



*The Withholding Compliance Program Is
Improving Taxpayer Compliance; However,
Additional Enforcement Actions Are Needed*

August 29, 2008

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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



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 29, 2008

**MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT**

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Withholding Compliance Program Is
Improving Taxpayer Compliance; However, Additional Enforcement
Actions Are Needed (Audit # 200840002)

This report presents the results of our review to evaluate the effectiveness of the Internal Revenue Service's (IRS) actions on underwithheld tax compliance cases. This audit was conducted as part of our Fiscal Year 2008 Annual Audit Plan and addresses the management challenge associated with Tax Compliance Initiatives.

Impact on the Taxpayer

The goal of the Withholding Compliance 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 of the lock-in letters and to penalize taxpayers making false statements that result in the underwithholding of taxes. Those taxpayers who voluntarily file their tax returns and pay their taxes in a timely manner expect that others will be held to the same standards of compliance with the law.

Synopsis

The Withholding Compliance Program analyzes wage and tax information reported on the Wage and Tax Statement (Form W-2) and tax return data to identify taxpayers who have not had enough taxes withheld and are also not compliant with filing and/or paying their taxes. In most cases, the IRS systemically issues notices called "lock-in letters" to both employers and



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employees (taxpayers), which direct the employers to withhold taxes from their employees' wages at a specified rate.

To evaluate the effectiveness of the Program, we selected a statistically valid random attribute sample of 67 taxpayers¹ from a population of 27,207 employees whose employers were sent lock-in letters due to underwithholding of taxes on wages earned in Tax Year 2003.² From Tax Years 2003 to 2006, the percentage of taxes withheld from wages increased from 2.1 percent to 14.2 percent for this sample. Based on our sample results, we estimated that the IRS collected \$192 million in additional tax withholding for Tax Year 2006 and that 13,044 taxpayers would be compliant with their filing and payment requirements in Tax Year 2006 as a result of the lock-in letters.

Lock-in letters have generally improved taxpayer compliance.

Nonetheless, some employers did not withhold taxes from their employees at the rates specified in the lock-in letters. If employers do not properly withhold these taxes, they are liable for paying the employees' portions to the IRS. Based on our sample results, an estimated 4,100 taxpayers are still underwithholding taxes because their employers did not comply with the lock-in letter instructions. We estimated that employers who did not comply with the lock-in letters are liable for \$34.5 million in underwithheld taxes. The Withholding Compliance Program does not have a process in place to identify employers who fail to comply with the lock-in letters.

In addition, taxpayers are generally not penalized for making false statements that result in the underwithholding of taxes. Internal Revenue Code Section 6682 and related tax regulations allow assessment of a \$500 civil penalty if a taxpayer furnishes a false statement on the Employee's Withholding Allowance Certificate (Form W-4) that results in the underwithholding of tax and there is no reasonable basis for such a statement. In May 2006, the Internal Revenue Manual³ was revised to state that the Form W-4 civil penalty will be assessed by the Withholding Compliance Program only on referrals from other IRS functions or special projects. However, we believe that this policy is improper because it could result in inconsistent treatment of similarly situated taxpayers solely on the basis of whether their cases were referred from another IRS function. Further, it appears that IRS employees in other

Penalties are not applied as provided by law to promote compliance.

¹ Our initial sample was 73 taxpayers. However, this analysis excluded three taxpayers who were not subject to withholding because of their types of employment [REDACTED] and three taxpayers who had no Form W-2 information available on IRS computer systems for Tax Year 2006.

² These cases were worked by the pilot Withholding Compliance Program in Fresno, California. Each case was manually screened prior to issuance of the lock-in letter. Systemic issuance of lock-in letters did not start until the Withholding Compliance Program was transferred to Lowell, Massachusetts, in Fiscal Year 2006.

³ Internal Revenue Manual Section 5.19.11.5(5).



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compliance functions are not submitting Forms W-4 with their referrals. As a result, during Fiscal Year 2006, only 29 Form W-4 civil penalties were assessed by the Withholding Compliance function in Lowell, Massachusetts, and none were assessed in Fiscal Year 2007.

If IRS employees in other functions had followed current policies and made an effort to obtain the questionable Forms W-4 from employers and referred them to the Withholding Compliance Program, penalties potentially totaling approximately \$11 million could have been assessed against taxpayers referred to the Withholding Compliance Program by other IRS functions in Fiscal Years 2006 and 2007. 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.

The Internal Revenue Manual⁴ advises all IRS employees working compliance cases to consider using lock-in letters to correct taxpayers' withholding as a means of ensuring future compliance. However, IRS employees outside of the Withholding Compliance Program do not have access to the systems used to issue lock-in letters. Instead, they are required to submit a referral to the Withholding Compliance Program for lock-in letter issuance. According to Program management, the referral process is necessary because access to the Withholding Compliance Program systems that process and issue lock-in letters cannot be given to other IRS employees until these systems are linked. Upgrading the Withholding Compliance 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.

Recommendations

We 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 Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to develop examination criteria for referring these employers; 3) coordinates with the Large and Mid-Size-Business, Small Business/Self-Employed, and Tax Exempt and Government Entities 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 limitation of referrals and special projects. Related guidance and training should then be provided to the appropriate IRS employees to ensure consistent application of the criteria. Finally, we recommended that the Commissioner, Wage and Investment Division, create a single data entry point for processing Withholding Compliance Program cases and, through the Deputy

⁴ Internal Revenue Manual Section 5.19.11.3.4(2).



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Commissioner for Services and Enforcement, provide lock-in letter issuance authority to other IRS functions.

Response

IRS management generally agreed with all of our recommendations. The Wage and Investment Division will develop an annual report that will identify employees who continue to work for the same employer after a lock-in letter has been issued yet have no significant change in their withholding patterns. The Wage and Investment Division will provide pertinent employer and worker information where a lock-in letter was deemed necessary. This information will be provided in an electronic format to be used in the Service-Wide Employment Tax Research System, currently under development. Using this System, the Small Business/Self-Employed Division will analyze the data and incorporate it into the scoring model to identify cases with the greatest compliance risk. The data will be available in the Service-Wide Employment Tax Research System for use in case selection processes for Large and Mid-Size Business Division and Tax Exempt and Government Entities Division employers.

The Wage and Investment Division will also develop a corporate Continuing Professional Education training module outlining the Withholding Compliance Program referral criteria. This training module will be provided to Large and Mid-Size Business, Tax Exempt and Government Entities, and Small Business/Self-Employed Division management to allow them to deliver it to the appropriate employees within their Divisions. In addition, the Wage and Investment Division will establish a cross-functional team to evaluate current W-4 civil penalty guidelines and make recommendations on situations in which the guidelines can be expanded. Based on the findings, the Division will reevaluate the need to develop training.

As part of its long-term strategy, the Wage and Investment Division plans to develop a web-based format that will allow a single point of entry that, in turn, will allow communication between compliance systems. However, because this is a significant programming change, the Wage and Investment Division is currently working through the IRS Information Technology Modernization, Vision, and Strategy process to secure funding for Fiscal Year 2011. Once the funding decisions are approved, the Division will create a timeline for development, testing, and implementation of the web-based program. Upon implementation, the Division will reassess how individual authority to issue lock-in letters could be delegated to other IRS functions.

While IRS management agreed with our recommendations, they did not believe that our sample size was large enough to make reliable projections to the population. As a result, the IRS disagreed with the outcome measures in Appendix IV of this report. We believe that our sample size was appropriate and our projections accurate within the stated precision. Furthermore, a portion of our outcome measure was not based on a sample. Rather, it was based on the total population of cases referred by other IRS functions. Management's complete response to the draft report is included as Appendix V.



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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 Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.



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Abbreviations

FY	Fiscal Year
IRS	Internal Revenue Service
QW-4	Questionable Form W-4
TY	Tax Year



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Background

The Internal Revenue Code¹ requires employers to withhold taxes from employees' (taxpayers') pay so that the taxes are paid to the Department of the Treasury on a ratable basis throughout the year. Proper withholding helps to ensure that taxpayers do not end the year with substantial tax balances due. In Fiscal Year (FY) 2007, \$928.6 billion (more than one-third of total tax revenues for the year) were collected through income tax withholding. Because of income tax withholding, tax payment compliance is generally very high for wage earners. Nonetheless, underwithholding of tax on wages remains a major cause of tax noncompliance for some individuals.

The Internal Revenue Service (IRS) Questionable Form W-4 (QW-4) Program was designed to address those taxpayers attempting to evade income tax withholding requirements by overstating withholding allowances or improperly claiming to be exempt from withholding. The QW-4 Program required employers to submit to the IRS all Employee's Withholding Allowance Certificates (Form W-4) that claimed a total exemption from withholding on wages of more than \$200 per week or more than 10 withholding allowances. After the IRS reviewed the Form W-4 information and determined that the employee was not withholding enough taxes, the IRS would issue a notice, commonly referred to as a "lock-in letter," to the employer specifying the maximum number of withholding allowances permitted for the employee.

In October 2002, the Treasury Inspector General for Tax Administration reported² that the QW-4 Program was not effectively identifying instances when employers and taxpayers were not complying with directives to increase withholding amounts. In addition, management information reports did not identify the most productive cases.

***The Treasury Inspector General
for Tax Administration
previously reported that the IRS
has had difficulty identifying
employers who do not comply
with notices to increase tax
withholding amounts.***

In November 2003, the Government Accountability Office raised the following concerns about the QW-4 Program:³

¹ Internal Revenue Code Section 3402.

² *Improvements to the Questionable Form W-4 Program Are Needed to Determine Program Impact on Taxpayer Compliance* (Reference Number 2003-40-006, dated October 2002).

³ *IRS's Use of Information on Taxpayers Claiming Many Allowances or Exemption From Federal Income Tax Withholding* (Letter Report GAO-04-79R, dated November 6, 2003).



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- **Accuracy:** The IRS had no means to determine the extent of employer compliance or noncompliance with QW-4 Program regulations, and anecdotal information strongly suggested that it was low.
- **Currency:** The IRS had no means to update information when employees subsequently filed non-questionable Forms W-4.
- **Fairness:** The IRS reviewed employee data received only from employers who complied with QW-4 Program reporting regulations.

In response to the Government Accountability Office report, the IRS discontinued the QW-4 Program and in January 2004 established the Withholding Compliance Task Force. The Task Force conducted a comprehensive review of the QW-4 Program and recommended that it be replaced by the Withholding Compliance Program, which is based on the Wage and Tax Statement (Form W-2).

The Task Force research showed that 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. Figure 1 shows the estimate of potentially collectible taxes lost annually from wage-earning taxpayers.

**Figure 1: Estimate of Potentially Collectible Taxes Lost Annually
Due to Underwithholding**

Taxpayer Compliance Status	Number of Taxpayers	Dollars Lost Annually
Non-filer With Substantial Wages	5.5 million	\$4.9 billion
Non-filer With Invalid Social Security Number	7.7 million	\$1.0 billion
Taxpayer With Balance Due After Remittance	1.5 million	\$1.7 billion
Totals	14.7 million	\$7.6 billion

Source: IRS Withholding Compliance Task Force Report dated January 31, 2005.

In FY 2005, the IRS implemented the Withholding Compliance Program with the case selection methodology based on underwithheld wages reported on the Form W-2. According to the Internal Revenue Manual,⁴ the Withholding Compliance Program's mission is "to ensure that taxpayers who have serious underwithholding problems are brought into compliance with

⁴ Internal Revenue Manual Section 5.19.11.1(1).



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[F]ederal income tax withholding requirements The goal is to correct withholding to ensure that taxpayers have enough income tax withheld to meet their tax obligations.”

The pilot Withholding Compliance Program, based on Tax Year (TY) 2003 Form W-2 cases, was worked at the IRS Fresno Campus⁵ in Fresno, California, between December 2004 and December 2005. In October 2005, the Withholding Compliance Program was moved to the Andover Campus in Lowell, Massachusetts. The Andover Campus team began work on the TY 2004 Form W-2 cases, while the Fresno Campus team finished working the TY 2003 Form W-2 cases through December 2005.

This review was performed at the Withholding Compliance function in Lowell, Massachusetts, and the Wage and Investment Division Headquarters in Atlanta, Georgia, during the period July 2007 through April 2008. 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.

⁵ 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.



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Results of Review

Lock-in Letters Have Generally Improved Taxpayer Compliance

The Withholding Compliance Program identifies its potential inventory by analyzing wage and tax information reported on Forms W-2 and tax return data to identify taxpayers who have tax underwithholding issues and are not compliant with filing and/or paying their taxes. In most cases, the IRS systemically issues lock-in letters to both employers and employees (taxpayers). According to Withholding Compliance Program management, the Program issued lock-in letters to approximately 122,000 and 132,000 employees and their employers in FYs 2006 and 2007, respectively.

The letters sent to the employers direct them to withhold taxes from their employees' wages at a specified rate, and the letters sent to the employees inform them of the instructions provided to their employers. If employers comply with the lock-in letter instructions, the taxes withheld from their employees' wages should be enough to meet the employees' tax withholding obligations. If the employees disagree with the IRS' lock-in letter rate, they are instructed to contact the IRS and provide supporting information to justify a different withholding rate or to have the lock-in letter withholding rate rescinded. Once Withholding Compliance Program personnel are in contact with the taxpayers, they will work all issues related to the underwithholding problems, address the filing requirements for delinquent tax returns, and/or help taxpayers prepare installment agreements.⁶

We selected a statistically valid random attribute sample of 67 taxpayers⁷ from a population of 27,207 taxpayers whose employers were sent lock-in letters due to underwithholding on wages earned in TY 2003.⁸ We compared the taxpayers' withholding and wage amounts reported on the TY 2003 Forms W-2 to the withholding and wage amounts reported on the TY 2006 Forms W-2.⁹ Analysis of the 67 taxpayers determined that from TYs 2003 to 2006, the percentage of taxes withheld from wages increased from 2.1 percent to 14.2 percent (a total

⁶ An agreement between the IRS and a taxpayer that allows the taxpayer to make installment payments on a tax liability over a prescribed period of time.

⁷ Our initial sample was 73 taxpayers. However, this analysis excluded three taxpayers who were not subject to withholding because of their types of employment¹ and three taxpayers who had no Form W-2 information available on IRS computer systems for TY 2006.

⁸ These cases were worked by the pilot Withholding Compliance Program in Fresno, California. Each case was manually screened prior to issuance of the lock-in letter. Systemic issuance of lock-in letters did not start until the Withholding Compliance Program was transferred to Lowell, Massachusetts, in Fiscal Year 2006.

⁹ TY 2006 was the first complete tax year after the lock-in letters were issued to employers and taxpayers for wages earned in TY 2003.



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withholding increase of \$689,582). Figure 2 shows the percentage of total withholding to wages for TYs 2003 and 2006.

**Figure 2: Overall Tax Withholding Improvement for TYs 2003
and 2006**

Tax Year	Wages	Withholding	Percentage
2003	\$6,216,310	\$130,998	2.1%
2006	\$5,773,870	\$820,580	14.2%

Source: Treasury Inspector General for Tax Administration analysis of sampled TYs 2003 and 2006 Forms W-2 data.

For those taxpayers who worked for the same employers in TYs 2003 and 2006 (i.e., employers who were issued a lock-in letter), there was an increase in the percentage of withholding as compared to wages from 1.8 percent to 15.2 percent. For those same taxpayers who also worked for a new employer in TY 2006 (i.e., employers who were not issued a lock-in letter), the percentage of withholding to wages with the new employer increased from 1.8 percent to 13.9 percent. Figure 3 shows the percentage of total withholding to wages for taxpayers who worked for the same employers in TYs 2003 and 2006, as well as the percentage of withholding to wages for these same taxpayers who also worked for a new employer in TY 2006.

**Figure 3: Tax Withholding Improvement for TYs 2003 and 2006
by Employer Type**

TY 2003			TY 2006			
Wages	Withholding	Percentage	Employer	Wages	Withholding	Percentage
\$4,654,338	\$82,726	1.8%	Same	\$3,838,455	\$582,166	15.2%
			Different	\$569,456	\$78,925	13.9%

Source: Treasury Inspector General for Tax Administration analysis of sampled TYs 2003 and 2006 Forms W-2 data.

For those taxpayers who worked for a new employer after TY 2003, the increase in withholding could have been caused by a change in taxpayer behavior resulting from the previous lock-in letter but might also have occurred for other reasons related to the change in employment. However, it appears that lock-in letters have a positive effect on withholding compliance for those taxpayers who continue to work for the same employer. Based on our analysis, we



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estimated that the IRS collected approximately \$192 million¹⁰ in additional tax withholding for TY 2006 as a result of the Withholding Compliance Program contacting employers of underwithheld taxpayers.

Lock-in letters also appear to have a positive effect on taxpayer filing and payment compliance. In analyzing our sample of 70 taxpayers,¹¹ we found that between TYs 2003 and 2006, some noncompliant taxpayer filing and payment behaviors changed significantly. For example, in TY 2003, [redacted] taxpayers in our sample either were non-filers or had filed balance-due tax returns and been assessed a failure to pay penalty by the IRS. In TY 2006, this number decreased by 51 percent to only 34 taxpayers. Figure 4 shows the filing and paying compliance of our sample of taxpayers for both tax years.

¹⁰ The estimated figure of \$192 million was calculated in the following manner. Based on our analysis, 46 (63.01 percent) of the 73 taxpayers in our TY 2003 sample continued to work for the same employers in TY 2006. By applying this percentage (63.01 percent) to the 27,207 TY 2003 sample population, we estimated that 17,144 taxpayers continued to work for the same employers in TY 2006. For the 46 taxpayers in our sample who continued to work for the same employers in TY 2006, the percentage increase in tax withholding between TYs 2003 and 2006 was 13.4 percent [15.2 percent – 1.8 percent = 13.4 percent]. To calculate the estimated average tax withholding increase for those taxpayers in our sample who worked for the same employers in TYs 2003 and 2006, we multiplied the percentage increase in tax withholding [13.4 percent] by the total wages for TY 2006 [\$3,838,455] and divided by the number of taxpayers in our sample who continued to work for the same employers in both Tax Years [46]. This resulted in an estimated average tax withholding increase of \$11,181.59. We then multiplied this amount [\$11,181.59] by the number of TY 2003 taxpayers in our sample population who we estimated continued to work for the same employers in TY 2006 [17,144].

¹¹ Our initial sample was 73 taxpayers. However, this analysis excluded three taxpayers who were not subject to withholding because of their types of employment [redacted]



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**Figure 4: Taxpayer Filing and Paying Compliance Comparison
for TYs 2003 and 2006**

Tax Return Filing Status	TY 2003	TY 2006
Non-filed Tax Return	1	29
Significant Balance-Due Tax Return Filed/Failure to Pay Penalty Assessed	1	1
Significant Balance-Due Tax Return Filed and Paid/Failure to Pay Penalty Assessed	1	1
Subtotals	3	34
Nominal Balance-Due Tax Return Filed and Paid	1	3
Refund Tax Return Filed ¹²	1	33
Totals	70	70

Source: Treasury Inspector General for Tax Administration analysis of sampled TYs 2003 and 2006 Individual Master File¹³ data.

The Internal Revenue Code¹⁴ requires taxpayers to file tax returns and pay income taxes on wages earned. Our analysis found that the increased withholding resulting from the lock-in letters was the primary reason that 36 taxpayers in our sample received either a refund or had a nominal balance due when filing their TY 2006 tax returns. Further, we estimated that from the TY 2003 population of 27,207 taxpayers who were sent lock-in letters, 13,044 would be compliant with filing and paying in TY 2006 as a result of the Withholding Compliance Program contacts.¹⁵

¹² 1

¹³ The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.

¹⁴ Internal Revenue Code Sections 1, 6011(a), 6012(a), 6072(a), and 6151.

¹⁵ The increase in filing and paying compliance of the TY 2003 sample population was calculated by multiplying the percentage of taxpayers in our sample who would be subject to tax withholding and were sent lock-in letters $[(70/73) \times 27,207]$ by the TY 2003 sample population, which resulted in 26,089 taxpayers. This number [26,089] was then multiplied by the percentage increase in filing and paying compliance between TYs 2006 and 2003 $[(36-1)/70 = 50 \text{ percent}]$. This resulted in an estimated increase in filing and paying compliance between TYs 2003 and 2006 for approximately 13,044 taxpayers.



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**Additional Actions Are Needed to Further Improve Taxpayer
Withholding Compliance**

**Enforcement actions should be taken against employers who do not comply with
lock-in letter instructions**

The IRS issues lock-in letters to employers to modify the tax withholding of employees who are not entitled to claim exemption from withholding or more than a specified number of withholding allowances. The lock-in letter instructs employers to disregard the information on the employee's current Form W-4 and to withhold income tax based on the marital status and withholding allowances stipulated in the letter. According to the Internal Revenue Manual,¹⁶ the default withholding rate used in the lock-in letters is based on a marital status of Single with zero withholding allowances. Any modification to the lock-in withholding rate will occur only if the IRS receives information from the taxpayer supporting a change.

While lock-in letters have generally improved taxpayer compliance, we determined that some employers do not follow the lock-in letter instructions and withhold taxes from their employees at the rates specified in the lock-in letters. In our sample of 67 taxpayers, 46 (68.7 percent) worked for the same employers in TYs 2003 and 2006 (i.e., employers who were issued a lock-in letter). The employers of 11 (23.9 percent) of the 46 taxpayers did not follow the lock-in letter instructions. Of these 11 taxpayers, 1 continued to be non-filers, and 10 filed tax returns with significant balances due. There was no indication that any of these 11 taxpayers requested that the IRS modify the withholding rates as required by the lock-in letters. Figure 5 shows the withholding information for these taxpayers for TY 2006.

**Figure 5: Estimated Underwithholding for TY 2006 for 11 Taxpayers in
Our Sample Who Continued to Work for the Same Employer**

Wages	Actual Withholding	Estimated Withholding Based on Lock-in Letter	Estimated Underwithholding
\$733,750	\$51,211	\$143,891	\$92,680

Source: Treasury Inspector General for Tax Administration analysis of sampled TYs 2003 and 2006 Forms W-2 data.

For the 46 taxpayers who worked for the same employers in TYs 2003 and 2006, the actual withholding rates for TY 2006 ranged from 0 percent to 25 percent. For the 11 taxpayers whose employers did not comply with the lock-in letter instructions, the TY 2006 average withholding rate as a percentage of wages was 7 percent. If the employers had followed the lock-in letter instructions, we estimated that the average withholding rate for these 11 taxpayers would have

¹⁶ Internal Revenue Manual Sections 5.19.11.3.5(4), 5.19.11.3.12.1.2(4), and 5.19.11.4.1(5)(e).



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been approximately 20 percent, which would have resulted in \$92,680 in additional withholding collected.

Tax assessments can be applied to employers to penalize those that do not comply with the lock-in letters. The Internal Revenue Code requires employers to withhold taxes from wages paid to employees.¹⁷ Based on our results, we estimated that from the TY 2003 population of 27,207 taxpayers, 4,100 taxpayers are still underwithholding taxes because their employers did not comply with the lock-in letter instructions. Further, we estimated that employers who did not comply with the lock-in letters are liable for \$34.5 million in underwithheld taxes for TY 2006.¹⁸

The Withholding Compliance Program does not have a process in place to identify employers who fail to comply with the lock-in letters, which has contributed to the significant underwithholding conditions identified during this review. Current Withholding Compliance Program management reports used to monitor Program effectiveness do not provide data on employer compliance with lock-in letters. Further, the corporate filing and tax withholding reports that the Withholding Compliance Program is developing do not contain any analysis on employer compliance.

In response to our findings, Withholding Compliance Program management stated that they would give the Small Business/Self-Employed Division Employment Tax Program access to the Withholding Compliance Program data file to develop audit leads for employer examinations. However, according to Withholding Compliance Program management, this initiative had not been started due to funding issues. Given the delay, Withholding Compliance Program management has requested and is still waiting for personnel from the Small Business/Self-Employed Division Employment Tax Program to provide system guidelines to enable the referral of employer cases.

Taxpayers are generally not penalized for making false statements that result in the underwithholding of taxes

The Internal Revenue Code¹⁹ and related tax regulations allow assessment of a \$500 civil penalty for furnishing a false statement on the Form W-4 if 1) the statement made on the Form W-4 results in less income tax withheld than what would have been withheld if the Form W-4 had been correctly completed and 2) there was no reasonable basis for such a statement. Prior to creation of the Withholding Compliance Program, employers were required to submit to the IRS

¹⁷ Specifically, Internal Revenue Code Section 3402 states that “. . . every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary [of the Department of the Treasury].” If an employer does not properly withhold these taxes, the employer is liable for paying the employee’s portion to the IRS. Internal Revenue Code Section 3403 states that “The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter [collection of income tax at source on wages]. . . .”

¹⁸ See Appendix IV for details.

¹⁹ Internal Revenue Code Section 6682.



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all Forms W-4 on which the employee 1) erroneously claimed a total exemption from withholding on wages of more than \$200 per week or 2) claimed more than 10 withholding allowances. IRS procedures require that a copy of the erroneous Form W-4 be obtained to assert the civil penalty.

In April 2005, the Code of Federal Regulations²⁰ was changed to no longer require employers to routinely submit questionable Forms W-4 to the IRS. Instead, employers have to submit the Form W-4 only if directed to do so by the IRS in a written notice or under any published guidance.²¹

In May 2006, even though the scope of the IRS' authority to assess the \$500 civil penalty had not changed, the Internal Revenue Manual²² was revised to state that the Form W-4 civil penalty will be assessed by the Withholding Compliance Program only on referrals²³ from other IRS functions or special projects. However, we believe that this policy is improper because it could result in inconsistent treatment of similarly situated taxpayers solely on the basis of whether their cases were referred from another IRS function. Further, it appears that IRS employees in other functions are not submitting Forms W-4 with their referrals. As a result, during FY 2006, only 29 Form W-4 civil penalties were assessed by the Withholding Compliance function in Lowell, Massachusetts, and none were assessed in FY 2007. Figure 6 shows the number of penalties assessed as compared to the number of taxpayers issued lock-in letters by the Withholding Compliance Program, as well as the number of taxpayer referrals from other IRS functions by fiscal year.

²⁰ 26 Code of Federal Regulations Section 31.3402(f)(2)-1 (2005).

²¹ Published guidance means a revenue procedure or notice published in the Internal Revenue Bulletin. The Internal Revenue Bulletin is the authoritative instrument of the IRS Commissioner for announcing official rulings and revenue procedures of the IRS and for publishing Department of the Treasury decisions, executive orders, tax conventions, legislation, court decisions, and other items of general interest.

²² Internal Revenue Manual Section 5.19.11.5(5).

²³ In addition to working its selected inventory, the Withholding Compliance Program issues lock-in letters to underwithheld taxpayers based on referrals from other IRS functions.



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**Figure 6: Taxpayers Issued Lock-in Letters Compared to
Form W-4 Civil Penalties Assessed in FYs 2006 and 2007**

Fiscal Year	Taxpayers Issued Lock-in Letters	Referred Taxpayers Issued Lock-in Letters	Penalties Assessed	Total Penalty Amount²⁴
2006	122,140	9,182	29	\$14,500
2007	131,803	12,786	0	\$0

Source: IRS Withholding Compliance Program management and Treasury Inspector General for Tax Administration analysis of Individual Master File data.

IRS employees do not consistently assess the Form W-4 civil penalty on underwithheld taxpayers. If IRS employees in other functions had followed current policies and made an effort to obtain the questionable Forms W-4 from employers and referred them to the Withholding Compliance Program, penalties potentially totaling approximately \$11 million could have been assessed against taxpayers referred to the Withholding Compliance Program by other IRS functions in FYs 2006 and 2007. If the IRS removed its current limitations and assessed penalties on all underwithheld taxpayers who were issued lock-in letters, penalties potentially totaling approximately \$127 million could have been assessed against these taxpayers.²⁵

According to the Internal Revenue Manual,²⁶ penalties exist to encourage voluntary compliance by supporting the standards of behavior expected by the Internal Revenue Code. Penalties encourage voluntary compliance by:

- Defining standards of compliant behavior.
- Defining remedial consequences for noncompliance.
- Providing monetary sanctions against taxpayers who do not meet the standards.

To promote the fairness of our tax system and encourage voluntary compliance, the IRS has a responsibility to impose penalties for noncompliant taxpayer behavior consistently and equitably. Those taxpayers who voluntarily file their tax returns and pay their taxes in a timely manner expect that others will be held to the same standards of compliance with the law. Therefore, those taxpayers who make false statements on Form W-4 in an effort to avoid paying taxes

²⁴ The total penalty amount was calculated by multiplying the \$500 penalty by the number of penalties assessed during the fiscal year (i.e., $\$500 \times 29 = \$14,500$).

²⁵ For both the \$11 million and \$127 million penalty estimates, our calculations are based on the total number of taxpayers issued lock-in letters. Some of these taxpayers could have provided supporting information that resulted in the Withholding Compliance Program rescinding the lock-in letter withholding rate. As a result, these taxpayers would not be subject to the Form W-4 civil penalty because their Forms W-4 would be considered correct. Even though Withholding Compliance Program management could not provide us with the number of taxpayers who fit this category, we believe that this number would be fairly small.

²⁶ Internal Revenue Manual Section 20.1.1.2.



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should be subject to the penalties provided by law. The deterrent effect of the penalties might help to reduce the overall rate of noncompliance in this area.

Recommendations

The Commissioner, Wage and Investment Division should ensure that the Director, Compliance, Wage and Investment Division:

Recommendation 1: Develops a process to identify those employers who do not adequately withhold taxes from their employees after receiving a lock-in letter.

Management's Response: IRS management agreed with this recommendation. The Wage and Investment Division will develop an annual report that will identify employees who continue to work for the same employer after a lock-in letter has been issued yet have no significant change in their withholding patterns.

Recommendation 2: Works with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to develop employer examination criteria for referring those employers that did not follow lock-in letter instructions.

Management's Response: IRS management agreed with this recommendation. The Wage and Investment Division will provide pertinent employer and worker information where a lock-in letter was deemed necessary. This information will be provided in an electronic format to be used in the Service-Wide Employment Tax Research System, currently under development. Using this System, the Small Business/Self-Employed Division will analyze the data and incorporate it into the scoring model to identify cases with the greatest compliance risk. The data will be available in the Service-Wide Employment Tax Research System for use in case selection processes for Large and Mid-Size Business Division and Tax Exempt and Government Entities Division employers.

Recommendation 3: Coordinates with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to develop and deliver training to appropriate IRS employees on the existing criteria for the current referral process.

Management's Response: IRS management agreed with this recommendation. The Wage and Investment Division will develop a corporate Continuing Professional Education training module outlining the Withholding Compliance Program referral criteria. This training module will be provided to Large and Mid-Size Business, Tax Exempt and Government Entities, and Small Business/Self-Employed Division management to allow them to deliver it to the appropriate employees within their Divisions.



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Recommendation 4: Works with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to research and develop criteria that will expand use of the Form W-4 civil penalty beyond the current limitation of referrals and special projects. Guidance and training should then be provided to the appropriate IRS employees to ensure consistent application of the criteria.

Management's Response: IRS management agreed with this recommendation in part. The Wage and Investment Division will establish a cross-functional team to evaluate current Form W-4 civil penalty guidelines and make recommendations on situations in which, if warranted, the guidelines can be expanded. Based on the findings, the Wage and Investment Division will reevaluate the need to develop training, which in turn could be turned over to the other operating divisions for delivery.

While IRS management agreed with the above four recommendations, they did not believe that our sample size was large enough to make reliable projections to the population. As a result, the IRS disagreed with the outcome measures in Appendix IV of this report.

Office of Audit Comment: We are pleased that IRS management agreed to implement the above recommendations. However, we do not agree with management's assessment of the projected outcome measures. We believe that our sample size was appropriate and our projections accurate within the stated precision. The purpose of audit sampling is to identify potential problems and to quantify their effect to the extent possible. We balance the cost of audit oversight with the fiscal expectations of Congress and the taxpaying public. While a larger sample might identify less common errors, our sample was adequate to identify and quantify the issues found in the Withholding Compliance Program that our recommendations and related outcome measures address. Furthermore, a portion of our outcome measures was not based on a sample. Rather, it was based on the total population of cases referred by other IRS functions.

Changes Are Needed to Improve the Effectiveness of Processing Referral Cases

The Internal Revenue Manual²⁷ advises all IRS employees working compliance cases to consider using lock-in letters to correct taxpayers' withholding as a means of ensuring future compliance. However, IRS employees outside of the Withholding Compliance Program do not have access to the systems used to issue lock-in letters. Instead, they are required to submit a referral to the Withholding Compliance Program for lock-in letter issuance.

²⁷ Internal Revenue Manual Section 5.19.11.3.4(2).



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For example,²⁸ a taxpayer who had not paid income taxes over the last several years is working with an IRS employee from the Automated Collection System.²⁹ The employee determines that the taxpayer continues to file balance-due tax returns because he or she has not had enough tax withheld from his or her wages. The IRS employee recommends that the taxpayer change his or her withholding rate, but the taxpayer refuses. To ensure a change in the taxpayer's withholding, the IRS employee must submit a referral to the Withholding Compliance Program for a lock-in letter to be issued to the taxpayer's employer(s). Once a referral is received by the Withholding Compliance Program, it is worked just like any other manually screened case. According to Withholding Compliance Program management, referral cases are considered the second highest work priority and are to be resolved within 30 calendar days of receipt.

In FYs 2006 and 2007, 24,864 taxpayers were referred by other IRS functions to the Withholding Compliance Program for lock-in letter consideration. During the same periods, lock-in letters were issued to 21,968 referred taxpayers and their employers.

According to Withholding Compliance Program management, the referral process is necessary because access to the Withholding Compliance Program systems that process and issue lock-in letters cannot be given to other IRS employees until these systems are linked. Currently, the Withholding Compliance Program uses three separate information systems for case processing: the Integrated Data Retrieval System,³⁰ Desktop Integration,³¹ and the Withholding Compliance System.³² Because these systems are not linked, case information must be entered independently on all three systems for manually screened and/or referred cases. To maintain the integrity of the information being input to these systems, the Withholding Compliance Program controls all case processing and issuance of lock-in letters.

Upgrading the Withholding Compliance 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. Taxpayer underwithholding could be immediately addressed by other IRS functions, thereby reducing the amount of time needed to correct the withholding for "referred" taxpayers. In addition, a single data entry point would allow Withholding Compliance Program employees to work more underwithholding cases by reducing the amount of time currently being spent on inputting information to three separate systems.

²⁸ This hypothetical example is provided for illustrative purposes only.

²⁹ A telephone contact system through which telephone assistors collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

³⁰ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

³¹ Desktop Integration provides employees with access to multiple IRS systems through their computers and allows for inventory management, case delivery, history narratives, print-to-fax capabilities for sending information to taxpayers, and electronic referral generation.

³² The Withholding Compliance System uses the Form W-2 to identify employees with a potential underwithholding problem that could be causing tax compliance problems. This System consists of two applications: the Withholding Compliance System Case Creation and the Withholding Compliance System Database.



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Recommendation

Recommendation 5: The Commissioner, Wage and Investment Division, should create a single data entry point for processing Withholding Compliance Program cases and, through the Deputy Commissioner for Services and Enforcement, provide lock-in letter issuance authority to other IRS functions.

Management's Response: IRS management agreed with this recommendation. As part of its long-term strategy, the Wage and Investment Division plans to develop a web-based format that will allow a single point of entry that, in turn, will allow communication between compliance systems. However, because this is a significant programming change, the Wage and Investment Division is currently working through the IRS Information Technology Modernization, Vision, and Strategy process to secure funding for Fiscal Year 2011. Once the funding decisions are approved, it will create a timeline for development, testing, and implementation of the web-based program. Upon implementation, the Wage and Investment Division will reassess how individual authority to issue lock-in letters could be delegated to other IRS functions.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effectiveness of the IRS' actions on underwithheld tax compliance cases. Unless otherwise noted, our limited tests of the reliability of data obtained from IRS systems did not identify any errors. We validated the reliability of computer-processed data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, we traced a judgmental sample of each data set to IRS source files to ensure accuracy. We did not perform any testing of internal controls over the systems that were the sources of our data due to the scope of the review. To accomplish the audit objective, we:

- I. Determined how the IRS monitors and measures the success of the Withholding Compliance Program to ensure that taxpayers who have serious underwithholding problems are brought into compliance with Federal withholding requirements by interviewing Withholding Compliance Program management and by obtaining and evaluating related documentation.
- II. Determined the effectiveness of the lock-in letters issued by the Withholding Compliance Program in improving taxpayer withholding compliance.
 - A. Interviewed Withholding Compliance Program management to identify what processes are in place to measure the effectiveness of the lock-in letters.
 - B. Selected and evaluated a statistically valid random attribute sample of 73 taxpayers from a population of 27,207 TY 2003 Withholding Compliance Program cases processed between December 2004 and December 2005. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 5 percent, and precision of ± 5 percent. Our sampling methodology is sufficient enough to allow us to project our sample results to the population.
- III. Determined if the IRS is using penalty assessment authority to encourage taxpayers to have adequate taxes withheld from their wages by interviewing Withholding Compliance Program management and analyzing the Employee's Withholding Allowance Certificate (Form W-4) civil penalties assessed by the Withholding Compliance function in Lowell, Massachusetts, from October 2005 to October 2007.



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Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Marybeth Schumann, Director
Bryce Kisler, Audit Manager
Alan Lund, Lead Auditor
Julia Tai, Lead Auditor
Tanya Adams, Senior Auditor
Kristi Larson, Senior Auditor
Jean Kao, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities SE:T
Commissioner, Wage and Investment Division SE:W
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Director, Filing and Payment Compliance, Wage and Investment Division SE:W:CP:FPC
Chief, Filing Compliance, Wage and Investment Division SE:W:CP:FPC:FC
Field Director, Compliance Services (Andover), Wage and Investment Division
SE:W:CP:CS:AN
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 Liaison: Senior Operations Advisor, Compliance, Wage and Investment Division
SE:W:CP



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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$34.5 million in additional tax withholding in TY 2006 could have resulted if the Withholding Compliance Program had ensured that employers complied with the lock-in letter instructions and withheld taxes from their employees at the rates specified in the lock-in letters (see page 8).

Methodology Used to Measure the Reported Benefit:

We computed the potential increase in revenue if the Withholding Compliance Program had ensured employers' compliance with lock-in letter instructions based on the results of our statistically valid random attribute sample of 73 taxpayers whose employers were sent lock-in letters due to underwithholding on wages earned in TY 2003. The sample was selected from a population of 27,207 TY 2003 Withholding Compliance Program cases processed from December 2004 through December 2005. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 5 percent, and precision of ± 5 percent. We applied the \$1,269.59 sample average underwithheld dollars¹ to the 27,207 cases in the population to arrive at an estimated \$34.5 million² in total underwithheld taxes. The precision is \pm \$23.6 million, which results in a potential underwithheld dollar range of \$11.0 million to \$58.1 million.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$11 million in additional Employee's Withholding Allowance Certificate (Form W-4) civil penalty assessments in FYs 2006 and 2007 could have resulted if IRS employees had followed the Internal Revenue Manual,³ Internal Revenue Code,⁴ and

¹ The \$1,269.59 is the average [$\$92,680/73$] of the TY 2006 estimated underwithheld taxes for the sample of 73 taxpayers shown in Figure 5 in the report.

² The figure is rounded to the nearest million. The actual amount was \$34,541,735.

³ Internal Revenue Manual Section 5.19.11.5(5).

⁴ Internal Revenue Code Section 6682.



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related tax regulations allowing assertion of a \$500 civil penalty for furnishing a false statement on Form W-4 (see page 8).

Methodology Used to Measure the Reported Benefit:

We computed the potential increase in Form W-4 civil penalty assessments based on the 21,968 taxpayers⁵ who were referred by other IRS functions and issued lock-in letters in FYs 2006 and 2007 because of tax underwithholding. We applied the Internal Revenue Code⁶ civil penalty of \$500 to the 21,968 taxpayers and subtracted the \$14,500 in civil penalties that the IRS assessed in FY 2006 to arrive at \$11 million⁷ [(21,968 taxpayers x \$500) - \$14,500] in assessments.

⁵ Some of these taxpayers could have provided supporting information, resulting in the Withholding Compliance Program rescinding the lock-in withholding rate. As a result, these taxpayers would not be subject to the Form W-4 civil penalty because their Forms W-4 would be considered correct. Even though Withholding Compliance Program management could not provide us with the number of taxpayers who fit this category, we believe that this number would be fairly small.

⁶ Internal Revenue Code Section 6682.

⁷ This figure is rounded to the nearest million. The actual amount was \$10,969,500.



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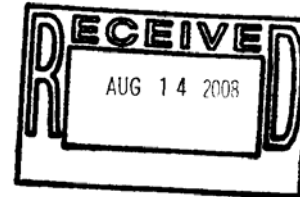
Appendix V

Management's Response to the Draft Report



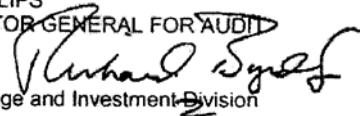
COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



AUG 14 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Withholding Compliance Program Is
Improving Taxpayer Compliance; However, Additional
Enforcement Actions Are Needed (Audit # 200840002)

I reviewed the subject draft report and agree with your overall conclusions. As you noted, and as the Government Accountability Office (GAO) found during their prior review, the Withholding Compliance program is having a dramatic impact on taxpayer filing and payment compliance. In fact, the GAO Performance and Accountability Report for Fiscal Year (FY) 2007 conservatively estimated the program has resulted in the collection of \$423 million (net present value) in additional income tax withheld for FY 2005 and 2006.

Additionally, based on the data you reported, the amount of withholding collected has increased an astonishing 526 percent from Tax Year (TY) 2003 to TY 2006. There was also a dramatic 51 percent reduction in the number of taxpayers who were either nonfilers or had filed a balance due return during the same timeframe. These results from both GAO and Treasury Inspector General for Tax Administration (TIGTA) represent only the initial pilot year of 27,207 taxpayers. Since this program has experienced substantial growth in the past two years, there is a reasonable expectation that the staggering numbers listed here will continue to improve in unprecedented proportions.

We recognize that the use of civil penalties is always an avenue to improve compliance; however, we do not feel that widespread W-4 Civil Penalty assessment is the most effective means to ensure compliance. Based on historical data from the Questionable W-4 program in FY 2002, we reviewed over 88,000 Questionable Form W-4s, yet assessed only 1,690 (1.9 percent) W-4 Civil Penalties based on the penalty application criteria. We do not believe these results warrant blanket penalty assessments.



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Nonetheless, we plan to partner with the Small Business/Self-Employed Operating Division, which is charged with penalty administration for the IRS, to evaluate our current policies regarding the Form W-4 Civil Penalty application and develop a strategy for effective utilization of this penalty. Furthermore, we will work with them to identify employers who are failing to comply with lock-in letter instructions and formulate a strategy to effectively deal with those who are non-compliant.

The number of taxpayers selected for the program from our initial startup in FY 2005 has increased over 400 percent, yet we are continually assessing and improving our program to ensure long term success. We are analyzing and refining our case selection criteria to ensure we are selecting the most productive cases. We are also working on an automation initiative to redesign our system to allow for more efficient processing of cases and create a system architecture that is in line with the overall modernization strategy of the IRS. To date, we have expanded our customer service initiatives to include Spanish-speaking assistants and have established a number that allows international taxpayers to call in for assistance.

While we agree with your overall conclusions, we disagree with the outcome measures you outlined in Appendix IV of your report. The Wage and Investment Research Division staff reviewed your sampling methodology and use of projections, and determined your sample size was too small to make reliable projections to the population.

Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact Jim Grimes, Director, Compliance, Wage and Investment (W&I) Division, at (404) 338-9904.

Attachment



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Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should ensure that the Director, Compliance, Wage and Investment Division, develops a process to identify those employers that do not adequately withhold taxes from their employees after receiving a lock-in letter.

CORRECTIVE ACTION

We agree with this recommendation. The W&I Division will develop an annual report that will identify employees who continue to work for the same employer after a lock-in letter has been issued, yet have no significant change in their withholding patterns.

IMPLEMENTATION DATE

December 15, 2009

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should ensure that the Director, Compliance, Wage and Investment Division, works with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to develop employer examination criteria for referring those employers that did not follow lock-in letter instructions.

CORRECTIVE ACTION

We agree with this recommendation. The W&I Division will provide pertinent employer and worker information where a lock-in letter was deemed necessary. This information will be provided in an electronic format to be used in the Service-Wide Employment Tax Research System (SWETRS), currently under development. Using SWETRS, the Small Business/Self-Employed (SB/SE) Division will analyze the data and incorporate it into the scoring model to identify cases with the greatest compliance risk. The data will be available in SWERTS for use in case selection processes in Large & Mid-Size Business (LMSB) and Tax Exempt & Government Entities (TE/GE) Division employers.

IMPLEMENTATION DATE

January 15, 2009 (The W&I Division will provide information to SB/SE)
May 15, 2010 (The SB/SE Division will incorporate data into SWETRS)



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RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division
Director, Specialty Programs, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 3

The Commissioner, Wage and Investment Division, should ensure that the Director, Compliance, Wage and Investment Division, coordinates with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to develop and deliver training to appropriate IRS employees on the existing criteria for the current referral process.

CORRECTIVE ACTION

We agree with this recommendation. The W&I Division will develop a corporate Continuing Professional Education training module outlining the Withholding Compliance referral criteria. This training module will be provided to LMSB, TE/GE, and SB/SE Operating Divisions to allow them to deliver to the appropriate employees within their operating divisions.

IMPLEMENTATION DATE

December 15, 2009

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 4

The Commissioner, Wage and Investment Division, should ensure that the Director, Compliance, Wage and Investment Division, works with the Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions to research and develop criteria that will expand the use of the Form W-4 civil penalty beyond the current limitation of referrals and special projects. Guidance and training should then be provided to the appropriate IRS employees to ensure consistent application of the criteria.



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CORRECTIVE ACTION

We agree with this recommendation, in part. The W&I Division will establish a cross-functional team to evaluate current W-4 Civil Penalty guidelines and make recommendations on situations where, if warranted, the W-4 Civil Penalty guidelines can be expanded. Based on the outcome of these findings, the W&I Division will re-evaluate the need to develop training, which in turn could be turned over to the other operating divisions for delivery.

IMPLEMENTATION DATE

December 15, 2010

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 5

The Commissioner, Wage and Investment Division, should create a single data entry point for processing Withholding Compliance Program cases and, through the Deputy Commissioner for Services and Enforcement, provide lock-in letter issuance authority to other IRS functions.

CORRECTIVE ACTION

We agree with this recommendation. As part of our long-term strategy, we plan to develop a web-based format that will allow single point of entry which, in turn, will allow communication between compliance systems. However, since this is a significant programming change, we are currently working through the IRS Information Technology (IT) Modernization, Vision and Strategy (MV&S) process to secure funding for FY 2011. Once the funding decisions are approved, we will develop a timeline for development, testing and implementation of the web-based program. Upon implementation, we will then re-assess how individual authority to issue lock-in letters could be delegated to other IRS functions.

IMPLEMENTATION DATE

December 15, 2013

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division



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CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.