

**WRITTEN TESTIMONY OF
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SERVICES AND ENFORCEMENT
INTERNAL REVENUE SERVICE
BEFORE THE
SENATE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
THE COLLECTION OF FEDERAL EMPLOYMENT TAXES**

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Introduction

Chairman Levin, Ranking Member Coleman, and members of the Subcommittee, thank you for the opportunity to testify today on the status of Internal Revenue Service's (IRS) efforts to collect Federal employment taxes. I appreciate the contribution this Subcommittee has made over the last four years with its investigations of Federal contractors who are delinquent on their taxes and of efforts by unscrupulous promoters and taxpayers to avoid taxation in the U.S. by moving income and assets offshore. The IRS has found valuable the opportunity to work with you and your staffs on each of these issues.

Similarly, we look forward to working with you to improve our efforts in the collection of Federal employment taxes. We have made great progress over the last five years, but as the Governmental Accountability Office (GAO) report released this morning demonstrates, we can still do better.

This morning I want to provide you a little background to our employment tax program including our efforts at both service and enforcement.

Background

Employment taxes were first established for collection of Social Security taxes in 1935, for Federal Income Taxes in 1943, and for Medicare taxes in 1965. These taxes constitute the primary source of revenue for the federal government. Employment taxes include:

- Federal Income Tax Withholding (FITW)
- Federal Insurance Contribution Act (FICA) – Social Security and Medicare

- Railroad Retirement taxes
- Federal Unemployment taxes (FUTA)

Today, employment taxes represent the largest portion of total tax dollars collected by the IRS. In FY 2007 for example, of the \$2.7 trillion in taxes collected by the IRS, \$1.7 trillion was payroll taxes. This means that approximately two out of every three dollars collected by the IRS are from required withholding on employment tax returns.

Of this \$1.7 trillion collected in withholding and FICA taxes, approximately \$778 billion was collected for Social Security and Medicare and approximately \$922 billion was collected for individual withholding taxes.

The magnitude of this program can be seen in other ways. For example, the number of employment tax returns filed in FY 2007 totaled over 30 million. The IRS is particularly concerned with the accuracy of employment tax filing in that it is through these filings that the Department of the Treasury transfers funds from the general fund to the Social Security Trust Fund to pay benefits to millions of retired and disabled Americans.

We are also seeing a shift in who files payroll tax returns. In addition to traditional employers, the filers of these returns now include payroll service providers, reporting agents, employee leasing companies, professional employer organizations, and other types of organizations.

This marks a significant departure from traditional employment tax filings, which were filed by the individual business. Now a single payroll tax provider may act as the withholding agent for multiple businesses.

This has added additional complexity to an already complex area thereby increasing risk to the Treasury. If a company that does payroll withholding for multiple businesses fails to file properly or stops filing completely the government potentially loses the employment taxes of all the businesses the payroll provider serves.

Enforcement is a Priority at the IRS

When Commissioner Shulman was going through his confirmation process, he was often asked whether he would be a Commissioner that emphasized service or enforcement. He responded that choosing one or the other represented a “false choice”. He emphasized that we must do a good job at both service and enforcement.

This balanced approach to service and enforcement represents a continuation of IRS’ approach for the last six years. This is reflected in a comparison of the enforcement numbers.

In FY 2001 the IRS collected an estimated \$33.8 billion in enforcement revenue. This number grew to over \$59 billion in FY 2007. Of these totals, collections increased from an estimated \$24.3 billion to \$31.8 billion, an increase of nearly 31 percent.

Similar increases can be seen in other enforcement metrics. The number of levies issued has increased over 400 percent – from 674,080 in FY 2001 to over 3.7 million in FY 2007. Liens have grown from 426,166 in FY 2001 to 683,659 in FY 2007.

Examinations of individual returns have nearly doubled since FY 2001 and the audit coverage rate has increased from 0.58 percent to 1.03 percent in FY 2007. Of this total, the greatest increases have been seen among high income individuals. In FY 2007 the coverage rate for individuals with incomes greater than \$1 million was 9.25 percent.

Examination of business returns has also risen. In FY 2001, we looked at just over 41,000 business returns as opposed to nearly 60,000 in FY 2007.

More relevant to this Subcommittee is the increase in employment tax audits. From FY 2005 to FY 2007 the number of audits increased by 66.8 percent, while the audit coverage rate rose from 0.11 percent to 0.20 percent.

We have also seen a significant rise in the number of overall tax cases that we are closing. Total closures from FY 2002 to FY 2007 more than doubled. They rose from 3.6 million in 2002 to 8.3 million in 2007.

Helping Businesses Comply with the Law

Even in a good economy, it is often difficult to start and maintain a business over a number of years. In addition to the considerable competitive pressures such businesses must face, they must also comply with myriad laws and regulations.

According to statistics from the Small Business Administration, more than a third of all small businesses do not last two years. Only half of all start-ups are still in business after four years, and that figure drops to 40 percent after six years.

These businesses are often undercapitalized. The owner often commits all of his or her personal financial resources to the business. As a business experiences problems, rather than submit the money they have withheld from employees for FICA and for Federal income taxes to the Federal government as required by law, the owners may use that money to fund payroll or to keep the utility company from cutting off power – to keep the business going in the hopes of better times.

This is a story we see repeated over and over again and is perhaps one of our greatest challenges in the collection of Federal payroll taxes.

To help avoid this situation, we work with small businesses upfront to ensure that they understand their obligations. The first aim of the IRS is to help employers avoid problems by educating them on employment tax responsibilities. One of the means to accomplish this is through the use of the Federal Tax Deposit Alert process, which helps to identify, at an early stage, taxpayers classified as bi-weekly depositors who have not made federal tax deposits during the current quarter, or have made deposits in substantially lower amounts from prior quarters.

Virtually all of the IRS functional and operating divisions participate in employment tax outreach and education. The IRS also provides substantial information about employment taxes on IRS.gov, on other Web sites through partnerships and work with other organizations, including groups that represent small businesses, and through electronic and print media.

Applicants for new Employer Identification Numbers receive considerable information based on what they indicate on their Form SS-4. Those who state they have or will have employees automatically get a copy of Circular E, Employer's Tax Guide; information for making Federal Tax Deposits; and enrollment information for the Electronic Federal Tax Payment System. The IRS.gov Web site has a newly redesigned section devoted to employment taxes, with information on worker classification, withholding and depositing taxes, employment tax forms and publications, and links to the Social Security Administration's (SSA) Employer's Web Page.

The IRS also works with other organizations to have them add employment tax information on their Web sites. To date in FY 2008, IRS has partnered with almost 700 tax professional and industry Web sites to add such information.

The IRS also works with community partners to present Small Business Tax Workshops throughout the United States. These workshops instruct new and prospective business owners in federal tax responsibilities, including employment taxes. To date in FY 2008, over 1,000 workshops have been conducted across the country.

Quarterly, the IRS sends out approximately seven million SSA IRS Reporter newsletters with Form 941, Employer's Quarterly Federal Tax Return. The newsletter contains information on subjects such as Social Security laws, the Electronic Federal Tax Payment System, or changes in Social Security or IRS electronic filing systems.

In addition, in 2007, the IRS developed a new brochure, Publication 4591 – Small Business Federal Tax Responsibilities, which includes information about employment taxes. Over 300,000 have been distributed to date including over 200,000 by state licensing agencies to people applying for new business licenses.

Brief Background: Case Flow within the IRS

The collection process within the IRS generally begins with a series of notices requesting payment. These notices allow us to collect nearly 80 percent of the outstanding deficiency as the taxpayers self-correct their returns.

The notices are followed by telephone contact in an attempt to secure payment. In FY 2007, we were able to resolve 3.5 million accounts via telephone contact.

If neither the notices nor the telephone contacts resolve the situation, cases are assigned to a field revenue officer for an attempt at in-person contact. In 2007, 1.2 million accounts were resolved by field contacts.

A slightly different process is used to collect employment taxes. The IRS sends fewer notices in employment tax cases so that personal contact can occur sooner. Our highest priority cases bypass the telephone operation in favor of making first contact in the field. Factors used in determining the priority of work include the age of the case (more recent cases are taken first) and the type of tax at issue (payroll taxes receive top priority).

Addressing Noncompliance in Payroll Tax Remittances

The tax code provides the IRS with tools to bring taxpayers into compliance and facilitate the payment of unpaid payroll tax liabilities.

These tools include:

- Notice of Federal Tax Lien – Filing of a Notice of Federal Tax Lien puts the public on notice that the taxpayer has outstanding Federal tax liabilities and establishes the government’s position with respect to other creditors.
- Levy or seizure – The Internal Revenue Code § 631 authorizes the IRS to levy –or seize – a taxpayer’s property to collect delinquent tax. Bank accounts and wages are among the most common assets levied. The term “seizure” is generally used to describe a levy on property that must then be sold by the IRS so that the proceeds can be applied to the taxpayers account. Most employment tax cases are included in the Federal Payment Levy Program (FPLP). This is an automated levy program that matches IRS balance-due information with pending Federal payment information provided by the Financial Management Services (FMS) function of the Department of the Treasury. This program is effective if the delinquent party is a Federal contractor or other creditor of the Federal government. In general, all employment tax accounts without an active payment plan or ongoing litigation are included in the FPLP.
- Summons – A summons is an administrative means of compelling the production of books, records or testimony. Summons authority is used when the desired

- Substitute Returns - Internal Revenue Code § 6020(b) authorizes the IRS to prepare unfiled employment, excise, and partnership returns if the taxpayer fails to file the returns as required by law.
- Trust Fund Recovery Penalty (TFRP) – Officers and employees of a corporation who do not turn over monies they collect in trust for the government are subject to being assessed the TFRP. The total amount that was withheld from employees' wages for Federal income taxes and FICA, and not paid over to the government is the amount that is asserted against the officers and/or employees and becomes the TFRP.

In some instances, traditional administrative collection remedies are not effective in bringing taxpayers into compliance with their payroll tax obligations. For example, taxpayers often attempt to “pyramid” their liabilities as a means of deferring payment or delaying enforcement action. One form of pyramiding occurs when the same business fails to remit payroll taxes for multiple quarters. The second form of pyramiding occurs when the owner of a delinquent business closes down once enforcement action begins. The owner will then simply incorporate as another entity often selling the same products as before. If he fails to remit for that business and enforcement action begins, he will start a third business. Meanwhile, his payroll tax liabilities continue to pyramid higher.

When pyramiding occurs, the IRS has the ability to subject the taxpayer to more stringent filing and payment requirements. An employer with a history of noncompliance can be required to Form 941 monthly, as opposed to quarterly, or can be required to make employment tax deposits to at a specific bank. Failure to comply with these restrictions can carry criminal penalties.

If these administrative remedies and requirements are not effective in bringing the taxpayer into compliance with the payroll tax requirements, the IRS may try to obtain an injunction against the business.

An injunction is a court proceeding whereby the IRS seeks to prevent the taxpayer from taking (or not taking) actions that threaten to cause or are causing harm to the IRS. Currently, in order to obtain an injunction, the IRS must be able to show irreparable injury and the lack of an adequate remedy at law.

The IRS is developing and testing streamline procedures that will assist Field Collection when developing and requesting a suit for injunctive relief. Specifically, through an understanding with the Department of Justice, the IRS will be putting forward injunction suits that are based on more flexible standards for showing that the government is being irreparably harmed by the non-payment of employment taxes, that further administrative activity would be futile, and that no adequate remedy at law exists.

In addition to requesting injunctive relief when necessary, the IRS also pursues criminal prosecution in appropriate instances, which have important deterrent effects. In FY 2008, examples of criminal prosecutions include the following, all of which are a matter of public record:

- On June 17, 2008, in Pittsburgh, Pa., James C. Platts was sentenced to 30 months in prison to be followed by three years of supervised release on his conviction of Federal tax evasion. Platts was found guilty at a trial by jury in March 2008. According to the United States Attorney, Western District of Pennsylvania, the evidence presented at trial showed that Platts evaded the payment of Federal payroll taxes and FICA taxes which Platts's company, the Pinnacle Building Company, withheld from employees during four separate tax quarters in 1998 and 1999.
- On May 22, 2008, in Chicago, Ill., Thomas Shumate was sentenced to 46 months in prison for failing to pay income and payroll taxes to the United States. Shumate owned and operated Propay, Inc, a business that prepared and filed tax returns. Shumate contracted with 34 corporate clients to calculate their payroll taxes and pay over the money they owed to the IRS. According to the plea agreement signed by Shumate, between 2001 and 2006, he falsely understated the amount of money that 23 of his clients owed the IRS. For eight of his clients, he failed to file the employer tax returns and failed to forward the money to the IRS.
- On May 19, 2008, in Greenbelt, Md., Ernest Lee, Jr., of Clinton, MD., was sentenced to 18 months in prison, followed by three years of supervised release, and ordered to pay \$340,001 in taxes owed. According to his plea agreement, beginning in or about February 1995 through at least 2002, Lee, Jr. was responsible for maintaining the payroll and financial and accounting records for the family-owned, ceramic-tile installation business called ELT, Inc. As part of his duties, Ernest Lee, Jr. was responsible for remitting FICA, withholding and federal unemployment taxes owed by ELT, Inc. to the IRS and the Social Security Administration for ELT, Inc. employees. For tax years 1998-2000, Lee Jr. failed to pay approximately \$161,000 in FICA, withholding and Federal unemployment taxes owed by ELT.
- On May 19, 2008, in St. Louis, Mo., Paul Scott King, Jr. was sentenced to 33 months in prison for failing to pay \$400,000 in employment taxes. In a plea agreement signed in February 2008, King admitted that during 2001 and 2003, he owned two corporations: Nurses Now LLC and Ichor Health Services, Inc. These businesses provided the temporary services of hundreds of nurses and medical professionals to hospitals and nursing homes. King withheld income taxes and Social Security taxes from the employees' wages and did not pay them over to the IRS as required by law. King admitted in his guilty plea that he failed to pay \$432,191 in employment taxes.

- On May 7, 2008, in St. Paul, Minn., Scott M. Tovey, of Elk River, Minnesota, was sentenced to 24 months in prison for failing to pay employment taxes on his employees. Tovey, owner of Tovey Tile Co., a tile-setting business with locations in Medina and Minnetonka, pleaded guilty in January 2008 to one count of failure to account for and pay over employment taxes. According to Tovey's plea agreement, he admitted that he issued W-2 forms to his employees reflecting that Federal employment taxes were withheld from their wages, but, he did not provide the W-2 forms to the Social Security Administration as required. Tovey also admitted he willfully failed to account for and pay those taxes to the IRS. From March 1999 through September 2003, the total tax owed by Tovey was approximately \$574,485.

In many ways the success we have had in these criminal cases and many others demonstrate the level of progress that the IRS has made in the payroll tax arena.

The IRS also works to prevent non-filing by using matching programs that identify potential non-filers. The IRS also works closely with the SSA in identifying non-filers. The IRS and the SSA jointly administer the Combined Annual Wage Reporting or CAWR Program. This is a Document Matching Program that compares the Employee Wage Information reported by the employer on Forms 94X to the IRS with Forms W-2 reported to the SSA. In FY 2008 the CAWR programs are projected to close 356,832 cases and have already assessed \$567,053,750 in taxes and penalties through May 31, 2008.

GAO Report

We have carefully reviewed and commented on the report that the Government Accountability Office (GAO) prepared for the Subcommittee on this matter. The \$58 billion in uncollected payroll taxes is an unacceptably high number, but as I hope my testimony illustrates, it represents a snapshot of unpaid employment taxes at the mid-point of a long-term improvement effort. Our numbers show dramatic improvement in the last several years, but we know we still have a long way to go.

After reviewing the findings in this report, I have directed the Service-wide Employment Tax Advisory Council (SETAC) Collections task force to re-focus its efforts to concentrate solely on the more effective use of enforcement tools in employment tax cases.

To support that effort, we are launching a series of research studies to be conducted by the IRS' Office of Research, Analysis, and Statistics (RAS), which together will give the Council the data necessary to determine the appropriate mix of taxpayer service and enforcement. Research areas will include: (1) effective use of the trust fund recovery penalty; (2) earlier consideration of the filing of liens; (3) greater use of automated collection tools throughout the collection process; and (4) whether there is a "point of no return" in employment tax cases (i.e., a number of quarters or amount of tax accrued) at which our enforcement posture should change.

The SETAC met last week and established an aggressive timeline for completing its review of the use of enforcement tools in employment tax cases. We think these efforts will result in continued improvements in enforcement results and will allow us to take a more strategic approach to the collection of employment taxes.

We have also advised GAO that we agree with their recommendations and look forward to working with both internal and external stakeholders to improve our efforts in the collection of Federal employment taxes.

Specifically, GAO made six recommendations on how the IRS could improve its procedures. We agree to:

- Explore the value of regularly extracting information from internal data sources to identify the most egregious payroll tax offenders. The information could be shared with the Director of Collection to supplement discussions with Area directors regarding the quality and timeliness of case work.
- Assign, when feasible, egregious payroll tax assessments and TFRP assessments to a single revenue officer. Treating payroll tax and TFRP assessments as a single unified and coordinated collection effort may achieve the advantages outlined in the report. Timely determinations, recommendations and assessment of the TFRP will accelerate the statutory notice requirements and may enable the revenue officer to leverage the assessments more effectively to gain compliance and/or prevent accumulation of additional unpaid payroll taxes.
- Evaluate our existing practices and determine if a change should be made to our current case routing criteria in order to allow liens to be filed as soon as a payroll tax liability is identified.
- Consider ways to use the reports available on the timeliness of TFRP assessment as part of our on-going quality review process.
- Evaluate the effectiveness and feasibility of establishing performance goals and measures based on the information in the reports tracking the timeliness of TFRP assessments.
- Work with those states that have developed a program to match financial accounts with tax debts to determine the effectiveness of their program and whether a similar program in IRS would be cost effective and consistent with privacy laws. In fact, we have already begun meeting with states to learn about their matching programs and determine whether a similar model can be adopted at the Federal level.

As we move forward in the employment tax arena, there are several promising aspects on which we are working. The first of these is attacking the overall tax gap by improving

the collection of payroll taxes. In August 2007, the Department of the Treasury and the IRS released a comprehensive strategy to improve voluntary compliance and reduce the tax gap. That strategy incorporated a comprehensive, multi-year, integrated, cross-functional, corporate-level approach, including the following seven components:

- Reduce Opportunities for Evasion
- Make a Multi-Year Commitment to Research
- Continue Improvements in Information Technology
- Improve Compliance Activities
- Enhance Taxpayer Service
- Reform and Simplify the Tax Law
- Coordinate with Partners and Stakeholders

In each of these components, payroll tax collections will play a significant role as the strategy is implemented. For example, RAS provides support by providing historical information studies and reports, gathering and analyzing data for future purposes, as well as providing general guidance and direction. In the long-term, our research efforts will provide a method and foundation for the development of a multi-year employment tax approach for FY 2009 and beyond. RAS will also consider initiating a National Research Program (NRP) relating to employment taxes to measure the tax gap further while also refining the issues that may be associated with employment tax non-compliance.

As a foundation for the strategic planning process, RAS analyzes data and helps to identify emerging trends and sources of noncompliance within employment tax. RAS also works to establish benchmarks and measure the quantitative and qualitative effectiveness of IRS efforts.

In addition to the tax gap plan, we are working on the Business Master File Case Creation Non-filer Identification Process (BMF CCNIP) project. This project will redesign and enhance the BMF Case Creation Program to allow for the selection of BMF inventory with the greatest potential for IRS intervention. The project will optimize limited resources, increase employee productivity, and reduce taxpayer burden. BMF CCNIP will improve workload selection and casework quality, resulting in improved customer and employee satisfaction.

Summary

The IRS' commitment to employment taxes is service-wide, as is the Department of the Treasury's. The IRS and Treasury are committed to striking the proper balance between

service and enforcement; to taking every possible step to minimize taxpayer burden; and to focusing on improving filing, reporting, and payment compliance.

Thanks for the opportunity to be here today, and I will be happy to respond to any questions.