



Treasury Inspector General for Tax Administration Office of Audit

THE WITHHOLDING COMPLIANCE PROGRAM IS IMPROVING TAXPAYER COMPLIANCE; HOWEVER, ADDITIONAL ENFORCEMENT ACTIONS ARE NEEDED

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Highlights

Highlights of Report Number: 2008-40-167 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

The goal of the Withholding Compliance Program (the Program) is to ensure that taxpayers have enough income taxes withheld from their wages to meet their tax obligations. While the Program has improved taxpayer compliance, more effort is needed to ensure that employers comply with the tax withholding requirements and to penalize taxpayers who make false statements that result in the underwithholding of taxes.

WHY TIGTA DID THE AUDIT

This audit was initiated because underwithholding of taxes on wages is a major cause of tax noncompliance for individuals who are primarily wage earners. Even though wage earners as a group pay 98 percent of the taxes they report on their individual income tax returns, approximately \$7.6 billion of potentially collectible taxes is lost annually due to withholding noncompliance. TIGTA evaluated the effectiveness of the Internal Revenue Service's (IRS) actions on underwithheld tax compliance cases.

WHAT TIGTA FOUND

Enforcement actions are not taken against employers who do not comply with lock-in letter instructions. TIGTA selected a statistically valid random attribute sample of employees (taxpayers) whose employers were sent lock-in letters due to underwithholding of taxes on wages earned in Tax Year 2003. Our analysis found some employers did not withhold taxes from their employees at the rates specified in the lock-in letters, and the Program does not have a process in place to identify employers who fail to comply with the lock-in letter instructions. Consequently, TIGTA estimated that 4,100 taxpayers are still underwithholding taxes and that the noncompliant employers are liable for \$34.5 million in underwithheld taxes.

Further, taxpayers are generally not penalized when they make false statements on the Employee's Withholding Allowance Certificate (Form W-4) that result in the underwithholding of taxes and there is no reasonable basis for such statements. TIGTA estimates that civil penalties of approximately \$11 million could have been assessed against taxpayers referred to the Program by other IRS compliance functions in Fiscal Years 2006 and 2007 if IRS employees had followed current policies and obtained Forms W-4 from employers. If the IRS consistently assessed penalties on all underwithheld taxpayers for whom lock-in letters were issued, penalties potentially totaling approximately \$127 million could have been assessed against these taxpayers.

In addition, IRS employees outside of the Program do not have access to the systems used to issue lock-in letters. Instead, they are required to submit a referral to the Program for lock-in letter issuance. Upgrading the Program case processing systems to create a single data entry point and allowing other IRS functions to issue lock-in letters would make the current referral process unnecessary.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division, ensure that the Director, Compliance, Wage and Investment Division:

- 1) develops a process to identify employers who do not adequately withhold taxes after receiving a lock-in letter;
- 2) works with the other IRS divisions to develop employer examination criteria for referring these employers;
- 3) coordinates with other IRS divisions to develop and deliver training to appropriate IRS employees on the existing criteria for the current referral process; and
- 4) forms a team to research and develop criteria that will expand use of the Form W-4 civil penalty beyond the current limited use. Related guidance and training should then be provided to ensure consistent application of the criteria. Finally, TIGTA recommended creating a single data entry point for processing Program cases and, through the Deputy Commissioner for Services and Enforcement, providing lock-in letter issuance authority to other IRS functions.

In their response to the report, IRS officials agreed with our recommendations and stated plans to take appropriate corrective actions.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2008reports/200840167fr.pdf>.

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