

GAO

Report to the Ranking Minority
Member, Committee on Small Business
& Entrepreneurship, U.S. Senate

January 2002

**TAX
ADMINISTRATION**

**IRS's Efforts to
Improve Compliance
With Employment Tax
Requirements Should
Be Evaluated**



G A O

Accountability * Integrity * Reliability

Contents

Letter		1
	Results in Brief	2
	Background	4
	Scope and Methodology	5
	Time Taken to Initially Notify Employers Of Delinquencies Can Vary	8
	Efforts to Evaluate IRS Programs to Prevent or Reduce Tax Delinquency Have Experienced Problems	13
	IRS' Ongoing Modernization Could Improve Intervention With Employers	18
	Conclusions	20
	Recommendation for Executive Action	21
	Agency Comments and Our Evaluation	21

Appendix I	Comments From the Internal Revenue Service	23
-------------------	---	----

Tables		
	Table 1: Form 941 Quarterly Return Data for Calendar Year 2000	11
	Table 2: Interest and Penalty Assessments for Depositors Missing the First and Last Deposits of the 4th Quarter 2000	13

Figure		
	Figure 1: IRS Processing Steps and Time Frames for Form 941 Returns and Related Notices for Fourth Quarter 2000	10

Abbreviations

ACS	Automated Collection System
BMF	Business Master File
EIN	Employee Identification Numbers
FTD	Federal Tax Deposit
IRS	Internal Revenue Service
SB/SE	Small Business and Self-Employed Division
TIGTA	Treasury Inspector General for Tax Administration



G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

January 15, 2002

The Honorable Christopher S. Bond
Ranking Minority Member
Committee on Small Business & Entrepreneurship
U.S. Senate

Dear Senator Bond:

Employers are required to withhold amounts from their employees' salary to cover individual federal income tax, Social Security, and Medicare taxes; match the amounts for Social Security and Medicare taxes; and deposit these amounts with the U.S. Treasury. In fiscal year 2000, the Internal Revenue Service (IRS) collected \$1.3 trillion in this manner. Although the majority of employers withholds and deposits these taxes as required, for those who fail to do so, the amount of unpaid employment taxes, penalty and interest has grown significantly. As of September 30, 2001, IRS data show that in 1997, 1998, 1999, and 2000, delinquent employers owed about \$3.2, \$3.5, \$4.4, and \$5.0 billion, respectively, in unpaid employment taxes, penalties, and interest.

Although its data systems do not track what percentage of these unpaid employment taxes are attributable to small businesses, IRS considers employment tax compliance to be among the most challenging issues for small businesses.¹ Small businesses may be challenged because their owners may not have sufficient capital or may lack experience or training in business tax obligations, making it difficult for these businesses to remain economically viable. According to Small Business Administration data, about 50 percent of new businesses fail to remain open for at least 4 years following their creation. When confronted with a choice between paying necessary operating expenses or depositing employment taxes, struggling businesses may opt to pay business expenses instead of taxes.

Employers who do not deposit employment taxes may gain an unfair advantage over those employers who comply voluntarily. Furthermore, noncompliant employers can accumulate substantial unpaid taxes with associated interest and penalties. Over time, these unpaid balances may

¹IRS defines small businesses as farmers, sole proprietorships, partnerships, and corporations with assets of \$5 million or less.

compound beyond the employers' ability to pay—ultimately placing their businesses in greater financial jeopardy.

Because of your interest in IRS' timely intervention to help employers—particularly those with a small business—avoid the pyramiding of taxes, interest, and penalties, you asked us to review various aspects of IRS' efforts to notify and intervene with employers concerning delinquent employment taxes. Accordingly, this report discusses (1) how long IRS takes to notify employers of employment tax delinquencies; (2) what types of intervention programs and initiatives IRS uses for employers with delinquent employment taxes and how IRS evaluates the effectiveness of these efforts; and (3) what new intervention programs or initiatives IRS is developing as part of its modernization efforts.

As described further in this report, the employment tax deposit requirements vary by the amount of employment taxes an employer owes. Employers with the smallest employment tax liabilities pay on a quarterly basis; those with the largest liabilities pay the next banking day; and those with intermediate-sized liabilities pay on a monthly or more frequent basis. Generally, small businesses would tend to be heavily concentrated in the employment tax deposit categories calling for less frequent payments. Although employment taxes for many employers must be paid throughout a calendar quarter, IRS' ability to determine whether employers have paid as frequently as required and in the amounts required is dependent on employers filing the Employer's Quarterly Federal Tax Return (Form 941 return).

Results in Brief

The time IRS takes to notify employers of delinquent payment of employment taxes varies. On average, IRS takes about 5 weeks to initially notify employers regarding employment tax delinquencies after the Form 941 return is received. Filing the Form 941 return is crucial because IRS matches its internal records of deposits employers made during the quarter to those deposits employers subsequently listed on their returns. When employers fail to file Form 941 returns, IRS normally takes from 14 to 28 weeks to notify them of this delinquency. From the employers' standpoint, however, the date of delinquent deposits is critical because interest and late penalties are computed from the date the deposits were due, not from the date of notification. Thus, the earlier deposits are missed in a quarterly period, the greater the financial consequence for employers.

Aside from its usual efforts to educate and inform taxpayers of their responsibilities, IRS has four programs to prevent or reduce employers'

tax delinquencies. Two of these programs were designed to achieve early contact with employers, and two were designed to identify employers with existing, multiple employment tax delinquencies and help them to return to compliance. Although all of the programs have an overall objective of increasing employers' compliance rate, three were small efforts to assess whether new approaches would be effective and should be adopted. IRS is attempting to improve the fourth effort, IRS' Federal Tax Deposit (FTD) Program, which has existed for many years. To evaluate the effectiveness of these programs and to support informed judgments about whether to adopt the new ones, IRS planned to compare compliance rates of test and control groups and to use customer surveys and focus groups. IRS' efforts to evaluate these programs are being adversely affected by, among other things, delays in obtaining reliable data.

IRS officials did not identify any specific programs to improve employment tax intervention under IRS' ongoing effort to modernize its organizational structure, management processes, and information technology systems. However, certain aspects of its modernization effort have some future potential to improve intervention. For example, one of the four new divisions IRS established in October 2000, the Small Business/Self Employed Division, focuses specifically on the needs of small businesses and self-employed persons. This focus is intended to enable IRS to better understand the tax issues of this population so it can more effectively serve their needs and promote their compliance. IRS also plans to place much more emphasis on providing services to all taxpayers, including small business employers, before they file their returns. This includes improved instructions and other materials to aid in the understanding of tax obligations, which is consistent with the early intervention efforts IRS has already begun. IRS' plans to replace the many information systems it uses to maintain taxpayer files with a single integrated system is central to its modernization efforts. This system will allow for more rapid daily processing of returns and related notices, including employment tax notices. IRS does not expect, however, the replacement system to be operational for Form 941 returns until at least 2005.

We are making a recommendation to the Commissioner of Internal Revenue to ensure that evaluations are performed to measure the effectiveness of IRS' early intervention programs. Evaluations are essential to the careful expenditure of IRS' resources because they determine the overall benefits of the programs, whether improvements are needed, or whether the programs should be continued.

We obtained IRS' written comments on a draft of this report in a January 3, 2002, letter from the Commissioner of Internal Revenue (see app. I). In commenting on a draft of this report, the Commissioner agreed with our recommendation and said that steps will be taken to evaluate the intervention programs cited in our report.

Background

All employers must file their Form 941 returns quarterly, although some are to make employment tax deposit on differing schedules during a quarter. The form contains information concerning the tax deposits made for a quarter and is generally due by the end of the month after the close of the quarter.² Until IRS receives and processes the Form 941 returns, it cannot match tax deposits reported on the returns with its records of deposits received. Once it matches this information, IRS notifies employers of any delinquencies using a written notice. This is the employers' first statutory notice of the delinquency. If the employer fails to respond to this first notice, IRS sends follow-up notices and may later contact the employer by phone or, eventually, make a personal visit. Although this entire process can take years for those employers who do not respond, under IRS' processing procedures, initial notices are sent within several weeks after IRS receives the Form 941 return.

IRS provides a variety of outreach efforts to help employers understand how to meet their tax obligations, many of which are designed to explain requirements and to meet other needs of small business taxpayers. For example, IRS makes tax forms with instructions and publications that explain requirements available to taxpayers in a variety of formats including hard copy, CD-ROM, and electronic form on the Internet. In addition to conducting various workshops and seminars, many of which are tailored to the needs of small businesses, IRS also recently established a Web site specifically designed to address the needs of small business taxpayers. Beginning in September 2001, IRS' Web site allows employers nationwide to use the Internet to deposit employment taxes via the Electronic Federal Tax Payment System On-Line.

Current IRS strategies and program plans call for providing more services to taxpayers, including employers, to prevent noncompliance. To that end, IRS has shifted its focus from addressing compliance issues after returns

²Employers who have deposited all employment taxes due during the quarter are allowed an additional 10 days to file the Form 941 return.

are filed to addressing them as early as possible, often through efforts to better educate taxpayers about their tax responsibilities and to improve forms, guidance, and other information available to taxpayers. This is consistent with IRS' strategic objectives to reduce taxpayer burden, uncertainty, and errors by clarifying tax law responsibilities and resolving issues early in the process. IRS believes that its efforts to reduce taxpayer burden will show significant progress over the next 2 years and will be further enhanced by its plans for long-term business systems modernization.

Scope and Methodology

- To determine how long IRS takes to contact employers after an employment tax delinquency occurs, we analyzed the time between (1) the receipt of a quarterly Form 941 return and IRS' mailing of an initial delinquency notice, (2) when a Form 941 was due and IRS' mailing of a delinquency notice when the employer fails to file a Form 941, and (3) when the employers should have deposited employment taxes during a quarter and IRS' mailing of an initial delinquency notice. For all three situations, we interviewed cognizant officials from IRS' Small Business and Self-Employed Division (SB/SE), IRS' National Office, and various field offices, and we obtained related documentation.
- To determine the time between when a Form 941 return was due but not filed and IRS' mailing of initial delinquency notices and the time between when an employer fails to make a deposit during a quarter and IRS' mailing of a notice, we relied on the flowchart of IRS' processes and associated timeframes that we developed. We confirmed our summaries of IRS' processes and related timeframes necessary to notify employers of delinquencies with appropriate IRS officials at the National Office, Atlanta Service Center and the Martinsburg Computer Center. IRS did not have data in its BMF One Percent Sample File that we could use to estimate these timeframes.
- To determine the length of time between when IRS receives the Form 941 return and the issuance of the initial notice to the employer,
 - we analyzed data extracted from IRS' Business Master File (BMF). The data we used in this time analysis was extracted from an IRS data file

entitled the BMF One Percent Sample File.³ IRS uses this data file to perform its own analysis of BMF information and to verify system performance and output. IRS considers the results of analysis from the BMF One Percent Sample data to be valid and uses the data file to perform comparable analyses, however it does not use the data file to make estimates projectable to the entire BMF. In addition, because we did not have access to taxpayer data, we were not able to independently verify taxpayer information contained in the data file. IRS officials did not have programming resources available to extract a random sample of employment tax-related delinquencies from the BMF, thus IRS' BMF One Percent Sample File provided the best alternative for obtaining the data for the time analysis. In providing delinquent employment tax information for the time analysis, IRS extracted Form 941 return records and associated transaction date information from the BMF One Percent Sample File. After removing the employee identification numbers (EIN) from the file, IRS provided us with a file containing transaction date information for the delinquent Form 941 returns selected. The data used in the time analysis reflects taxpayer account information from the BMF as of September 2001. For tax years 1999 and 2000, over 66,000 account records were used in the analysis. About 25,000 records were eliminated from the time analysis because they were not posted to the BMF as normal Form 941 quarterly returns. We also developed flowcharts to describe IRS' processes and associated timeframes for initially contacting delinquent employers to further validate the BMF sample timeframe analysis; and verified the accuracy of the flowchart with IRS officials.

- we reviewed and analyzed statistical information related to employment taxes—including the number of Form 941 returns filed based on amounts paid to determine the frequency of deposits. We also reviewed and analyzed IRS employment tax-related collection policies and procedures, obtained relevant publications and instructions, and reviewed relevant IRS web pages and related reports.
- To identify IRS' current employment tax intervention programs and program evaluation efforts, we
 - interviewed appropriate IRS officials within SB/SE and other operational groups who identified the following four intervention

³This data file contains approximately 1 percent of all the tax accounts in the BMF, across all tax segments. The selection criteria for the file are based on the last two digits of the 9-digit employer identification number (EIN). Entities and tax modules whose last two digits contain zeros are selected for inclusion in this data file.

programs: Mentoring and Monitoring, Federal Tax Deposit (FTD) Soft Letter, ABC's of FTDs, and FTD Alert Program; and

- obtained and discussed pertinent program documentation including plans, progress reports, and schedules with IRS officials.
- To determine IRS' plans under modernization as they related to employment tax intervention and evaluation efforts, we
 - interviewed and discussed with cognizant IRS officials IRS' business system modernization efforts; and
 - obtained and reviewed relevant documentation including IRS' Strategic Plan (Fiscal Year 2000-2005), and 2000 Progress Report-IRS Business Systems Modernization Program .

You expressed interest in the level of resources IRS uses to contact taxpayers with employment tax delinquencies. We researched this by interviewing IRS officials and reviewing past reports by IRS and us. On the basis of this work, we advised you that IRS' financial and data systems do not collect or produce such specific information. Currently, IRS cannot isolate the resources it uses to notify employers having employment tax delinquencies for specific form types such as the Form 941 return. As a result, you suggested that we not pursue the resource issue at this time.

You also expressed interest in whether there are intervention programs and initiatives in use at other federal agencies or relevant nonfederal organizations that could serve as best practice models for IRS. We are not reporting on this topic because during our review of eight federal agencies and five state tax authorities⁴ we did not find any intervention programs or initiatives that could serve as best practice models. The primary reason for this is that many of the organizations under review had significantly different procedures than IRS for formally identifying a delinquency. For example, these organizations often have shorter collection cycles than IRS which enables them to notify delinquent parties in less time than IRS. IRS' collection cannot begin until after it receives the quarterly Form 941 returns.

⁴These organizations were the Bureau of Alcohol, Tobacco and Firearms; United States Customs Service; Department of Education; Farm Service Agency; the Department of Housing and Urban Development; Pension Benefit Guaranty Corporation; Rural Housing Service; Small Business Administration; the Arizona Department of Revenue; the California Franchise Tax Board; Illinois Department of Revenue; Texas Comptroller of Public Accounts; and Washington State Department of Revenue. We selected them for their diversity of period payment collections. We interviewed officials and obtained and reviewed payment processing and collection procedures.

This review primarily focuses on IRS' intervention efforts as they relate to the initial notification of employment tax delinquencies. In addition, the review covers IRS' efforts to intervene with taxpayers in order to educate and inform them of their tax obligations and to expedite compliance. The review did not cover IRS' subsequent enforcement and collection activities such as contacting delinquent employers through IRS' Automated Collection System (ACS)⁵ or contacts made by IRS' collection representatives in the field.

We performed our work from June 2000 through December 2001 in accordance with generally accepted government auditing standards.

Time Taken to Initially Notify Employers Of Delinquencies Can Vary

The time IRS takes to notify employers of deposit or return delinquencies and the amount of interest and penalty assessed is affected if employers fail to meet two major employment tax responsibilities. Employers must make periodic employment tax deposits during each quarter and file Form 941 returns by the last day of the month following the close of each calendar quarter. The periodic deposits made throughout the quarter are subsequently reported on the Form 941 returns. Filing these returns is crucial because IRS determines compliance by matching its accounting records of deposits made throughout the quarter with the deposit information reported on the return. Consequently, failure to file Form 941 returns necessitates additional IRS processing and can further delay employer notification of delinquencies thus increasing employers' interest and penalty charges. Based on IRS data and our discussions with IRS officials, we found the following:

- Our analysis of IRS' data containing delinquent employment tax accounts shows that IRS took an average of about 5 weeks from the date the Form 941 returns were filed to notify employers of a missed, late, or underpaid deposit.
- Based on our analysis of the steps IRS follows to detect and notify employers of a failure to file a 941 return, which we confirmed with IRS officials, we found that IRS normally takes from 14 to 28 weeks. During

⁵The Automated Collection System (ACS) is a computerized inventory system that maintains balance due accounts and return delinquency investigations. Most balance due accounts and return delinquency investigations are issued to ACS after normal service center notices have been issued.

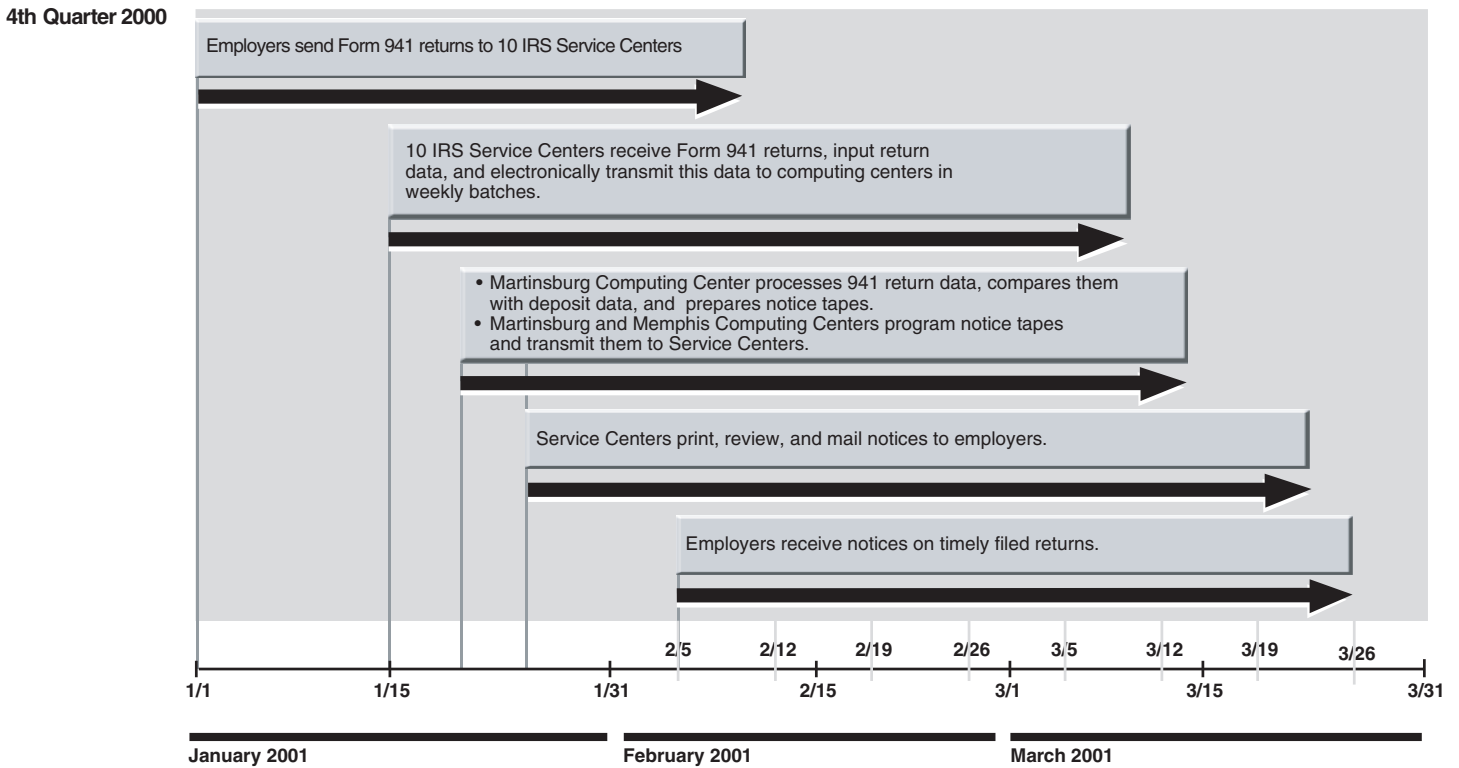
the first two quarters of the calendar year, individual return processing demands affect the time IRS takes to process these notices.

Following a similar analysis confirmed by IRS, we found that when employers have delinquent deposits, IRS notification reaches most employers from 3 to 23 weeks from the due date of the delinquent deposit the exact time is primarily dependent upon when the deposit involved was due. From the employers' standpoint, the date of any missed or underpaid deposit is important because IRS computes interest and penalties from the date of the delinquent deposit.

IRS Takes Several Weeks to Notify Employers of Employment Tax Delinquencies

Our analysis of IRS' delinquent employment tax data indicates that once IRS receives Form 941 returns, it takes about 5 weeks to notify employers of employment tax delinquencies. The time required to notify employers is contingent on the date that employers file their Form 941 returns and the ensuing IRS processing workload. Employers generally have until the end of the month after the quarter closes to file their returns. During calendar years 1999 and 2000, IRS received and processed about 5.7 million Form 941 returns per quarter. Using the 4th quarter of calendar year 2000 as an example, IRS service centers began receiving and processing Form 941 returns in mid-January 2001, although most were received in the surge of returns arriving at IRS service centers following the due date of January 31. Figure 1 shows the multiple steps involved in IRS' weekly batch processing of the Form 941 returns and the related time frames for each step of processing 4th quarter returns.

Figure 1: IRS Processing Steps and Time Frames for Form 941 Returns and Related Notices for Fourth Quarter 2000



Source: IRS.

Not Filing a Form 941 Return Further Delays Notification

When employers fail to file Form 941 returns, IRS takes longer to notify them because it first processes timely-filed returns before it begins to identify missing returns. In that regard, we found that IRS normally takes from 14 to 28 weeks after the due date to notify employers of their failure to file a Form 941 return. IRS officials concurred with that timeframe for IRS to notify employers of these delinquencies. IRS officials added that the time variance is due to differences of tax quarter workloads with the heaviest workload falling in the first two quarters of the calendar year. In response to increased workloads, IRS prioritizes the processing of taxpayer notices by notifying employers with the greatest liability and with repeated return delinquencies first.

These notices do not assess penalties or interest against the employers but rather advise them that IRS has not received the Form 941 returns and ask the employers for explanations. For employers who also have failed to

deposit taxes due, interest and penalties continue to accrue until they become compliant.

Time From Date of Delinquent Deposit Affects Interest and Penalties

Although the receipt date of the Form 941 returns is key to IRS' processing and employer notification, interest and late penalties accrue from the date of the employers' delinquent deposits. Accordingly, delinquent deposits from early in a quarter will result in higher interest and penalties than delinquent deposits from later in the quarter.

Employers owing smaller amounts of employment taxes are allowed to make less frequent deposits. As shown in table 1, in calendar year 2000, about 71 percent of employers owed employment taxes of \$50,000 or less annually and could make deposits on a quarterly or monthly basis. Conversely, 29 percent of employers owing more than \$50,000 annually had to deposit employment taxes more frequently.⁶ Employers who are in this deposit category made 95 percent of the total employment tax deposits.

Table 1: Form 941 Quarterly Return Data for Calendar Year 2000

Deposit frequency – category based on amount owed	First deposit due	Employers	Revenue
Quarterly—for employers owing less than \$1,000 per quarter	Due with the filing of the return—month after the quarter closes	19%	.2%
Monthly—for employers owing between \$1,000 to \$50,000 annually	15th of the month following the close of each month in the quarter	52%	4.3%
Depositor pays more frequently than monthly or quarterly—for employers owing more than \$50,000 annually	Varies, depending on how often employees are paid.	29%	95.5%

Source: Computations from IRS' FTD Payment and Penalty Report 200001-52.

Beginning January 1, 2001, more employers were allowed to pay employment taxes quarterly as opposed to monthly or more frequently.

⁶For employers owing over \$50,000 per year, deposits are made on either the Wednesday or Friday following the payday; for employers whose deposits accumulate to \$100,000 or more, the deposit must be made the next banking day.

From that date, employers owing less than \$2,500 (rather than \$1,000) could pay when they file their returns, reducing employer burden and decreasing the chance for delinquencies and other mistakes. Had this change been in effect during calendar year 2000, the number of employers depositing quarterly would have increased from about 19 percent to about 37 percent.

Because these employers pay when they file their Form 941 return, interest and penalties have less time to accrue before they receive a notice concerning delinquencies. Therefore, these depositors would be subject to less interest and penalty than employers who fail to make deposits during the quarter before the form 941 return is due.

A reduction in the frequency of required deposits can decrease the amount of time that interest and penalties can accrue. However, for employers who are required to deposit employment taxes more frequently than either monthly or quarterly, missing or underpaying their first payment in the quarter allows interest and penalties to accumulate for a longer period of time.

Table 2 shows the interest and penalty consequences for a hypothetical monthly depositor and a depositor who pays more frequently during the quarter, both of whom miss their first and last deposit due in the 4th quarter. The table demonstrates the increased interest and penalty amounts for missing deposits early in the quarter for both types of depositors. It also shows that the impact is greater on depositors who pay more frequently, as their deposits are due earlier in the quarter.

Table 2: Interest and Penalty Assessments for Depositors Missing the First and Last Deposits of the 4th Quarter 2000

Description of event	Deposit requirements			
	Deposits more frequently than monthly or quarterly		Monthly deposits	
	First deposit of quarter missed on Oct. 18, 2000	Last deposit of quarter missed on Jan. 3, 2001	First deposit of quarter missed on Nov. 15, 2000	Last deposit of quarter missed on Jan. 15, 2001
Amount of missed deposit	\$ 10,000.00	\$ 10,000.00	\$ 1,000.00	\$ 1,000.00
Interest and penalty				
Failure to deposit correct amount on time (10 % if paid within 10 days of the notice)	1,000.00	1,000.00	100.00	100.00
Interest from date of missed deposit ^a	373.67	176.59	30.25	14.90
Late pay penalty (one-half of 1% for each month or part of a month late)	250.00	150.00	25.00	15.00
Total interest and penalty	1,623.67	1,326.59	155.25	129.90
Interest and penalty as a percent of missed deposit	16.2%	13.2%	15.5%	13.0%

^aIRS uses the interest rates determined each quarter by the Department of Treasury. IRS personnel computed these interest charges based on the rates in effect for the 4th quarter 2000.

Source: IRS

If employers fail to respond to the initial notice of a delinquency, interest and penalty amounts can pyramid. For example, if employers fail to deposit the correct amount within 10 days of receiving the notice, the penalty increases from 10 to 15 percent of the delinquent deposit. Interest continues to accrue until the deposit is paid. Generally, the late pay penalty can accumulate up to 25 percent of the delinquent amount. Had these employers also failed to file Form 941 returns, they would be subject to an additional penalty of 4.5 percent per month, which could also compound to 22.5 percent.

Efforts to Evaluate IRS Programs to Prevent or Reduce Tax Delinquency Have Experienced Problems

IRS has developed several specific programs designed to intervene with employers to help prevent employment tax delinquencies and reduce the pyramiding of additional tax, interest, and penalty charges. IRS officials identified four programs that specifically seek to intervene with employers to prevent or reduce delinquent employment taxes: (1) Mentoring and Monitoring, (2) Federal Tax Deposit (FTD) Soft Letter, (3) ABC's of FTDs, and (4) FTD Alert. While the first three programs are in various stages of completion, the fourth is an established program that is undergoing changes intended to improve it. To evaluate the effectiveness of these programs, IRS planned to compare compliance rates of test and control groups and to use customer surveys and focus groups. IRS has experienced difficulties in completing performance evaluations for such

reasons as time delays in obtaining the data required to determine the programs' effectiveness. The programs and IRS' evaluations of them are discussed below.

Mentoring and Monitoring Program. This pilot program is IRS' largest recent effort to prevent employment tax delinquencies among new employers. Under the program new employers are given special educational materials at the time they receive their employer identification number and some of these new employers receive follow-up monitoring. IRS conducted this pilot program for more than 13,000 new employers in four states (Kansas, New Mexico, Oklahoma, and Texas). The 2-year program began in August 1999, and IRS expects to complete its evaluation in early 2002.

IRS sent the special educational materials to two separate test groups of new employers and offered additional services to the ones IRS considered at higher risk of noncompliance.⁷ Every employer in the test groups received educational materials that included a videotape, entitled "ABC's of FTDs;" a workbook concerning FTD requirements; and other information to help new employers. Nearly 7,000 employers in test groups considered higher risk were offered additional monitoring services, which included assigning a Small Business Representative to act as a mentor to answer questions, provide forms and publications, and remind employers of deposit and filing requirements during monthly monitoring calls. Of the 1,716 employers that initially accepted IRS' offer of these services, about 800 remained in this part of the program at the time it was discontinued in July 2001.

IRS planned a two-pronged evaluation, using customer surveys for the test group and a comprehensive evaluation of compliance data comparing the test and control groups. In contrast to the special materials and services provided the test groups, employers in the control groups received only the letter IRS normally sends when new employers request an EIN.

IRS planned to mail customer surveys to test employers in fiscal year 2000, directly after the educational materials were delivered and the monitoring services were under way. These surveys were designed to obtain the views

⁷IRS identified higher risk employers as those who had paid employment taxes before obtaining an EIN, who had previous delinquencies associated with other businesses, and who were in industries with historically high delinquency rates.

of test employers on the program materials and other services, but the surveys were never conducted because of a lack of funding. As of October 2001, IRS had awarded a contract to have focus groups conducted in place of the customer surveys; however, the focus groups were not expected to be completed until mid-January 2002. The delays between the time that materials and services were received and the time focus groups were to provide their opinions could affect the usefulness of their responses.

IRS also plans to evaluate this program by comparing the compliance rate of various risk categories of employees among the test group employers and with corresponding categories within the control groups. Although it has been delayed, IRS plans to begin evaluating the compliance data for the test and control groups when they become available in late fall 2001. The data will include such information as deposits made, returns filed, delinquencies and resulting notices sent, and FTD penalties assessed. The analysis of these data, along with a cost-benefit summary will be included in the business analysis case that will be prepared to support recommendations about the program's future.

In an August 2001 audit report⁸ on the results of its review of the Mentoring and Monitoring pilot, the Treasury Inspector General for Tax Administration (TIGTA) reported that the program should help new business taxpayers with their federal employment tax responsibilities. TIGTA expressed concerns, however, about the program's sampling methodology, cost-effectiveness, and level of management oversight and raised certain questions about expanding it nationwide at this time. Among other things, TIGTA recommended that SB/SE Division management should provide oversight for the remainder of the project, including the planned business case analysis of the compliance results achieved under the pilot.

FTD Soft Letter. This pilot program seeks to improve employers' voluntary compliance through intervening much earlier than IRS' long-standing FTD Alert Program⁹ allows. The FTD Soft Letter was sent only to employers required to make deposits more frequently than monthly and who appeared to have underpaid tax deposits during the quarter. Before

⁸See TIGTA, *A Prototype to Help New Small Business Employers Appears Effective, But More Information Is Needed Before Expanding It Nationwide* (August 2, 2001). TIGTA was previously known as IRS' Office of Internal Audit.

⁹See page 17 regarding the FTD program.

their quarterly Form 941 return was due, IRS sent these employers a letter advising them of the potential discrepancy. IRS sent letters only to those employers identified nationwide who had historically been compliant but were assessed an FTD penalty in one of the past four quarters and paid it but appeared to have made smaller than expected tax deposits in the current quarter.

In October 2000, IRS sent a soft letter to 1,806 employers nationwide who met the criteria. The letter included a phone number they could call to request assistance, and a tear-off portion to notify IRS if they were no longer in business or had no employees. In response, 339 of the 1,806 informed IRS that their businesses were defunct or no longer had employees.

IRS originally planned to evaluate the compliance of the test group against a control group of similar employers that had not received a soft letter. IRS was to begin the evaluation in January 2001, with the final report due by July 2002. As of October 2001, IRS had not begun the evaluation, and no decision had been made on whether or not to proceed with it.

According to IRS officials, evaluation plans were disrupted as the result of IRS' ongoing reorganization. In that regard, responsibility for the soft letter program was transferred from the now defunct Small Business Lab to the SB/SE Division, established in October 2000. Although the program was transferred in early 2001, IRS did not assign formal program responsibility to the division until August 2001. In October 2001, newly assigned program officials decided to evaluate the program to determine the program's effectiveness and possible future use. Current plans call for a report based on four quarters of compliance data to be completed by April 2002.

The ABC's of FTDs. This 2-hour class on FTD, including videotape entitled "The ABC's of FTDs" and a course workbook, was designed to assist employers who experienced difficulties in staying compliant with their federal tax deposit obligations. Employers were invited to attend classes that were held in September 1998, February 1999, and June 1999 in the Seattle metropolitan area. If employers attended the class and remained compliant for two subsequent quarters, IRS excused them from paying up to three tax quarters of the FTD penalties they had previously incurred. However, only 28 of 315 employers invited to attend classes actually did so, according to IRS data.

To analyze the pilot program, IRS established both a test group consisting of those employers who attended the educational classes and received the

materials and various control groups that did not. IRS had planned to track payment compliance for these groups through June 2001, but instead concluded the evaluation in June 2000, using compliance data from five quarters. IRS' evaluation of the program revealed that employers made more FTD deposits and filed fewer delinquent returns after attending the classes; however, IRS could not attribute these improvements to class attendance. The evaluation made several other points regarding the program:

- Low class attendance diminished the impact of the program.
- The test group tended to make more deposits than the control groups, even before they were invited to attend.
- The employers who attended chose to come and, therefore, may have been more motivated to be compliant.

The evaluation made several recommendations that have apparently not been acted upon.¹⁰ The educational videotape and course workbook also were used, however, as part of the Mentoring and Monitoring program materials in an effort not only to educate employers but also to further evaluate the materials' effectiveness. As previously discussed, however, the evaluation of this program, expected to be completed in mid-January 2002, is to be based on input from employer focus groups held more than a year after IRS' originally planned customer surveys.

FTD Alert. IRS' FTD Alert program has existed since 1972 and is intended to improve overall employment tax compliance. The current program's selection criteria identifies only those depositors who owe more than \$50,000 per year, have delinquencies resulting in FTD penalties in recent quarters, and appear to have underpaid the current quarter. If the employers have FTD penalties in the four previous quarters, IRS Revenue Officers are required to contact them to help them understand deposit requirements and the cost and consequences of not depositing as required. Although the program provides IRS with an opportunity to intervene with these employers concerning their delinquencies, several aspects of the

¹⁰The recommendations included that IRS use focus groups or surveys to determine why so many employers declined to participate in the program and to obtain feedback about how the course should be improved. The evaluation also recommended that IRS consider developing an alternative means of educating taxpayers on FTD requirements, such as self-study courses or offering on-line or CD-ROM versions in order to increase participation.

program have been criticized. IRS is in the early stages of addressing these weaknesses, as discussed below.

Over the years, both our reports and IRS internal audit reports have been critical of several aspects of the FTD Alert Program. For example, we stated in a 1991 report that IRS lacked a tracking system to determine the result of contacts made with delinquent employers,¹¹ and IRS echoed this same criticism in TIGTA's 1998 internal report.¹² Without such a system, IRS cannot assess the effectiveness of the program. The IRS National Office FTD analyst responsible for the program stated that a meeting is planned in January 2002 to begin development of such a system.

As recommended by TIGTA in 1998, IRS' research organization has been exploring ways to improve the FTD Alert Program that may result in current selection criteria being replaced. According to IRS, earlier efforts have demonstrated some success in identifying the most collectible delinquencies and prioritizing the workload to target those delinquencies. IRS' effort to improve employer selection criteria was to be completed in mid-2000, but its information systems staff was unable to provide the required data when it was originally requested owing to competing priorities. IRS requires the data to develop algorithms based on the current selection criteria that will, if successful, allow IRS to identify and prioritize employers nationwide who are at risk of becoming delinquent. According to IRS officials, the needed data were to be delivered by August 30, 2001. IRS plans to test the algorithms during the winter, using test and control groups, and evaluate them by spring 2002. By the end of June 2002, IRS plans to prepare a final report detailing the methodology, findings, and recommendations regarding the selection criteria.

IRS' Ongoing Modernization Could Improve Intervention With Employers

IRS' ongoing modernization efforts do not currently include any programs specifically designed to improve IRS' notification to employers with tax delinquencies. However, sweeping organizational changes and information system improvements may in the future reduce taxpayer burden and improve compliance. These changes are not expected to be completed in the near term but will be phased in over the next several years. Information system improvements may help IRS to notify employers of tax

¹¹See *Tax Administration: Efforts to Prevent, Identify, and Collect Employment Tax Delinquencies* (GAO/GGD-91-94, August 28, 1991).

¹²See TIGTA, *Service Procedures for Monitoring Federal Tax Deposits* (Aug. 14, 1998).

delinquencies more quickly and effectively, but implementation is not expected to begin for business returns, such as the Form 941 returns, until at least 2005.

Organizational Changes Could Begin to Help Employers

IRS is making major organizational changes designed to reduce taxpayer burden and improve services. For example, it has created four new operating divisions tailored to more effectively meet the needs of specific groups of taxpayers. Similarly, IRS is also designating that only certain service centers will receive and process business tax returns and related tax information, and officials believe this specialization could eventually expedite processing. As part of its strategic plan, IRS will emphasize providing assistance to taxpayers before tax returns are filed and providing earlier intervention with taxpayers when problems arise.

One of IRS' four new operating divisions is dedicated to serving the needs of small business and self-employed taxpayers, while another serves large and mid-sized businesses.¹³ According to IRS' plans, taxpayers in each of these divisions should benefit from IRS' handling of all their respective tax issues within a single organization. IRS management and staff are expected to provide more tailored products and services to help their respective taxpayer segments comply with applicable tax laws. Although the new divisions officially began operations on October 1, 2000, they are still developing processes and operating procedures. The SB/SE Division, in particular, is not yet fully staffed.

In addition, IRS is shifting its workload to allow certain locations to specialize in processing business returns. For example, instead of all 10 IRS service centers processing Form 941 returns, IRS plans to have only two service centers doing this work. IRS does not expect this change to be completed until at least 2002. Furthermore, according to an IRS modernization official, the specialized services centers are not expected to initially impact the current IRS processing time for Form 941 returns, although the processing time could be reduced as IRS gains experience in these two service centers.

¹³The SB/SE division is expected to serve about 45 million fully or partially self-employed individuals and businesses that have assets under \$5 million. In contrast, the Large/Mid-Sized Division is expected to serve about 210,000 filers that include corporations with assets over \$5 million. Both types of filers tend to have more complex tax issues and more frequent contact with IRS than do individual taxpayers.

Under the new structure, IRS also plans to place an increased emphasis on pre-filing activities, such as taxpayer education, outreach, and earlier intervention with taxpayers. This new emphasis on preventing problems instead of fixing them after the fact is one of modernization's key changes intended to help employers avoid, or at least minimize, tax delinquencies.

Major Information System Improvements for Business Taxpayers Will Not Be Available Until at Least 2005

Central to IRS' achieving its modernization vision is replacing the multiple, antiquated information systems it currently uses to maintain taxpayer accounts and to provide customer service with a single, integrated system known as the Customer Account Data Engine (CADE). IRS expects CADE to greatly improve its customer service capabilities by providing immediate updates of taxpayer accounts and expediting its processing of returns and payments. For example, CADE is to replace the current once-a-week processing schedule that adds to the time IRS takes to notify employers of employment tax delinquencies, with daily processing that could reduce the time for this notification. These changes, however, are not expected to be available for business processes for many years. IRS plans to incrementally phase CADE in, beginning with the simplest individual tax accounts. Accordingly, IRS will begin by processing the form 1040EZ using the CADE system and progress eventually to using the system for more complex forms, such as business returns. As a result, IRS' plans do not call for CADE to begin processing Form 941 returns until at least 2005.

Conclusions

Early notification can help businesses that have failed to pay in a timely manner their full employment tax liability or to timely file a Form 941 quarterly return by minimizing the penalty and interest charges associated with delinquent deposits and tax returns. Until IRS improves its computer systems, there does not appear to be much that can be done to further decrease the time that IRS' processes require for routinely notifying all businesses of their employment tax delinquencies.

In the interim, IRS has developed three new programs designed to prevent or reduce employment tax delinquencies by speeding up or enhancing the notification to certain groups of businesses. However, IRS has not successfully followed through on its plans to evaluate these programs. It has also experienced delays in evaluating its efforts to improve its long-standing FTD Alert program. We believe IRS needs to properly evaluate whether the benefits to be derived from expansion of the pilot programs and retention of the FTD Alert program justify the program costs.

Recommendation for Executive Action

We recommend that the IRS Commissioner require the SB/SE Commissioner to develop and execute a plan for evaluating the effectiveness of the employment tax early intervention programs. The plan should address the resources needed to evaluate the interventions, ensure the clear and timely assignment of responsibility for the evaluations, and include milestones for completing the efforts.

Agency Comments and Our Evaluation

On January 3, 2002, we received written comments on a draft of this report from the Commissioner of Internal Revenue (see app.I). The Commissioner said that IRS has researched measurement practices used by public and private sector institutions in conjunction with SB/SE's efforts to develop plans for outreach measurement. The Commissioner also said that the intervention programs we identified have already provided valuable insight into the needs of small business taxpayers. He agreed with our recommendation and said that the Commissioner, SB/SE, will review each of the programs in our report and determine the extent of evaluation required. Further, when the review is completed, each SB/SE office responsible for a program will evaluate the specific intervention effort and make recommendations for implementation.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Commissioner of Internal Revenue and other interested parties. We will also make copies available to others upon request.

If you have any questions regarding this report, please contact me or Joseph E. Jozefczyk at (202) 512-9110. The major contributors to this report were Marvin McGill, Linda Standau, Tom Bloom, and Grace Coleman.

Sincerely yours,

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive style with a large initial "M".

Michael Brostek
Director, Tax Issues

Appendix I: Comments From the Internal Revenue Service



COMMISSIONER

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

January 3, 2002

Mr. Michael Brostek
Director, Tax Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Brostek:

I reviewed your draft report titled "IRS' Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated" and agree with your recommendation. The Commissioner, Small Business/Self-Employed (SB/SE), is evaluating ways we can help employers comply with their employment tax responsibilities.

The Commissioner, SB/SE, is also developing plans for outreach measurement. Working with our Office of Program Evaluation and Risk Analysis, we researched best practices of public and private sector institutions to identify the best available measures. That office also researched the measurement practices of private sector groups that focus on outreach including the United Way and the Kellogg Foundation. While our research did not provide any quantitative results, we did develop an understanding of the problem, and we believe your recommendation will provide the desired remedy.

The intervention programs identified in your report have provided us with valuable insight into the needs of Small Business taxpayers. We expect to measure their effectiveness over several years as we continue to apply lessons learned and seek new approaches to improving compliance with employment tax requirements. In addition, our Collection Reengineering changes will provide an immediate, positive impact on the timeliness of our field contacts with employment tax taxpayers.

The Commissioner, SB/SE will review each of the early intervention programs in your report to determine the extent of evaluation required. When we complete this review, each office within SB/SE that has responsibility for a program will evaluate the specific intervention effort and make recommendations for implementation.

If you have any questions, please contact Martha Sullivan, Director, Compliance Policy, at (202) 283-2200.

Sincerely,

A handwritten signature in cursive script that reads "Charles O. Rossotti".

Charles O. Rossotti

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily e-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
P.O. Box 37050
Washington, D.C. 20013

To order by Phone: Voice: (202) 512-6000
 TDD: (202) 512-2537
 Fax: (202) 512-6061

Visit GAO's Document Distribution Center

GAO Building
Room 1100, 700 4th Street, NW (corner of 4th and G Streets, NW)
Washington, D.C. 20013

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm,
E-mail: fraudnet@gao.gov, or
1-800-424-5454 or (202) 512-7470 (automated answering system).

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G. Street NW, Room 7149,
Washington, D.C. 20548