makes a federal tax deposit in that amount. To the extent these withheld amounts are not forwarded to the federal government, the employer is liable for these amounts, as well as the employer's matching Federal Insurance

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Contribution Act contributions for Social Security and Medicare. Individuals employed by the contractor (e.g., owners or officers) may be held personally liable for the withheld amounts not forwarded and assessed a civil monetary penalty known as a trust fund recovery penalty.<sup>7</sup> Willful failure to remit payroll taxes can also be a criminal felony offense punishable by imprisonment of up to 5 years,<sup>8</sup> while the failure to properly segregate payroll tax funds can be a criminal misdemeanor offense punishable by imprisonment of up to a year.<sup>9</sup> The law imposes no penalties upon an employee for the employer's failure to remit payroll taxes since the employer is responsible for submitting the amounts withheld. The Social Security and Medicare trust funds are subsidized or made whole for unpaid payroll taxes by the federal government's general fund. Thus, personal income taxes, corporate income taxes, and other government revenues are used to pay for these shortfalls to the Social Security and Medicare trust funds.

Although each of our estimates for taxes owed by federal contractors was a significant amount, it understates the full extent of unpaid taxes owed by these contractors. The IRS tax database reflected only the amount of unpaid federal taxes either reported on a tax return or assessed by IRS through its various enforcement programs. The IRS database did not reflect amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed tax amounts due. Our analysis did not attempt to account for businesses or individuals that did not file required payroll or other tax returns or that purposely underreported income and were not specifically identified by IRS as owing the additional federal taxes. According to IRS, underreporting of income accounted for more than 80 percent of the estimated \$345 billion annual gross tax gap.<sup>10</sup>

As result of the work we performed for the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs we made numerous recommendations to DOD and civilian agencies to improve their controls over levying payments to contractors with tax debt. Many of those recommendations have been

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<sup>7</sup> 26 U.S.C. § 6672.

<sup>8</sup> 26 U.S.C. § 7202.

<sup>9</sup> 26 U.S.C. § 7215 and 26 U.S.C. § 7512 (b).

<sup>10</sup> According to IRS, nonfilers and underpayment of taxes comprised the rest of the gross tax gap.

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implemented and have resulted in additional collections of unpaid tax debt. We also referred 122 contractors to IRS for further investigation and prosecution.

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## Examples of Federal Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

In our previous testimonies, we discussed the results of our in-depth audits and related investigations of 122 federal contractors with outstanding tax debt. For each of these 122 federal contractors, we found instances of abusive or potentially criminal activity related to the federal tax system.<sup>11</sup> Many of our case study contractors were small, closely held companies that operated in wage-based industries, such as security, weapon components, space and aircraft parts, building maintenance, computer services, and personnel services. These 122 federal contractors provided goods and services to a number of federal agencies including DOD, GSA, the National Aeronautics and Space Administration, and the Departments of Homeland Security, Justice, and Veterans Affairs. The types of contracts that were awarded to these contractors also included products or services related to variety of government functions including law enforcement, disaster relief, and national security.

Most of the contractors in our case studies owed payroll taxes, with some federal tax debts dating back nearly 20 years. However, rather than fulfilling their role as “trustees” and forwarding these funds to IRS, many of these federal contractors used the funds for personal gain or to fund their contractor operations.

Our investigations also revealed that some owners or officers of our case study federal contractors with unpaid taxes were associated with other businesses that had unpaid federal taxes. For example, we reported that one of our case study contractors had a 20-year history of opening a business, failing to remit taxes withheld from employees to IRS, and then closing the business, only to start the cycle all over again and incur more tax debts almost immediately through a new business. We also found that a number of owners or officers of our case study contractors had significant personal assets, including a sports team, commercial properties, multimillion dollar houses, and luxury vehicles. Several owners also gambled hundreds of thousands of dollars at the same time they were not paying the taxes that their businesses owed. Despite owning

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<sup>11</sup> We considered activity to be abusive when a federal contractor’s actions or inactions, though not illegal, took advantage of the existing tax enforcement and administration system to avoid fulfilling federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable.



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substantial assets and gambling significant amounts of money, the owners or officers did not ensure the payment of the delinquent taxes of their businesses, and sometimes did not pay their own individual income taxes. Table 1 provides summary information on 10 of our 122 case study contractors that we discussed in our previous testimonies and related reports.

**Table 1: Summary Information on 10 Federal Contractors with Unpaid Federal Taxes**

Case	Nature of work	Federal payments <sup>a</sup>	Unpaid federal tax <sup>b</sup>	Comments
Case 1	Base support and custodial services for DOD	Over \$1 million	Nearly \$10 million	<ul style="list-style-type: none"> <li>State tax authorities levied the business bank account.</li> <li>The owner borrowed nearly \$1 million from the business.</li> <li>The owner bought a boat, several cars, and a home outside the United States</li> <li>The business was dissolved in 2003 and transferred its employees to a relative's business, where it submitted invoices and received payments from DOD on a previous contract through August 2003.</li> </ul>
Case 2	Research services for DOD	Up to \$100,000	Over \$700,000	<ul style="list-style-type: none"> <li>DOD awarded the business a contract in 2002 for nearly \$800,000.</li> <li>Owner had over \$1 million in loans related to cars, real estate, and recreational activities.</li> <li>Owner owned a high-performance airplane.</li> </ul>
Case 3	Vehicle repair services for DOD	Over \$100,000	Over \$100,000	<ul style="list-style-type: none"> <li>The business was investigated for paying employee wages in cash.</li> <li>Owner purchased million dollar home and luxury sports car while owing a substantial tax liability.</li> <li>Owner owed child support.</li> </ul>
Case 4	Health-care-related services for Departments of Veterans Affairs and Health and Human Services	Over \$100,000	Over \$18 million	<ul style="list-style-type: none"> <li>Business was affiliated with many other health care-related facilities, including nursing and convalescent homes.</li> <li>Business and related entities owed taxes covering over 80 tax periods.</li> <li>Owner purchased multimillion-dollar properties, an unrelated business, and a number of luxury vehicles at the same time the business was not fully paying its payroll taxes.</li> <li>Owner owned other real estate holdings including residential and commercial properties valued in the tens of millions of dollars.</li> </ul>
Case 5	Security guard services to Departments of Homeland Security and Veterans Affairs	Over \$100,000	Over \$400,000	<ul style="list-style-type: none"> <li>Business had not filed all required tax returns for several years.</li> <li>Business owed taxes covering over 25 tax periods. Tax debt amount also included owner's individual income taxes totaling tens of thousands of dollars.</li> <li>Owner had repeatedly failed to file personal income tax returns.</li> <li>Owner diverted unpaid payroll taxes to a foreign bank account to build a house overseas.</li> </ul>
Case 6	Armed security guard services to several federal agencies including the Department of Justice and the Environmental Protection Agency	Over \$100,000	Nearly \$400,000	<ul style="list-style-type: none"> <li>Business owed over \$200,000 in payroll taxes for almost 10 tax periods.</li> <li>Business did not file income tax returns in the early 2000s.</li> <li>Officer of the business was convicted for stealing hundreds of thousands of dollars from the business.</li> <li>The owner was indicted for embezzlement and money laundering.</li> </ul>

Case	Nature of work	Federal payments <sup>a</sup>	Unpaid federal tax <sup>b</sup>	Comments
Case 7	Payroll and temporary employment services to the Department of Housing and Urban Development	Over \$1 million	Nearly \$900,000	<ul style="list-style-type: none"> <li>The owner's history of delinquency stretched nearly 20 years and covered multiple businesses.</li> <li>The owner typically incurred payroll taxes on one business, was assessed a trust fund penalty on that business but made no or little payments, closed the business, started another company, and repeated the same pattern. In at least one case, the owner closed the business and immediately established a new business with a similar name at the same address that provided the same services.</li> <li>The owner rented office space in an expensive area of a major metropolitan city and purchased a luxury automobile at the same time the business was not remitting all of the payroll taxes.</li> </ul>
Case 8	Security services under a GSA contract	Over \$1 million	Over \$9 million	<ul style="list-style-type: none"> <li>Business filed for bankruptcy in 2000s.</li> <li>At the time business was not remitting all of its payroll taxes to IRS, the owner withdrew large amounts of funds from the company for personal use.</li> <li>Owner used over \$100,000 on gambling.</li> <li>Business submitted false reports on a government contract.</li> <li>Owner was investigated for fraud.</li> </ul>
Case 9	Emergency supplies under a GSA contract	Up to \$100,000	Over \$700,000	<ul style="list-style-type: none"> <li>Business made large loans to a company officer at same time the business was not paying its taxes.</li> <li>Business filed for bankruptcy protection owing substantial state and federal taxes.</li> <li>The owner owned multiple real properties, including a million dollar home and a luxury vehicle, while business owed taxes.</li> <li>Business had a federal tax lien at time GSA awarded a federal supply schedule contract.</li> </ul>
Case 10	Human resource services under a GSA contract	Over \$100,000	Over \$400,000	<ul style="list-style-type: none"> <li>Owner owned multiple real properties and several luxury vehicles at the time the business owed taxes.</li> <li>At the time owner did not remit all taxes owed to IRS, the owner made multiple, large cash withdrawals at gambling casinos.</li> <li>Business obtained contract for hurricane relief efforts.</li> </ul>

Source: Previous GAO testimonies on federal contractors with tax debts.(GAO-04-414T, GAO-05-683T, and GAO-06-492T.)

Notes: Dollar amounts are rounded. The information provided in this table has not been updated in the information provided from our original testimonies.

<sup>a</sup> Federal payments represent payments made by federal agencies to federal contractors for goods and services. Payments for cases 1, 2, and 3 were made by four DOD contractor payment systems during fiscal year 2002. Payments for cases 4, 5, 6, and 7 were made by the Department of Treasury on behalf of other federal agencies during fiscal year 2004. Payments for cases 8, 9, and 10 were amounts reported by the Department of the Treasury and GSA from October 2003 through June 2004.

<sup>b</sup> Unpaid tax amount for cases 1, 2, and 3 are as of September 30, 2002. Unpaid tax amount for cases 4, 5, 6, and 7 are as of September 30, 2004. Unpaid tax amount for cases 8, 9, and 10 are as of June 30, 2005.

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The following provides additional detailed information from our previous testimonies on case numbers 1, 4, and 8 summarized in table 1:

**Case # 1:** In February 2004, we testified on a business that had nearly \$10 million in unpaid federal taxes, and was contracted by DOD to provide services such as trash removal, building cleaning, and security at U.S. military bases. The contractor reported that it paid the owner a six figure income and that the owner had borrowed nearly \$1 million from the business. The owner bought a boat, several cars, and a home outside the country. This contractor went out of business in 2003 after state tax authorities seized its bank account for failure to pay state taxes. The contractor subsequently transferred its employees to a relative's business, which also had unpaid federal taxes, and continued submitting invoices and receiving payments from DOD on the previous contract.

**Case # 4:** In June 2005, we testified on a case that involved many related companies that provided health care services to the Department of Veterans Affairs (VA). During fiscal year 2004, these related companies received over \$300,000 in federal contract payments. The related companies had different names, operated in a number of different locations, and used several different Taxpayer Identification Numbers (TIN).<sup>12</sup> However, they shared a common owner and contact address. At the time they were paid by VA, the businesses collectively owed more than \$18 million in unpaid federal taxes—of which nearly \$17 million was unpaid federal payroll taxes dating back to the mid-1990s. During the early 2000s, at the time when the owner's business and related companies were still incurring payroll tax debts, the owner purchased a number of multimillion dollar properties, an unrelated business, and a number of luxury vehicles. Our investigation also determined that real estate holdings registered to the owner totaled more than \$30 million.

**Case # 8:** In March 2006, we testified on a GSA contractor that provided security services for a civilian agency. Our investigative work indicated that an owner of the company made multiple cash withdrawals, totaling close to \$1 million, while owing payroll taxes. In addition, the company's owner also diverted the cash withdrawals to fund an unrelated business

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<sup>12</sup>A TIN is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number assigned by IRS serves as the TIN. For individuals, the Social Security number, assigned by the Social Security Administration, serves as the TIN.

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and purchased a men's gold bracelet worth over \$25,000. The company's owner has been investigated for embezzlement and fraud.

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## Contractors with Unpaid Taxes Are Not Prohibited from Receiving Contracts from the Federal Government

Federal law and regulations, as reflected in the FAR, do not prohibit contractors with unpaid federal taxes from receiving contracts from the federal government. Although the FAR provides that federal agencies are restricted to doing business with responsible contractors, it does not require federal agencies to deny the award of contracts to contractors that abuse the federal tax system, unless the contractor was specifically debarred or suspended by a debarring official for specific actions, such as conviction for tax evasion.

The FAR specifies that unless compelling reasons exist, agencies are prohibited from soliciting offers from, or awarding contracts to, contractors who are debarred, suspended, or proposed for debarment for various reasons, including tax evasion.<sup>13</sup> Conviction for tax evasion is cited as one of the causes for debarment and indictment for tax evasion is cited as a cause for suspension. The deliberate failure to remit taxes, in particular payroll taxes, is a felony offense, and could result in a company being debarred or suspended if the debarring official determines it affects the present responsibility of the government contractor. Most of the contractors in our case studies owed payroll taxes, for which willful failure to remit payroll taxes, a criminal felony offense,<sup>14</sup> or failure to properly segregate payroll taxes, a criminal misdemeanor offense, may apply.<sup>15</sup> At the time of our review, none of the 122 federal contractors described in our previous case study work were debarred from government contracts, despite conducting abusive and potentially criminal activities related to the tax system.

As part of the contractor responsibility determination for prospective contractors, the FAR also requires contracting officers to determine whether a prospective contractor meets several specified standards, including determination as to whether a contractor has adequate financial

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<sup>13</sup> Prior to awarding a contract, contracting officers are required to consult a governmentwide list, called the Excluded Parties List System (EPLS), of contractors that have been debarred, suspended, or declared ineligible for government contracts, and review the prospective contractor's self-certification of debarment and suspension.

<sup>14</sup> 26 U.S.C. § 7202.

<sup>15</sup> 26 U.S.C. § 7215 and 26 U.S.C. §7512 (b).

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resources and a satisfactory record of integrity and business ethics. However, the FAR does not require contracting officers to consider tax debt in making this determination.

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## Restrictions on IRS Tax Disclosure and Failure to Use Available Tools Hamper Consideration of Tax Debts in Contractor Qualification Determinations

Because of statutory restrictions on the disclosure of taxpayer information, even if contracting officers were required to consider tax debts in contractor qualification determinations, contracting officers do not currently have access to tax debt information unless reported by prospective contractors themselves or disclosed in public records. Consequently, unless a prospective contractor consents, contracting officers do not have ready access to information on unpaid tax debts to assist in making contractor qualification determinations with respect to financial capability, ethics, and integrity.

Further, contracting officers do not routinely obtain and use publicly available information on contractor federal tax debt in making contractor qualification determinations. Federal law generally does not permit IRS to disclose taxpayer information, including tax debts.<sup>16</sup> Thus, unless the taxpayer provides consent,<sup>17</sup> certain tax debt information generally can only be discovered from public records when IRS files a federal tax lien against the property of a tax debtor.<sup>18</sup> However, contracting officers are not required to obtain credit reports. In the instances where they are obtained, contracting officers generally focus on the contractor's credit score rather than any liens or other public information showing federal tax debts. However, while the information is available, IRS does not file tax liens on all tax debtors nor does IRS have a central repository of tax liens to which contracting officers have access. Further, the available information on tax liens may be of questionable reliability because of

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<sup>16</sup> 26 U.S.C. § 6103.

<sup>17</sup> For example, contractors must provide IRS the consent to validate TINs provided by the contractors in the Central Contractor Registration system. GSA officials stated that a contractor is not registered into the system until the TIN is validated with IRS records.

<sup>18</sup> Under section 6321 of the Internal Revenue Code, IRS has the authority to file a lien upon all property and rights to property, whether real or personal, of a delinquent taxpayer.

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deficiencies in IRS's internal controls that have resulted in IRS not always releasing tax liens from property when the tax debt has been satisfied.<sup>19</sup>

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## Contractors with Tax Debts Have Unfair Advantage in Contract Competition

Federal contractors who owe tax debts have an unfair competitive advantage over contractors who pay their fair share. This is particularly true for federal contractors in wage-based industries, such as security and moving services. By not paying the employee taxes, these contractors keep their payroll tax, which is typically over 15 percent of each employee's wages, thereby reducing the contractor's costs. In this way, contractors who do not pay their taxes do not bear the same costs that tax compliant contractors have when competing on contracts. As a result, tax delinquent contractors can set prices for their goods and services lower than their tax compliant competitors.

In March 2006, we testified that we found some GSA contractors who did not fully pay their payroll taxes who were awarded contracts based on price over competing contractors that did not have any unpaid federal taxes. Federal contractors' tax debts were not considered in contract award decisions. For example, a GSA Schedule contractor was awarded two contracts for services related to moving office and equipment furniture. On both contracts, the contractor's offer for services was significantly less than three competing bids on the first contract and two competing bids on the second contract. The contractor owed about \$700,000 in taxes (mostly payroll taxes) while its competitors did not owe any federal taxes.

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<sup>19</sup> GAO, *IRS Lien Management Report: Opportunities to Improve Timeliness of IRS Lien Releases*, [GAO-05-26R](#) (Washington, D.C.: Jan. 10, 2005) and GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, [GAO-07-136](#) (Washington, D.C.: Nov. 9, 2006).

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## Proposed FAR Rule Would Require Prospective Contractors to Provide Tax-Related Certifications

The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (councils) have proposed to amend the FAR to require prospective contractors to certify whether or not they have, within a 3-year period preceding the offer, been convicted of or had a civil judgment rendered against them for violating any tax law or failing to pay any tax, or been notified of any delinquent taxes for which they still owe the tax. In addition, the prospective contractor will be required to certify whether or not they have received a notice of a tax lien filed against them for which the liability remains unsatisfied or the lien has not been released. The proposed rule also adds the following as additional causes for suspension or debarment: delinquent taxes, unresolved tax liens, and a conviction of or civil judgment for violating tax laws or failing to pay taxes.

By issuing the proposed rule on tax delinquency, the councils have acknowledged the importance of delinquent tax debts in the consideration of contract awards. The proposed rule requires offerors to certify whether they have or have not, within a 3-year period preceding the offer, been notified of any unresolved or unsatisfied tax debt or liens. Contracting officers generally cannot verify whether prospective contractors certifying that they have not received notice of unresolved or unsatisfied tax debts actually owe delinquent federal taxes, unless that information is disclosed in public records or unless the offeror provides consent for IRS to disclose its tax records. In March 2006, we testified that in one contractor file we reviewed, a GSA official did ask the prospective contractor about a federal tax lien. The prospective contractor provided documentation to GSA demonstrating the satisfaction of the tax liability covered by that lien. However, because the GSA official could not obtain information from the IRS on tax debts, this official was not aware that the contractor had other unresolved tax debts unrelated to this particular tax lien.

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## Concluding Comments

Over the past several years, we have testified that thousands of federal contractors failed in their responsibility to pay billions of dollars of federal taxes yet continued to get federal contracts. This practice is inconsistent with the fundamental concept that those doing business with the federal government should be required to pay their federal taxes. With the serious fiscal challenges facing our nation, the status quo is no longer an option. Increasing federal revenues by enhanced contractor requirements to pay their taxes would likely increase contractor tax compliance. Federal law seeking to achieve these objectives should provide flexibility to agencies, such as exceptions for contractors critical to national security. Due process and other safeguards should be built into the system to ensure



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that contractors that pay their federal taxes are not inadvertently denied federal contracts. We look forward to working with the Subcommittee on this important matter.

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

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