

## DOCUMENT RESUME

05377 - [B0865787]

IRS Can Improve Its Programs To Collect Taxes Withheld by Employers. GGD-78-14; B-137762. February 21, 1978. 20 pp. + 3 appendices (4 pp.).

Report to Rep. Al Ullman, Chairman, Joint Committee on Internal Revenue Taxation; Sen. Russell B. Long, Vice Chairman; by Elmer B. Staats, Comptroller General.

Issue Area: Tax Administration (2700).

Contact: General Government Div.

Budget Function: General Government: Central Fiscal Operations (803).

Organization Concerned: Internal Revenue Service.

Congressional Relevance: House Committee on Ways and Means; Senate Committee on Finance; Joint Committee on Internal Revenue Taxation. Rep. Al Ullman; Sen. Russell B. Long.

Authority: Social Security Act.

In fiscal year 1976, employment trust fund taxes (income tax withheld and social security tax) accounted for \$191 billion of Federal gross receipts; these trust fund taxes accounted for 63% of Federal gross receipts over the past 3 years. Collection of these tax funds is the foremost delinquency problem facing the Internal Revenue Service (IRS). During fiscal year 1976, the IRS initiated collection action against employers for nonpayment of \$2.4 billion in trust fund taxes.

Findings/Conclusions: If a business with a tax liability over a certain dollar amount fails to make a deposit by a specified date, a "tax deposit alert" is generated by a computer, and a revenue officer gets in touch with the taxpayer. However, IRS revenue officers are not always given enough information to determine the extent of action needed to bring taxpayers into compliance. In 18% of alerts reviewed, additional information on prior delinquencies could have made revenue officers more effective in their investigations. The review showed that, despite the issuance of alerts, 43% of the involved taxpayers subsequently became delinquent. Confusion exists over who is responsible for computing failure-to-deposit penalties. Over 20% of delinquent taxpayers reviewed claimed at least one fictitious deposit which delayed collection action. Employers filing tax returns each month are required to pay employment taxes monthly instead of more frequently as required under the Federal Tax Deposit System. Recommendations: The Commissioner of Internal Revenue should: provide district offices with taxpayer delinquency histories, establish procedures to use information to make periodic effectiveness evaluations of the alert program, provide information on taxpayer delinquent accounts to show whether penalties were considered, and require monthly filers to deposit taxes under the Federal Tax Deposit System. The Congress should enact a civil penalty to be used as a deterrent to filers who claim false deposits on their tax returns. (RRS)

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*REPORT TO THE  
JOINT COMMITTEE ON TAXATION  
CONGRESS OF THE UNITED STATES*



*BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES*

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**IRS Can Improve Its Programs  
To Collect Taxes Withheld  
By Employers**

IRS programs aimed at collecting taxes withheld by employers should

- provide revenue officers with taxpayers' delinquency histories to enable them to perform their duties more efficiently,
- assess consistently the failure-to-deposit penalty and collect moneys now being lost, and
- eliminate the financial advantages to taxpayers required to pay their taxes monthly.

The Congress should enact legislation to provide a civil penalty to be used against taxpayers who claim fictitious tax payments on their tax returns and thereby delay collection efforts.



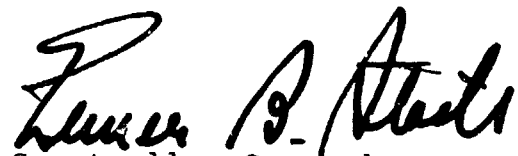
COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman  
Joint Committee on Taxation  
Congress of the United States

This report, one of a series in response to your Committee's request, discusses ways in which IRS can improve its programs to collect taxes withheld by employers. The report also points out a need for the Congress to enact legislation to provide a civil penalty to be used against taxpayers who claim fictitious tax payments on their tax returns.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

  
Comptroller General  
of the United States

D I G E S T

Collection of employment taxes--income tax withheld and social security tax--is the foremost delinquency problem facing the Internal Revenue Service (IRS). These taxes, called employment trust fund taxes, accounted for \$191 billion of the \$303 billion in Federal gross receipts in fiscal year 1976. During that year, IRS began actions to collect \$2.4 billion in these taxes from employers who had not paid them on time.

MORE TAXPAYER INFORMATION CAN  
INCREASE FEDERAL TAX DEPOSIT  
ALERT PROGRAM EFFECTIVENESS

Under the Federal Tax Deposit System, employers are required to make periodic deposits with a Federal Reserve bank or an approved commercial bank. This reduces Government borrowing and speeds revenues to the Treasury.

If a business with a tax liability over a certain dollar amount fails to make a deposit by a specified date, a "tax deposit alert" is generated by a computer, and a revenue officer gets in touch with the taxpayer. IRS hopes that identifying employers who have not deposited trust fund taxes will prevent them from eventually becoming delinquent.

IRS revenue officers, however, are not always given enough information to determine the extent of action needed to bring taxpayers into compliance. In 18 percent of the alerts GAO reviewed, additional information on prior delinquencies could have made revenue officers more effective in their investigations. (See pp. 7 to 9.) The Commissioner of Internal Revenue should, therefore, provide district offices with taxpayers' delinquency histories. (See p. 13.)

IRS believes that it is not yet clear whether the benefits derived from providing additional taxpayer

information outweigh the costs involved, but it has agreed to study this question. (See p. 10.)

The effectiveness of the alert program in reducing the pyramiding of trust fund delinquencies has never been measured adequately. Information was not available for GAO to make this evaluation. GAO's review showed that despite the issuance of alerts, 43 percent of the involved taxpayers subsequently became delinquent. (See p. 9.)

Therefore the Commissioner of Internal Revenue should maintain adequate information to allow IRS to periodically evaluate the alert program's effectiveness in reducing the pyramiding of delinquencies. IRS agrees with this recommendation. (See p. 13.)

#### FAILURE-TO-DEPOSIT PENALTY NEEDS TO BE CONSISTENTLY ASSESSED

A 5-percent penalty is supposed to be assessed against taxpayers who fail to make required tax deposits without adequate reason. However, confusion exists over whether the cognizant IRS service center or district office is responsible for computing failure-to-deposit penalties. District office personnel do not always know whether they should compute and assess the penalty. As a result, penalties may not be assessed. In the Chicago district this confusion results in a loss of about \$1 million a year. (See pp. 9 to 12.)

The Commissioner of Internal Revenue should provide information on taxpayer delinquent accounts that shows whether the penalty was considered at the service center, and he should clarify instructions to district offices on their responsibilities. IRS agrees; it will provide a code on the taxpayer's account to show whether the penalty was considered at the service center and will also clarify its failure-to-deposit penalty procedures. (See p. 13.)

#### A PENALTY IS NEEDED FOR TAXPAYERS WHO FALSELY CLAIM TAX DEPOSITS ON EMPLOYMENT TAX RETURNS

Taxpayers claiming false deposits on their tax returns cause lengthy delays in collection action.

Over 20 percent of the delinquent taxpayers GAO sampled claimed at least one fictitious deposit which delayed collection action. IRS attempted to solve this problem by trying to institute criminal prosecutions and by using administrative measures; neither has had much impact. (See pp. 14 to 17.)

Since IRS, using current provisions of law, has not been able to discourage taxpayers from claiming false deposits, GAO recommends, and IRS agrees, that the Congress enact a civil penalty to deter false claims. (See p. 20.)

MONTHLY FILERS NEED TO  
BE UNDER THE FEDERAL  
TAX DEPOSIT SYSTEM

Employers filing tax returns each month are required to pay employment taxes once a month instead of more frequently as under the Federal Tax Deposit System. Consequently, the Government's receipt of these revenues is delayed. Also, monthly filers who fail to pay when they file their returns are not subject to the 5-percent failure-to-deposit penalty. (See pp. 17 to 19.)

Accordingly, the Commissioner of Internal Revenue should revise regulations and require monthly filers to use the Federal Tax Deposit System. IRS agrees and is pursuing a change in the regulations. (See p. 20.)

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ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service



CHAPTER 1  
INTRODUCTION

In fiscal year 1976, employment trust fund taxes--income tax withheld and social security tax--accounted for \$191 billion of the \$303 billion in Federal gross receipts. These trust fund taxes accounted for 63 percent of gross receipts over the past 3 years. Considering the significance of these funds, the Internal Revenue Service (IRS) has not done all it can do to see that employers turn over trust fund taxes to the Government. Nonpayment of trust fund taxes is the foremost delinquency problem facing IRS' collection activity. During fiscal year 1976, IRS initiated collection action against employers for nonpayment of \$2.4 billion in trust fund taxes.

Employers became involved in the withholding of social security taxes from employee wages as a result of the passage of the Social Security Act in August 1935. In June 1943, employers became liable to withhold income taxes from employee wages. To make the most efficient use of withheld taxes, IRS requires employers to periodically deposit taxes with a Federal Reserve bank or an approved commercial bank and report the amounts quarterly on the "Employer's Quarterly Federal Tax Return." While the requirements for using the Federal Tax Deposit System are fairly complex, employers are generally required to deposit withheld taxes when the accumulated amount during the month reaches \$2,000 or at least monthly if the withheld taxes are over \$200. If quarterly liability is less than \$200, then taxes may be paid with the quarterly return.

Withholding income taxes avoids the hardships to individual taxpayers of making lump-sum payments at the end of the year. It also minimizes the potential for individuals to avoid payment of their taxes. One problem with the withholding system, however, is that it gives employers the opportunity to use the withheld taxes for their own benefit without paying them over to the Government. Testifying in 1976 before the House Ways and Means Subcommittee on Oversight, IRS officials expressed concern that employers use withheld taxes as low interest loans from the Federal Government.

As social security rates and incomes increase, so does the temptation for employers to use this money. Yearly withheld taxes on an employee earning \$10,000 a year could

be as high as \$2,000, <sup>1/</sup> and, when the employer's share of social security is included, taxes could be over \$2,500. <sup>2/</sup> Medium-size firms with up to 100 employees could have annual withheld taxes up to \$256,000.

#### IRS PROGRAMS AIMED AT IMPROVING EMPLOYMENT TRUST FUND TAX COMPLIANCE

IRS uses a number of different programs and procedures to improve trust fund compliance. Under the Federal Tax Deposit Alert Program, IRS identifies and contacts potential delinquent taxpayers before the tax return is due. IRS is able to accelerate the referral of delinquent accounts to IRS district offices by reducing the number of tax due bills sent to the taxpayer by IRS service centers. District revenue officers can require delinquent taxpayers to file their tax returns monthly rather than quarterly. IRS can also require chronically delinquent taxpayers to make deposits in a special account within 2 banking days after the taxes are withheld, and failure to do so is a misdemeanor.

#### Federal Tax Deposit Alert Program

Although trust fund taxes are frequently required to be deposited before the quarterly return is due, the taxes are not considered delinquent until the tax return is due. IRS can identify potential delinquencies by using the alert program to compare tax deposits with prior quarter liabilities. Alerts are computer generated for taxpayers who, having prior quarter liabilities high enough to require frequent deposits, did not make any deposit by a certain date. Also, unless the prior tax liability is above a certain dollar amount, the taxpayer must have had a delinquency in the past year to meet the criteria for issuing an alert. IRS service centers send alerts to IRS district offices four times a year, shortly

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<sup>1/</sup>This figure represents taxes for a single taxpayer claiming one dependent. Yearly income taxes can be lower depending on the marital status of the employee and the number of dependents claimed.

<sup>2/</sup>The 1977 social security rate is 5.85 percent each, for the employer and the employee, taxed on a maximum of \$16,500 a year. The social security tax laws were recently changed to provide substantial increases in both the tax rate and taxable ceiling.

before the quarterly returns are due. IRS district revenue officers are required to contact taxpayers before the tax return is due in an attempt to prevent a delinquency and to promote voluntary compliance.

### Accelerated issuances of tax delinquency accounts

When IRS determines that a taxpayer is delinquent, it bills the taxpayer for the delinquency. If a taxpayer does not pay the delinquency after the first notice, two additional notices may be sent by the service center to the taxpayer. A delinquency not satisfied through this process is sent to an IRS district office for more intense collection action.

Delinquencies over a certain dollar level are flagged for accelerated collection action. If the delinquency is not satisfied after the first tax notice, the service center refers it to the district office where personal contact with the taxpayer may be made. This procedure saves about 3 months over the normal service center process. This is particularly important for employment tax returns that are filed quarterly since delays in collection action could result in the pyramiding of trust fund delinquencies.

### Other programs

Under section 7512 of the Internal Revenue Code, IRS can require chronic delinquents to make deposits of withheld taxes into a special account instead of using the Federal Tax Deposit System. Generally, section 7215 of the Code makes failure to deposit in the special account a misdemeanor punishable by fines up to \$5,000 and/or imprisonment up to 1 year. This penalty was incorporated into the law in 1958 after the Congress concluded that felony penalties were of limited use against chronic trust fund delinquents.

Along with deposits in the special accounts, IRS may require some chronic delinquents to file monthly rather than quarterly returns. (Taxpayers can be required to file monthly returns without making deposits in a special account.) Since taxes are not considered delinquent until the tax return is due, monthly filing enables IRS to take collection action faster because taxes become delinquent monthly rather than quarterly. These monthly filings continue until IRS determines that the taxpayer will comply with the required tax filing and deposit requirements.

IRS uses these provisions in the following manner. First, a formal warning letter is issued to a delinquent taxpayer explaining that continued noncompliance with trust fund requirements will result in either the special account provisions and/or monthly filing being imposed. The taxpayer is then monitored for a minimum of two quarters. If the taxpayer still does not comply, IRS can (1) require the taxpayer to file his return monthly and deposit the taxes in a special account within 2 banking days after they are withheld or (2) require the taxpayer to file his return monthly and pay his taxes with the return.

Another procedure IRS uses to combat trust fund delinquencies is the levying of penalties for failure to comply with certain sections of the Internal Revenue Code. The penalties are to act as deterrents to future violations. Three common abuses for which penalties are assessed are for failure to file returns, to pay taxes, and to make required deposits. Taxpayers who fail to file a return without reasonable cause are penalized 5 percent a month, up to 25 percent maximum, on the amount of tax that should have been reported. The failure-to-pay penalty is 1/2 percent per month, up to a 25-percent maximum, on the amount of unpaid tax. If a taxpayer fails, without reasonable cause, to make the required deposits under the Federal Tax Deposit System, a 5-percent penalty is imposed on the underpayment at the time the deposit is due.

#### REVIEW OBJECTIVES AND SCOPE

The Joint Committee on Taxation requested us to study the effectiveness and adequacy of IRS' efforts to identify and take appropriate administrative action to insure more timely payment of employment taxes.

Our work covered IRS' Federal Tax Deposit Alert Program, the accelerated issuance of delinquent accounts to district offices, and other efforts to insure timely payment of employment taxes. We interviewed IRS officials at its national office, Washington, D.C.; Midwest Regional and district offices in Chicago; and the Kansas City service center, Kansas City, Mo. We reviewed 335 of the 713 delinquent employment tax accounts closed during the period February 22-25, 1977, in the Chicago district. We also reviewed 190 of the 459 Federal tax deposit alerts issued during December 1976 to the Chicago district office. For the taxpayers reviewed, we obtained master file transcripts from the IRS National Computer Center, Martinsburg, W. Va., and reviewed selected employment tax returns.

We discussed our Chicago work with IRS national office officials who generally agreed with our findings and recommendations. Because of this agreement, expansion of our review to other locations was not warranted.

## CHAPTER 2

### BETTER IRS ADMINISTRATIVE PRACTICES CAN IMPROVE

#### THE EFFECTIVE COLLECTION OF WITHHELD TAXES

IRS can improve the collection of withheld taxes by

--providing its revenue officers with taxpayers' delinquency histories to enable them to perform their duties more efficiently and

--consistently assessing the penalty for failure to deposit under the Federal Tax Deposit System and collecting moneys now being lost.

Without adequate information about taxpayers' prior delinquencies, IRS employees cannot always determine the extent of action needed to obtain compliance with trust fund requirements. As a result, chronic delinquents may avoid stern IRS action. In 18 percent of the alerts we reviewed (34 of 190), stronger action should have been taken based on the taxpayers' delinquency histories.

Inconsistent assessment of the failure-to-deposit penalty reduces its deterrent value and results in significant amounts of penalties not being assessed. IRS district office employees do not always know when they are responsible for computing this penalty. As a result, 24 percent of the delinquent accounts we reviewed (79 of 335) did not have the penalties assessed when they should have been.

#### USE OF MORE TAXPAYER INFORMATION CAN IMPROVE THE FEDERAL TAX DEPOSIT ALERT PROGRAM

In 1972 IRS initiated the Federal Tax Deposit Alert Program to prevent the pyramiding of trust fund delinquencies through early identification of taxpayers who are not making their required deposits. Alerts are computer generated quarterly in March, June, September, and December, shortly before the end of the quarterly reporting period. An alert is issued when IRS finds that (1) no deposits were made by a certain date and (2) the taxpayer falls within certain tax dollar and/or prior delinquency criteria.

The service center forwards the alerts to the collection division of the district office, where they are first handled by the office branch and then, if necessary, by the field

branch which will contact the taxpayer. The office branch receives the alerts about 1 month before the return is due from the taxpayer and reviews records to see if the taxpayer has any current or previous delinquencies. Because one of the objectives is to contact the taxpayer before the return is due, the office branch has 1 week to search the files before the alert is sent to the field branch.

Field branch revenue officers contact the taxpayer prior to the tax return due date in an attempt to prevent a tax delinquency. While first time offenders may only receive a verbal warning, repeaters are dealt with more sternly. They may be formally warned of potential civil and criminal penalties, or if already warned, they may be required to file monthly rather than quarterly returns or placed under the special deposit requirements of section 7512 of the Code.

During 1976 IRS issued 38,202 alerts nationwide, 2,839 in the Chicago district. In 1977 the dollar criterion for issuing an alert was lowered, and for the first two quarters of that year 38,404 alerts were issued nationwide, 2,415 in Chicago.

Revenue officers do not have  
enough information on taxpayers

IRS does not give revenue officers who are working alerts enough taxpayer delinquency information to determine the amount of action needed to get the taxpayer's compliance with trust fund tax requirements. Based on taxpayer delinquency histories, we determined that revenue officers did not take strong enough action in 34 of the 190 cases reviewed (18 percent).

The criteria we used to determine if the revenue officer should have taken stronger action was the taxpayer's delinquency history and whether a formal warning letter, which is the first step toward criminal prosecution, was issued. Although 34 cases met IRS criteria for having a formal warning letter issued, none was issued. These 34 taxpayers averaged six prior delinquencies before the current tax return was due, and 30 did not appear to be complying in the succeeding quarter. The revenue officers who contacted the taxpayers accepted current compliance and taxpayer statements that they did not know about deposit requirements as reasons for not taking stronger action. In one case, the revenue officer accepted the taxpayer's explanation that this was the first deposit ever made late, although the taxpayer was penalized for failing to make

deposits in seven prior periods. In another case, IRS records showed that the revenue officer justified not taking stronger action by stating that the taxpayer was currently complying. This taxpayer became delinquent for that period and was also delinquent in 10 prior periods. Such claims would not be accepted if IRS used information in its files to judge their accuracy or reasonableness.

The taxpayer information needed is on microfilm and in the closed alert and delinquent account files which are available at the district offices. Alert files are kept for 6 months after they are closed, and delinquent account files are held for a minimum of 2 years before they are sent to the records center for storage. IRS procedures require only that closed alert and delinquent account files be searched whenever a taxpayer is to be contacted for an alert. But the procedures do not require a search of the computer or microfilm files. We do not know why this information is not provided; however, it appears that IRS believes that the cost of providing the information would be too great.

Current procedures are inadequate to insure that revenue officers handling alerts are aware of the taxpayers' prior delinquencies. We were unable to identify specific problems with the manual search of closed files because the alerts we reviewed did not identify what information had been provided to the revenue officers. However, IRS Chicago procedures require only that the prior quarter's alerts be searched and that once the most recent delinquent accounts are found, no further searches of the closed files are made.

In addition to relying on the manual search of the closed files, IRS tries to assign all collection activity contacts with a particular taxpayer to the same revenue officer. However, because of IRS attempts to equalize workloads and employee rotation and turnover, taxpayers are not always contacted by the same revenue officer.

Providing additional taxpayer information to the revenue officer may not, in itself, insure that appropriate action is taken against the taxpayer. Of the seven revenue officers interviewed, two said they were not concerned with the taxpayer's prior history but only with his current status, while the other five said additional information would be helpful. IRS procedure is to consider prior delinquencies in determining what action is needed, and supervisors are



responsible for IRS procedure being followed. However, without the taxpayer's prior history, supervisors cannot adequately evaluate whether revenue officers took appropriate action.

Adequate information not maintained  
to evaluate program effectiveness

IRS has never adequately evaluated the alert program's effectiveness in reducing the pyramiding of trust fund delinquencies. The periodic evaluations that have been made evaluated procedures rather than overall effectiveness. We were unable to measure the effectiveness of the alert program because IRS does not maintain information in its permanent files as to the number of alerts issued on a taxpayer, and alert files are destroyed 6 months after closing. However, the alert program may not be working as effectively as possible since, in Chicago, 43 percent of the taxpayers (82 of 190) for whom alerts were issued subsequently became delinquent. Also, 57 percent (109 of 190) did not appear to be complying in the succeeding quarter.

IRS is developing a new information system which will be used to develop a data base on all taxpayers who have been subject to collection activity. The data base will contain information on collection activity, including whether an alert was issued. Initial collection of information for the data base was scheduled to start in September 1977 and to be in full operation by October 1978.

CONSISTENT ASSESSMENT OF THE FAILURE-  
TO-DEPOSIT PENALTY IS NEEDED

The only economic sanction IRS has against employers who do not deposit trust fund taxes with the Government is a 5-percent failure-to-deposit penalty; interest does not apply until the tax return is due and the tax is delinquent. We found that IRS district office personnel are not computing penalties when they should because they do not always know whether they are responsible for computing the penalty.

Unless the taxpayer can provide a valid reason why deposits were not timely, the failure-to-deposit penalty should be assessed. Guidelines at one service center provide 26 situations which could be considered reasonable cause for having IRS not assess the failure-to-pay penalty.

Employment tax returns are processed by computer. One step in the processing of the return is to determine whether timely tax deposits were made. If the tax liability is over a certain dollar amount and none of the required deposits

was made during the quarter, a failure-to-deposit penalty is automatically computed. Occasionally, the penalty is computer generated, when some but not all of the required tax deposits are made. In complex cases, notices are issued to the service center for manual determination of the penalty. IRS employees then secure the business' tax returns and either determine that the penalty does not apply or write the taxpayer, proposing assessment of the penalty unless the taxpayer can show reasonable cause why the penalty should not be assessed.

There are 11 situations where the computer does not compute the failure-to-deposit penalty. In three situations, notices are issued for service center computation; in the other eight situations, the district offices are supposed to compute the penalty.

Information provided to IRS district offices does not adequately show when the district is responsible for computing the penalty

Neither the IRS manual nor information on a taxpayer's delinquent account adequately shows who is responsible for computing the penalty. The manual states that the district offices have primary responsibility for determining failure-to-deposit penalties when some but not all of the required tax deposits have been made. The manual goes on to say, however, that sometimes the computer will generate penalties for these cases. The manual also states that failure-to-deposit penalty determinations need only be made during in-person or telephone contacts with taxpayers, while in the previous paragraph it states that actual dates and amounts of deposits should be used in computing the penalty unless personal contact is not made. To further complicate the matter, delinquent accounts only show when the penalty was assessed, not whether the penalty was considered and not assessed because the taxpayer had a reasonable cause.

Interviews with revenue officers support this confusing situation. Two of the seven revenue officers interviewed stated they would never calculate a failure-to-deposit penalty if it was not shown on the account because that was the service center's responsibility. Three said they would compute the penalty on a delinquent account. Although the other two did not specifically say what they would do, they thought it would be extremely rare that an account would not have the penalty on it. One district official said that if the failure-to-deposit penalty was not shown on the account, the taxpayer must have shown reasonable cause and it was not the revenue officer's place to second guess the service center.

We reviewed 335 delinquent accounts closed during a 4-day period in February 1977 and found that 79 (24 percent) should have had the failure-to-deposit penalty assessed but did not. We calculate the penalties on these cases to be \$8,500. Although our sample represents .8 percent of the trust fund delinquent accounts closed in Chicago during a 1-year period, the IRS Chief, Collection Division of the Chicago office, said our sample was probably representative of all cases closed during a year. If this is true, then the district may not be assessing about \$1 million a year in penalties.

IRS officials said they were aware that penalties were not always computed by the district's office branch but were not aware that the problem existed in the field branch. However, as shown in the following table, 70 percent of the accounts where the penalty was not assessed were closed by revenue officers in the district's field branch.

<u>Taxpayer delinquent account closed by</u>	<u>Number</u>	<u>Percent</u>	<u>Amount of penalty not assessed</u>	<u>Percent</u>
Field branch	55	70	\$6,153	73
Office branch	<u>24</u>	<u>30</u>	<u>2,303</u>	<u>27</u>
Total	<u>79</u>	<u>100</u>	<u>\$8,456</u>	<u>100</u>

Some of the taxpayers may have sound reasons for not having the penalty assessed, although the percentage is probably small. Service center records showed that only 3 of the 335 cases we reviewed had valid reasons for not making timely deposits. In nine cases, the penalty was assessed and later abated, but reasons for abatement were not shown.

Inconsistent assessment of the failure-to-deposit penalty may be a nationwide problem. Two IRS internal audit reports support this. One report covers five districts in the Western Region, dealing in part with the lack of assessments by the districts' field branches. The other, of nationwide scope, found inconsistent assessment by districts' office branches.

The Western Region report, dated January 23, 1973, notes that two districts were operating under the belief that the service center was responsible for all failure-to-deposit penalties. In all five districts, the penalties were not always assessed. A 1972 report, based on the reviews in several regions, stated that failure-to-deposit

penalty determinations were not being made by the office branch on accelerated delinquent account issuances. Some limited corrective action was taken. The Western Region agreed to initiate tighter management controls. Also, national instructions were issued requiring office branches to make penalty determinations if they made telephone contact with the taxpayer. Based on our findings, this action was not enough.

## CONCLUSIONS

Inadequate IRS administrative practices reduce the effectiveness of the Federal Tax Deposit Alert Program and diminish the deterrent value of the failure-to-deposit penalty. Without sufficient information on the taxpayer's prior delinquencies, revenue officers assigned to the case do not always know the extent of action needed to bring the taxpayer into compliance with the trust fund requirements. Inconsistent assessment of the penalty reduces the deterrent effect of the penalty and results in substantial amounts of penalties not being assessed.

The effectiveness of the Federal Tax Deposit Alert Program is unknown because IRS presently does not maintain adequate records to allow such an evaluation. Before such an evaluation can be made, IRS needs information as to which taxpayers were the subjects of an alert. IRS is conducting a test to determine the effectiveness of the alert program.

Until such an evaluation of program effectiveness is made, IRS can improve the program by providing its employees with more taxpayer delinquency information. A limited amount of information is being provided manually in district offices. The manual system, however, only provides information on recent periods and may be subject to inaccuracies. The most accurate means of providing this information would be to maintain delinquency information on IRS computer files and provide this information to district office employees.

Because IRS district office personnel do not always know whether they are responsible for assessing the failure-to-deposit penalty, millions of dollars a year in penalties may not be assessed. Unless this situation is cleared up, the problem will continue and possibly magnify. As more taxpayers learn that the penalty is not always assessed, the penalty will continue to lose its deterrent value. IRS needs to take action to eliminate any confusion over the responsibility to make failure-to-deposit penalty determinations.

RECOMMENDATIONS TO THE COMMISSIONER  
OF INTERNAL REVENUE

We recommend that the Commissioner of Internal Revenue

- provide district offices with taxpayer delinquency histories,
- establish procedures to use information that will be available from the new system to make periodic effectiveness evaluations of the alert program,
- provide information on taxpayer delinquent accounts to show whether penalties were considered at the service center, and
- clarify IRS procedures so as to require penalty determinations by district offices on all cases where it was not considered by service centers.

IRS COMMENTS AND OUR EVALUATIONS

In an August 1977 letter, the Assistant Commissioner for Accounts, Collection, and Taxpayer Service stated that further study was necessary to determine the cost/benefit of providing additional information on alerts and agreed to perform this review. (See app. I.) We believe the study should be of sufficient scope to determine the extent that revenue officers are not adequately handling alerts because of the lack of taxpayer delinquency history. Benefits should also include the improved supervisory evaluations of revenue officers' activity and the elimination of manual file searches in the districts.

IRS agreed with our recommendation concerning periodic evaluations of the alert program to determine the long-range effect on voluntary compliance and pyramiding of tax liabilities. The Commissioner of Internal Revenue, in a January 4, 1978, letter, noted his agreement with the Assistant Commissioner's views. (See app. II.)

IRS agreed to provide a code on the taxpayer delinquent account showing whether reasonable cause has previously been considered by the service center and will clarify its procedures concerning the failure-to-deposit penalty.

## CHAPTER 3

### ADDITIONAL ENFORCEMENT AND ECONOMIC MEASURES

#### CAN IMPROVE COLLECTION OF WITHHELD TAXES

The collection of withheld trust fund taxes could be improved if

- IRS were authorized a civil penalty to use against taxpayers who falsely claim tax deposits on their tax returns and
- taxpayers required to file monthly rather than quarterly returns were also required to deposit taxes under the Federal Tax Deposit System.

Taxpayers who falsely claim tax deposits on their tax returns delay IRS collection action because IRS checks to determine if the discrepancy is an IRS recordkeeping problem. IRS has no civil penalties it can apply to discourage taxpayers from claiming false deposits and has been unsuccessful in prosecuting these taxpayers using criminal penalties. Although IRS has initiated administrative procedures to reduce the extent of the problem, more needs to be done.

IRS can require taxpayers to file tax returns monthly rather than quarterly, which allows IRS to assess taxes and take collection action against delinquents when the monthly return is due rather than when the quarterly return would be due. However, once taxpayers are required to file monthly returns, they no longer have to make deposits under the Federal Tax Deposit System. Therefore, taxpayers previously required to deposit taxes weekly or semimonthly now pay taxes monthly with their tax returns. Not being required to make deposits under the deposit system gives unfair financial advantages to these taxpayers and is costly for the Government.

#### FALSELY CLAIMED DEPOSITS DELAY COLLECTION ACTION

To delay the collection of delinquent taxes, the taxpayer falsely claiming deposits must either make the return appear to be fully paid or have a liability below a certain dollar amount. A tax return showing a liability above that dollar amount would be immediately processed as a delinquent account regardless of whether false tax deposits were claimed.

Tax returns are initially processed at IRS service centers. Tax return information is then forwarded to the IRS National Computer Center where comparisons are made between tax deposits claimed on the tax return and those actually posted to the taxpayer's account. If the tax return appears to be fully paid or shows a delinquency below a certain amount and the records do not agree, processing is held up for 8 weeks to check for delays in posting deposits. If discrepancies still exist, the open account is returned to the service center where checks are made of available records and the taxpayer is contacted if internal checks cannot solve the problem. The taxpayer is contacted to provide additional information on the deposit or deposits in question. IRS may also have to contact the bank to determine if a deposit was made. These checks made at the service center can take anywhere from 3 weeks to 4 months depending on the situation, thus delaying IRS' determination as to whether a delinquency exists.

When IRS determines a taxpayer is delinquent, it normally sends three tax due notices over a 3-month period. If at the end of that time the taxes are still not paid, the delinquent account is issued to the IRS district office for more intensive collection efforts. However, the importance of trust fund taxes has prompted IRS to refer trust fund delinquencies to the district office after the first tax due notice if the delinquency is over a certain dollar level.

We reviewed 335 of the 713 delinquent accounts closed during the period February 22-25, 1977, in the Chicago district. Taxpayers in 20 percent of the cases (67 of 335) falsely claimed deposits which showed their returns to be fully paid. These 67 accounts totaled \$93,000 in delinquent tax due, or 22 percent of the \$414,000 total delinquent tax due for the 335 delinquent accounts. Out of the 335 cases sampled, we analyzed the processing time taken in 148 cases. These cases included 53 of the 67 cases for which false deposits had been claimed. The following table shows the extent to which falsely claimed deposits can delay collection action.

	Normal processing time ( <u>95 cases</u> )	Processing time when delinquent taxpayer claims to be fully paid ( <u>53 cases</u> )	Difference in processing <u>time</u>
Account is ac- celerated-- referred to district after one tax due notice	38 days	141 days	103 days
Account is not accelerated-- referred to district after three tax due notices	86 days	154 days	68 days

As shown, claiming false deposits delays the collection of withheld taxes. The delay varies depending on the number of tax due notices sent to the taxpayer without the taxpayer incurring any penalties for claiming false deposits.

IRS has attempted to prosecute taxpayers who falsely claimed tax deposits for filing fraudulent returns under section 7206 of the Code. A program was initiated in June 1975 to identify the most flagrant cases (large dollar cases with three or more returns with false deposits claimed). According to IRS officials, the program was discontinued in September 1976 because of the difficulty of proving criminal willfulness.

The results of the effort as of July 1977 show that of the 24 cases referred to the Midwest Regional Counsel

- 1 was prosecuted and found guilty of a number of offenses including filing a fraudulent return;
- 15 were declined, 13 by the Regional Counsel and 2 by the Department of Justice;
- 7 were pending action by the Department of Justice or a U.S. Attorney; and
- 1 was awaiting trial.



Administrative procedures are also used to identify these taxpayers and speed up referral of the account to the district office. The procedures call for service center employees to identify on the master file taxpayers who claim false deposits. After these taxpayers file their second return with false deposits claimed, the master file is noted and subsequent returns with false deposits will bypass the internal checking; the accounts are immediately referred to the district office. This procedure has no effect until taxpayers file their third return with false tax deposits claimed, and then it only speeds referral of the delinquent account to the district office. Our sample of 335 delinquent accounts included only 14 which were identified as having previously claimed false deposits.

Since criminal prosecution and administrative actions have not been effective, it appears that civil penalties should be provided as an incentive to encourage taxpayer compliance with the tax filing and deposit requirements. Provisions for such a penalty would, however, have to be enacted by the Congress.

MONTHLY FILERS NEED TO BE PUT UNDER  
THE FEDERAL TAX DEPOSIT SYSTEM

IRS can assess taxes and take collection action more quickly against chronic delinquents who are required to file monthly returns than against those required to file quarterly, but monthly filers are not required to deposit taxes under the Federal Tax Deposit System. Therefore, monthly filers pay their taxes monthly with the return rather than as often as weekly under the deposit system. Consequently, the Government's receipt of these revenues is delayed. Although defaults in the monthly payment of taxes are subject to the 1/2 percent per month failure-to-pay penalty and interest, they do not offset the loss of the 5 percent failure-to-deposit penalty, which does not apply.

Nationally, the number of taxpayers required to file monthly returns has been increasing. The following table shows the number of taxpayers added to the monthly filing program each quarter since July 1, 1976.

<u>Quarter ending</u>	<u>Number of new taxpayers required to file monthly returns</u>
September 30, 1976	394
December 31, 1976	473
March 31, 1977	723
June 30, 1977	962

As of June 30, 1977, 2,898 taxpayers were required to file monthly returns.

Financial effects of not depositing taxes under Federal deposit system

The financial advantage to the taxpayer filing monthly returns is that tax deposits do not have to be made under the Federal Tax Deposit System. Taxpayers who would normally be required to deposit weekly or semimonthly now have full use of the money until the monthly return is due. For example, the following table shows the different deposit requirements for a taxpayer with a weekly payroll and a \$24,000 quarterly tax liability for the first quarter of 1977.

<u>Date</u>	<u>Deposits under the Federal Tax Deposit System</u>	<u>Payments under monthly filing</u>
1/12	\$ 2,000	
1/19	2,000	
1/26	2,000	
2/03	2,000	
2/10	2,000	
2/15	-	\$ 8,000
2/18	2,000	
2/25	2,000	
3/03	2,000	
3/10	2,000	
3/15	-	8,000
3/18	2,000	
3/25	2,000	
4/05	2,000	
4/15	-	<u>8,000</u>
Total	<u>\$24,000</u>	<u>\$24,000</u>

In August 1977 various banks quoted short-term business loan rates from 8.75 to 11.75 percent. Using the 11.75-percent rate for this example--because the taxpayers placed under monthly filing are usually in bad financial shape and would not be considered preferred customers--we found the advantage of being under monthly filing for a year was about \$350.

Another taxpayer advantage is that the failure-to-deposit penalty does not apply to missed payments for those under the monthly filing provisions. Although the failure-to-pay penalty and the interest charge apply as of the

monthly return due date, they do not compensate for the loss of the 5-percent failure-to-deposit penalty. The failure-to-pay penalty is only 1/2 percent per month. Using the example of the \$24,000 quarterly tax liability taxpayer, we found that default for all 3 months would result in failure-to-pay penalty and interest of \$449 versus the \$1,200 failure-to-deposit penalty. Therefore, taxpayers under monthly filing are susceptible to 63 percent less penalty. If the quarterly taxpayers fail to pay by the quarterly filing date, they too would be subject to a failure-to-pay penalty and interest, in addition to the \$1,200 in failure-to-deposit penalties.

The unfair advantages to the taxpayers are in effect the disadvantages to the Government. Since the Government does not have use of the money until the end of the month, it must borrow more to compensate for the loss. The loss to the Government, however, is not as great as the gain for the taxpayer because the Government can borrow at lower interest rates. The Government was paying 5.5 percent interest on short term loans in August 1977. For the taxpayer in our example, the Government would have to pay \$165 annually in interest because the taxpayer was not required to make deposits under the Federal Tax Deposit System.

The Government also loses much of the penalty's deterrent value since taxpayers not under the Federal Tax Deposit System are susceptible to 63 percent less penalties than those under the system. Based on our example, this could be a \$3,004 annual loss for each defaulting taxpayer.

## CONCLUSIONS

Taxpayers claiming false deposits on their tax returns delay IRS collection action, and IRS can do little about it. Even current administrative programs apparently do little to discourage the taxpayer from claiming false deposits. While the procedures may speed up the referral of the account to the district office, the taxpayer is not penalized for claiming the false deposits. The taxpayer has no incentive to file accurate returns. One way to discourage taxpayers from claiming false deposits is to provide a stringent penalty.

The penalty needs to be significant enough to discourage taxpayers from falsely claiming deposits. Because this practice delays the ultimate collection of the withheld taxes, a progressive penalty may be needed. A penalty like the failure-to-file penalty, 5 percent a month up to a maximum of 25 percent, should be considered as a possible solution.

Monthly filing would be more effective if the taxpayers were required to deposit taxes under the Federal Tax Deposit System. Since many taxpayers fail to meet trust fund requirements because of financial difficulties, monthly filing may be to their advantage. Taxpayers not only get extended use of the trust fund, but are penalized less when they default. Also, the Government is incurring needless interest costs to offset the lack of tax deposits during the month.

#### RECOMMENDATION TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that the Commissioner of Internal Revenue require monthly filers to deposit taxes under the Federal Tax Deposit System.

#### RECOMMENDATION TO THE CONGRESS

We recommend that the Congress enact a civil penalty to be used as a deterrent to filers who claim false deposits on their tax returns. The Congress may want to consider a penalty similar to the failure-to-file penalty, as mentioned above.

#### IRS COMMENTS

IRS agreed with the need for legislating a civil penalty to be used on taxpayers who claim false deposits. In commenting on the recommendation, the Commissioner of Internal Revenue pointed out that, pending further study of penalties in general, he did not want to comment on the particular type of penalty which should be imposed. The Commissioner also stated that, as a part of the study of penalties, IRS will be considering the question of whether the criminal penalty--under section 7215 for failure to collect, account for, and pay over employment taxes--should be reduced to bring prosecutions within the jurisdiction of U.S. magistrates.

IRS also agreed that the present monthly filing system could be advantageous to taxpayers and is currently pursuing a change which would place monthly taxpayers under the Federal Tax Deposit System.

Internal Revenue Service  
**memorandum**

date: AUG 29 1977

to: Richard Fogel  
Associate Director  
General Accounting Office

from: Assistant Commissioner (ACTS)

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subject: Comments on GAO's Proposals on Trust Fund Delinquencies

Based upon our review of your draft report and the meeting held on Monday, August 1, 1977 with members of your staff, we offer the following comments concerning your proposals.

GAO Proposal:

More Taxpayer Information Can Increase Federal Tax  
Deposit Alert System Effectiveness

We believe that further study is necessary to determine the cost/benefit of providing additional information (concerning non-compliance by taxpayers) on Federal Tax Deposit Alerts. Based on our experience in similar efforts, we believe the costs for providing additional information may exceed the benefits derived. We will review this area thoroughly, however, to determine the costs and related benefits. We agree with your recommendation concerning periodic evaluations of the program to determine the long range effect on voluntary compliance and pyramiding of tax liabilities.

GAO Proposal:

A Penalty is Needed for Taxpayers who Falsely Claim  
Tax Deposits on Employment Tax Returns

The Service endorses your proposal for a penalty contained in this recommendation. Taxpayers who falsely claim Federal Tax Deposits benefit from the delays resulting from additional service center processing to locate the non-existing deposits. However,

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Richard Fogel

we are implementing a new procedure which will substantially reduce such delay when a taxpayer is identified as having falsely claimed tax deposits. We nevertheless endorse your proposal and recommend that a provision for a penalty similar to negligence penalty be enacted.

GAO Proposal:

Failure-to-Deposit Penalty Not Being Assessed

We will provide for entry of a code on employment tax TDA's where reasonable cause has previously been considered by the service center. In situations where no such code is entered, it will be the responsibility of the employee contacting the taxpayer to determine if there is liability for a penalty and to make an assessment when appropriate. When payment of the tax is received without personal or telephone contact, however, the penalty will not be assessed automatically. We are considering which of these cases require personal contact for penalty determinations and which cases should be resolved by correspondence.

GAO Proposal:

Alternatives and Improvements to the Current Criminal Prosecution Program are Needed

The Service agrees with your position that trust fund prosecution cases probably would receive more favorable attention if they could be heard by U. S. Magistrates. We have previously submitted such a recommendation and appreciate your support of this position.

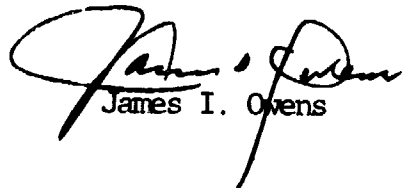
GAO Proposal:

Monthly Filers Should Remain Under the Federal Tax Deposit System

We agree that the present system dealing with monthly filers could be financially advantageous to such taxpayers. The Service previously considered changes in the requirements for depositing and a revision was drafted to require monthly filers to make deposits.

Richard Fogel

That proposed change in the regulations was not implemented but we are currently pursuing a change which would require monthly taxpayers to make deposits in a manner generally consistent with the requirements for quarterly taxpayers.



James I. Owens

## COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JAN 1 1978

Mr. Victor L. Lowe  
Director, General Government Division  
United States General Accounting Office  
Washington, D. C. 20548

Dear Mr. Lowe:

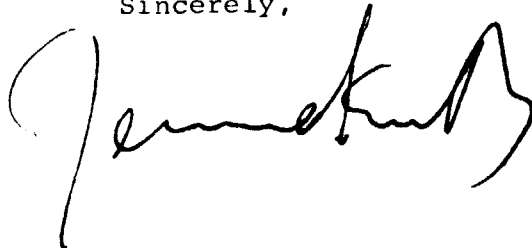
Thank you for the opportunity to review your draft report. "IRS Can Improve Its Programs to Collect Taxes Withheld by Employers". Although I concur with the views Assistant Commissioner Owens expressed this past August on a draft "digest", I want to comment on some differences outlined in the draft of the full report.

Your recommendation in the draft "digest" for a civil penalty against taxpayers who falsely claim tax deposits on employment tax returns did not specify the type of penalty. Assistant Commissioner Owens' response basically agreed with the need for a penalty and he merely suggested considering a "penalty similar to negligence". A study group has recently been established to review the area of penalties generally. We agree with the recommendation in the full draft report that an effective penalty be established; however, pending further study, we reserve comment on the particular type of penalty which should be imposed.

I understand that, pending a further study, you removed from the draft "digest" report your recommendation for using U.S. Magistrates in trust fund prosecution cases. The penalty study group described above will also be considering the question whether the criminal penalty under section 7215 for failure to collect, account for, and pay over employment taxes should be reduced to bring prosecutions within the jurisdiction of U.S. Magistrates.

With kind regards,

Sincerely,



Department of the Treasury Internal Revenue Service



PRINCIPAL OFFICIALS RESPONSIBLEFOR ADMINISTERING ACTIVITIESDISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
<b>SECRETARY OF THE TREASURY:</b>		
W. Michael Blumenthal	Jan. 1977	Present
William E. Simon	Apr. 1974	Jan. 1977
George P. Shultz	June 1972	Apr. 1974
<b>COMMISSIONER OF INTERNAL REVENUE:</b>		
Jerome Kurtz	May 1977	Present
William E. Williams (acting)	Feb. 1977	May 1977
Donald C. Alexander	May 1973	Feb. 1977
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
<b>ASSISTANT COMMISSIONER (COMPLIANCE):</b>		
Singleton B. Wolfe	Mar. 1975	Present
Harold A. McGuffin (acting)	Feb. 1975	Mar. 1975
John F. Hanlon	Jan. 1972	Jan. 1975
<b>ASSISTANT COMMISSIONER (ACCOUNTS, COLLECTION, AND TAXPAYER SERVICE):</b>		
James I. Owens	May 1977	Present
James I. Owens (acting)	July 1976	May 1977
Robert H. Terry	Aug. 1973	July 1976
Dean J. Barron	July 1971	Aug. 1973

(268045)