



Highlights of [GAO-04-414T](#), a testimony before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

Why GAO Did This Study

GAO addressed issues related to three high-risk areas including the Department of Defense (DOD) and the Internal Revenue Service (IRS) financial management and IRS collection of unpaid taxes. This testimony provides a perspective on (1) the magnitude of unpaid federal taxes owed by DOD contractors, (2) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, (3) whether DOD and IRS have effective processes and controls in place to use the Treasury Offset Program (TOP) in collecting unpaid federal taxes from DOD contractors, and (4) whether DOD contractors with unpaid taxes are prohibited by law from receiving federal contracts.

In a companion report issued today, GAO made recommendations to DOD for complying with statutory guidance and supporting IRS efforts in collecting unpaid taxes, to IRS for improving the effectiveness of collection activities, and to the Office of Management and Budget (OMB) to develop options for prohibiting awards to contractors that abuse the tax system. DOD and IRS partially agreed; OMB did not agree. DOD and OMB also did not agree with GAO's matters for congressional consideration that DOD report on its collections through TOP, and OMB report on policy options developed for contractors that abuse the tax system. GAO reiterated support for its recommendations as well as its suggestions to Congress.

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To view the full product, click on the link above. For more information, contact Gregory D. Kutz at (202) 512-9095 or kutzg@gao.gov, or Steven J. Sebastian at (202) 512-3406.

FINANCIAL MANAGEMENT

Some DOD Contractors Abuse the Federal Tax System with Little Consequence

What GAO Found

DOD and IRS records showed that over 27,000 contractors owed about \$3 billion in unpaid taxes as of September 30, 2002. DOD has not fully implemented provisions of the Debt Collection Improvement Act of 1996 that would assist IRS in levying up to 15 percent of each contract payment to offset a DOD contractor's federal tax debt. We estimate that DOD could have collected at least \$100 million in fiscal year 2002 had it and IRS fully utilized the levy process authorized by the Taxpayer Relief Act of 1997. As of September 2003, DOD had collected only about \$687,000 in part because DOD provides contractor payment information from only 1 of its 16 payment systems to TOP. In response to our draft report, DOD developed a schedule to provide payment information to TOP for all of its additional payment systems by March 2005.

Furthermore, we found abusive or potentially criminal activity related to the federal tax system through our audit and investigation of 47 DOD contractor case studies. The 47 contractors provided a variety of goods and services, including building maintenance, catering, dentistry, funeral services, and parts or support for weapons and other sensitive military programs. The businesses in these case studies owed primarily payroll taxes with some dating back to the early 1990s. These payroll taxes included amounts withheld from employee wages for Social Security, Medicare, and individual income taxes. However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund the business.

For example, owners of two businesses each borrowed nearly \$1 million from their companies and, at about the same time, did not remit millions of dollars in payroll taxes. One owner bought a boat, several cars, and a home outside the United States. The other paid over \$1 million for a furnished home. Both contractors received DOD payments during fiscal year 2002, but one went out of business in 2003. The business, however, transferred its employees to a relative's company (also with unpaid taxes) and recently received payments on a previous contract.

IRS's continuing challenges in collecting unpaid federal taxes also contributed to the problem. In several case studies, IRS was not pursuing DOD contractors due to resource and workload management constraints. For other cases, control breakdowns resulted in IRS freezing collection activity for reasons that were no longer applicable. Federal law does not prohibit contractors with unpaid federal taxes from receiving federal contracts. OMB is responsible for providing overall direction to governmentwide procurement policies, regulations, and procedures, and is in the best position to develop policy options for prohibiting federal contracts to contractors that abuse the tax system.