



The Private Debt Collection Program Was Effectively Developed and Implemented, but Some Follow-up Actions Are Still Necessary

March 27, 2007

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 27, 2007

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Private Debt Collection Program Was
Effectively Developed and Implemented, but Some Follow-up Actions
Are Still Necessary (Audit # 200630022)

This report presents the results of our review of the Internal Revenue Service's (IRS) Private Debt Collection program (Program). The overall objective of this review was to evaluate the effectiveness of the IRS' implementation of the Program.

Impact on the Taxpayer

To implement the Program, the IRS will use private collection agencies (hereafter referred to as PCAs or contractors) as an additional resource to help collect delinquent Federal taxes. In July 2004, the Department of the Treasury estimated the IRS will collect \$1.4 billion through the Program over the next 10 years (Fiscal Years 2006-2015). Balance-due cases were first placed with three contractors on September 7, 2006. Overall, the IRS effectively developed and implemented several aspects of the Program, thus providing better assurance that taxpayer rights are protected and Federal tax information is secure. Specifically, contractor employees were adequately trained, background investigations were completed, telephone call monitoring and oversight procedures were established, and computer and physical security procedures were established before cases were assigned. However, the IRS needs to follow up on computer security issues, update procedure guides, and update the application used to calculate projected revenue.



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Synopsis

As of September 30, 2006, the gross accounts receivable to the IRS totaled \$271 billion. On October 22, 2004, the President signed the American Jobs Creation Act,¹ which created a new Internal Revenue Code Section 6306 (2004) to permit PCAs to help collect Federal tax debts.

Overall, the IRS has taken proactive measures to effectively develop and implement the Program.

- The IRS took appropriate steps to ensure contractor employees received sufficient and adequate training on applicable laws and regulations before allowing them access to Federal tax information. This included providing contractors with an orientation and overview of the training required and conducting an onsite assessment of the contractor training.
- The IRS required all contractor employees assigned to the Program contract, or who have access to Federal tax information, to undergo background investigations. The IRS granted either interim or final approval of background investigations for each employee working on the contract at the time of our review.
- The IRS established adequate oversight through telephone call monitoring, case action reviews, taxpayer satisfaction surveys, and a variety of other reviews to ensure contractors adhere to contract requirements and protect taxpayer rights.
- The IRS took appropriate and sufficient steps to ensure development and implementation of the Program were effective throughout the process. The IRS met regularly with the contractors to address concerns and issues, tested contractor systems for readiness and accuracy, and evaluated contractor computer and physical security.
- At the IRS' request, the Treasury Inspector General for Tax Administration Office of Investigations participated in various implementation areas such as creating a training video for the contractors, participating in onsite contractor training, and reviewing various security issues.

Concurrent to our review, the IRS performed its own tests and analyses to identify and address risks and concerns. After our audit work was completed, the IRS continued to monitor the PCAs and, on February 14, 2007, announced the contracts for two of the PCAs had been extended through March 8, 2008. The agency decided, and the third PCA agreed, that their contract would not be extended.

While we identified several issues during implementation, the IRS resolved most concerns prior to the initial placement of cases with the contractors. Nonetheless, some issues still need to be

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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addressed. One contractor maintained Federal tax information on a computer server that was also used to maintain data for four other contractor clients. Use of a shared server increases the risk that Federal tax information may be inadvertently disclosed, lost, or stolen. Although use of a single, dedicated server is not required, we believe this would strengthen security over Federal tax information. One contractor was using Telnet to transmit Federal tax information. This significantly increases the risk that Federal tax information may be inadvertently disclosed or stolen. One contractor had not loaded antivirus software on its operating system or encryption software on its laptops. This significantly increases the risk that Federal tax information may be corrupted or disclosed. At both contractors, we identified computer security concerns about the protection of Federal tax information and audit trails. While the security concerns are not as significant as those noted previously, improvements could be made to better enhance computer security. Many of the computer security issues identified, including the maintenance of data on a shared server, were risks identified at the location of the contractor for which the IRS did not extend the contract.

We also identified physical security concerns at both contractors that presented various weaknesses. By the time we had concluded our onsite reviews, the contractors were in the process of resolving some of the computer and physical security concerns. We were subsequently notified by the contractors that they had resolved most of the concerns.

Some sections in the Program guides and handbooks need to be strengthened and/or clarified. If procedures are not updated, these conditions could result in untimely suspension of contractor collection action, unsatisfactory customer service, and unidentified or untimely identified taxpayer complaints.

One contractor used an initial contact script that provided its employees with a very specific set of questions to ask the taxpayer. Another contractor used a series of general questions and a checklist of specific items for the employees to consider. The third contractor did not use an initial contact script and relied upon training provided to employees to ask the appropriate questions. There was no requirement for contractors to have scripts. However, we believe taxpayer rights would be better protected if contractors were required to use scripts for all types of telephone contacts with taxpayers and provide the scripts to the IRS, which could then review and approve them.

Finally, the IRS hired a contractor to develop a revenue model and used this model to calculate projected revenue based on the inventory the IRS plans to place with contractors. The IRS is in the process of updating this model and the revenue projection goals, and we identified three additional areas that we believe management should consider during this update. The IRS should consider the impact of those taxpayers who opt out of the Program; the age of the cases that will be assigned to the contractors; and the actual percentage of dollars being collected, which was projected to be higher than those achieved by collection agencies used by other Federal Government agencies.



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Recommendations

We recommended the Director, Collection, Small Business/Self-Employed Division, include in the Request for Quotation² a requirement for PCAs to maintain Federal tax information on a separate server; follow up to ensure PCAs have completed their efforts to resolve the specified computer and physical security concerns; update the Contracting Officer's Technical Representative³ and Telephone Monitoring and Case Action Review procedures to ensure consistency and completeness; include in the Request for Quotation a requirement for PCAs to provide a copy of scripts for all telephone contacts with taxpayers to the IRS, which will then review and approve them; and continue updating and/or modifying the revenue model to ensure the IRS appropriately accounts for the impact of taxpayers who opt out of the Program, the age of the balance due, and the actual collection rate achieved.

Response

The IRS agreed with our recommendations and will address security issues in the next contract negotiations and PCA security reviews, update policies to provide consistent and complete instructions regarding taxpayer complaints, strengthen control of taxpayer contacts, and address concerns in the revised revenue model. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.

² A Request for Quotation is a formal solicitation to sources outside of the Federal Government for offers to provide products or services.

³ Contracting Officer's Technical Representatives are responsible for managing the PCA contracts and ensuring compliance with requirements.



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Abbreviations

COTR	Contracting Officer's Technical Representative
IRS	Internal Revenue Service
PCA; contractor	Private collection agency



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Background

As of September 30, 2006, the gross accounts receivable to the Internal Revenue Service (IRS) totaled \$271 billion. To help address this tax debt inventory, the Department of the Treasury proposed that Congress pass legislation authorizing the IRS to use private collection agencies (hereafter referred to as PCAs or contractors) to help collect tax debts for simpler types of cases. The IRS refers to this effort as the Private Debt Collection program (Program).

One objective of the Private Debt Collection program is to use private collection agencies to help collect the \$271 billion in taxes owed to the Federal Government.

On October 22, 2004, the President signed the American Jobs Creation Act,¹ which created a new Internal Revenue Code Section (§) 6306 (2004) to permit PCAs to help collect Federal tax debts. The law allows PCAs to locate and contact any taxpayer specified by the IRS, to request from such taxpayer full payment of the amount of Federal tax due, and to obtain financial information with respect to such taxpayer. The law allows the IRS to retain and use an amount not in excess of 25 percent of the amount collected by the PCAs for the cost of services performed under a contract and an amount not in excess of 25 percent of the amount collected for collection enforcement activities of the IRS.

According to the IRS, the three main objectives of the initiative to use contractors are to:

- Help to significantly reduce the growing number of uncollected tax liabilities.
- Help maintain taxpayer confidence in the fairness of the tax system by assisting the IRS in addressing more of its delinquent accounts.
- Assist the IRS in its continued focus to dedicate existing collection and enforcement resources on more difficult cases and issues.

The legislation provides that the provisions of the Fair Debt Collection Practices Act² shall apply to PCAs. The law also prohibits PCAs from committing any act or omission that IRS employees are prohibited from committing in the performance of similar services. The legislation created Internal Revenue Code § 7433A (2004) to permit civil actions by taxpayers for unauthorized collection actions by employees of the PCAs. The law also amended § 1203 of the IRS

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

² 15 U.S.C. §§ 1601 note, 1692-1692o (2000).



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Restructuring and Reform Act of 1998³ relating to termination of employment for misconduct to include employees of PCAs, if such individuals committed any act or omission described under subsection (b).

According to the IRS, contractors will be required to adhere to all taxpayer protections and will be prohibited from threatening or intimidating taxpayers, or otherwise suggesting that enforcement action will or may be taken, if a taxpayer does not pay the liability. The contractors must also adhere to all security and privacy regulations for systems, data, personnel, and physical security, and all taxpayer rights protections.

On March 9, 2006, the IRS awarded contracts to 3 firms from a field of 33 for the first phase of the Program. On September 7, 2006, the IRS placed an initial inventory of 11,562 balance-due accounts with the 3 contractors.

This review was performed in the IRS Small Business/Self-Employed Division in New Carrollton, Maryland, and the contractor worksites of Pioneer Credit Recovery, Inc. in Perry, New York; Linebarger Goggan Blair & Sampson, LLP in Austin and San Antonio, Texas; and The CBE Group Inc. in Waterloo, Iowa, during the period April through December 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



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Results of Review

The Internal Revenue Service Has Taken Proactive Measures to Effectively Develop and Implement the Private Debt Collection Program

Overall, the IRS effectively developed and implemented several aspects of the Program before cases were assigned to the contractors. These include contractor employee training, background investigations, and IRS oversight of the contractors.

- **The IRS conducted an orientation and overview of the required training and other contract assistance needed for all contractor employees working on the Program.** This event provided the contractors an opportunity to raise questions and clarify requirements. As observers of the event, we believe the IRS presenters were fully prepared and well versed in their subject areas. Overall, the orientation attendees expressed satisfaction with the training and the instructors. The attendees were then responsible for providing training sessions to their employees who were to be assigned IRS cases.
- **The IRS conducted onsite assessments of the training sessions to ensure contractor employees were trained on the applicable laws and regulations.** Topics required to be covered included the Fair Debt Collection Practices Act, IRS Restructuring and Reform Act of 1998 § 1203, and disclosure. The IRS reported the contractors conducted training sessions from August 8 through 30, 2006. Contractor employees were required to pass with a 70 percent or better rating in every examination taken. Those not passing were not allowed to work IRS cases or continue with the training. The IRS documented the contractors took appropriate actions to remove such employees from working on the contract.
- **The IRS Personnel Security and Investigation Program office granted either interim or final approval of background investigations for all the contractor employees working on the contract at the time of our review.** Contractors are required to submit to the IRS requests for background investigations for all employees assigned to work on the contract. On two separate occasions, we requested current lists of contractor employees working on the contract: one prior to and one subsequent to the placement of cases. We forwarded the lists to the Personnel Security and Investigation Program office to determine the status of the background investigations. Upon reviewing the response, we confirmed that contractor employees are not permitted to work on the private debt collection contract until approval has been granted. Also, we confirmed employees



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whose approvals were denied had been appropriately and timely removed from working on the contract.

- **The IRS established an adequate method to monitor the quality of work being performed by the contractors.** The proposed IRS oversight, designed to ensure contractors adhere to contract requirements and the protection of taxpayer rights, includes telephone call monitoring and case action reviews by quality analysts, taxpayer satisfaction surveys, and a variety of reviews by the Contracting Officer's Technical Representatives (COTR).⁴
- **The IRS ensured it and the contractors were appropriately prepared.** The IRS conducted regular meetings to plan and determine the status of implementation and to address concerns and issues; ran tests of the contractors' systems to determine readiness and verify accuracy; conducted computer and physical security reviews at each contractor worksite; and established an independent review team to review contractor safeguards, processes, and procedures and to evaluate risks.
- **The IRS engaged the Treasury Inspector General for Tax Administration Office of Investigations in the process.** The Office of Investigations participated in various implementation areas such as creating a training video for the contractors, participating in onsite contractor training, and reviewing various security issues.

Concurrent to our review, the IRS performed its own tests and analyses to identify and address risks and concerns. After our audit work was completed, the IRS continued to monitor the PCAs and, on February 14, 2007, announced the contracts for two of the PCAs had been extended through March 8, 2008. The agency decided, and the third PCA agreed, that their contract would not be extended.

While we identified several issues during implementation, the IRS resolved most concerns prior to the initial placement of cases with the contractors. Only a small number of issues still need to be addressed.

Many Computer and Physical Security Concerns Have Already Been Addressed

We conducted independent computer and physical security reviews at the worksites of two of the three contractors awarded contracts to work on the IRS Program. We also participated as third-party observers of the IRS review of physical security at the worksite of the third contractor.

⁴ COTRs are responsible for managing the PCA contracts and ensuring compliance with requirements.



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Overall, we believe the contractors implemented a strong system of computer and physical security controls. However, we identified the following concerns that presented a risk to security. Except where noted, the concerns relate to only one particular contractor. Our onsite reviews were conducted prior to the placement of cases with the contractors; therefore, the contractors had not yet received Federal tax information.

Maintaining data on a shared server increases the risk of disclosure, loss, and theft of Federal tax information

One of the contractors we reviewed used a separate, dedicated server⁵ to maintain Federal tax information. The other contractor we reviewed maintained Federal tax information on a server that was also used to store data for four other contractor clients. Using a shared server increases the risk that Federal tax information may be inadvertently disclosed, lost, or stolen. Contractors are required to ensure all account data are, at a minimum, partitioned off from other data maintained on their computer systems. While a single, dedicated server for Federal tax information is not required, we believe Federal tax information should be maintained on a separate server to adequately protect against unauthorized disclosure while on a contractor's computer system. Subsequent to our onsite review, the IRS informed us it verified the contractor had properly partitioned account data on its system.

The contractor that used the shared server used Telnet and Secure Shell to transmit Federal tax information. We have security concerns about the contractor's decision to use Telnet. This compounds our concern over the use of a shared server. Telnet is a network protocol used on the Internet or local area network connections. It is considered unsecure due to various security vulnerabilities. Secure Shell is a set of standards and an associated network protocol that allows users to establish a secure channel between a local and a remote computer. Secure Shell, which provides greater security, was designed to replace Telnet.

There are three main reasons why Telnet is not recommended for modern systems from the point of view of computer security:

- Commonly used Telnet daemons⁶ have several vulnerabilities discovered over the years, and several more probably still exist.
- Telnet lacks an authentication scheme⁷ that would make it possible to ensure communication is carried out between the two desired hosts and not intercepted in the middle.

⁵ A server is a computer on a network (a group of two or more computers) that manages network resources.

⁶ A daemon is a computer program that runs in the background, rather than under the direct control of the user.

⁷ An authentication scheme is a method of verifying the sender and/or receiver (host) of a data transmission, to ensure the data have not been intercepted or altered.



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- Telnet, by default, does not encrypt⁸ data sent over the connection, thereby allowing intercepted data to be easily read and later used for malicious purposes.

Contractor management informed us they use Telnet because their other clients who share the server with the IRS need Telnet to run their applications. However, using Telnet to transmit data significantly increases the risk that Federal tax information may be inadvertently disclosed or stolen. We were later informed by contractor management that they had resolved this issue by developing the procedure to implement Secure Shell prior to the activation of Telnet when transmitting data. Although Secure Shell was not designed to be used in conjunction with Telnet, we believe this technique is sufficient to address our concern. However, the contractor did not indicate whether it uses this technique when transmitting data to its other clients. Because we had not considered this procedure during our onsite review of computer security, we cannot report on the risks associated with the contractor transmitting data to its other clients using a different technique.

Antivirus and encryption software are needed to provide an additional layer of security

We noted, as did a contractor hired by the IRS to review computer security, that one PCA had not loaded antivirus software on its operating system. We also noted the same PCA had not loaded encryption software on the laptops of 16 individuals authorized to enter the worksite. At the time of our review, the PCA had been unable to locate antivirus software compatible with its operating system. Also, although PCA management's anticipated completion date for laptop encryption was subsequent to our onsite review, the IRS indicated the PCA agreed not to allow the laptops to be removed from the worksite until after the software had been loaded.

Contractors are required to ensure all Federal tax information is protected from unauthorized disclosure while on their computer systems and to protect and maintain the integrity of their systems. Contractors should employ virus protection mechanisms at essential information system entry and exit points (e.g., firewalls, routers, remote-access servers) and at workstations or servers on the network. Contractors should update virus protection mechanisms (including the latest virus definitions) when new releases are available.

Antivirus software is an additional layer of security needed to protect an operating system from viruses and worms. Encryption software would protect data from unauthorized disclosure in case a laptop is lost or stolen. When antivirus and encryption software are not installed, the risk that Federal tax information may be corrupted or disclosed increases significantly.

We were later informed by PCA management that they had loaded encryption software on their laptops. Also, although they stated they had not obtained antivirus software for their operating

⁸ Encryption is the process of converting data into a secret code. To read an encrypted file, a user must have access to a password that enables him or her to decrypt the data.



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system, they indicated the issue was addressed with the IRS by implementing other security measures within the Windows environment and by physically and logically locking the system down to prevent the loading of any software onto the system.

Contractors enhanced computer security by addressing various concerns

We identified the following concerns related to the protection of Federal tax information and audit trails. Each concern listed below is specific to either one or the other of the contractors we reviewed. While we do not consider these concerns to be as significant as the issues identified above, improvements could be made to enhance computer security.

1. An unnecessary service on the router had not been disabled.
2. There is no method in place for tracking system issues.
3. Two risks identified by a contractor hired by the IRS to review computer security have not been properly addressed by the PCA.
4. Audit logs have not been properly protected.
5. Access control lists have not been applied to the CISCO⁹ switch.¹⁰
6. Backup tapes are not marked as Federal tax information and stored separately.
7. The contractor has not completed development of a policy to address the IRS' concern regarding contractor managers having access to email.
8. User accounts are not disabled timely.

These concerns could permit inappropriate access to the system, inappropriate user capabilities, and unauthorized disclosure. Although we believe these issues need to be addressed, we did not consider them significant enough risks to prevent the assignment of cases to the contractors.

Contractors are required to implement system security controls, safeguards, and mechanisms at all levels of the system and application layers. Settings of information technology products must be configured to the most restrictive mode consistent with information system operational requirements. Also, the information system must be configured to provide only essential capabilities and specifically prohibit and/or restrict the use of unnecessary functions, ports,¹¹ protocols,¹² or services. Access to Federal tax information is to be restricted to only those persons whose duties or responsibilities require access; thus, information shall be clearly labeled "Federal tax data." Additionally, to avoid inadvertent disclosures, Federal tax information shall be kept separate from other information.

⁹ CISCO is a leading manufacturer of network equipment.

¹⁰ A switch is a device that filters and forwards data files between computers within a network.

¹¹ A port is an access point into and out of a computer. The ports on a computer or server are used to connect to communications lines and modems.

¹² A protocol is a convention or standard that controls or enables the connection, communication, and data transfer between two computing endpoints.



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While management of each contractor was in the process of addressing some of the concerns listed previously, the remaining concerns were not considered or were simply overlooked. By the time we concluded our onsite reviews, contractor management was in the process of addressing concerns 2, 4, 5, and 6. We were later informed by management of each contractor that they had resolved all of their respective issues. Many of the computer security issues discussed above, including the maintenance of data on the shared server, were risks identified at the location of the PCA for which the IRS did not extend the contract.

Contractors promptly resolved physical security concerns

The contractors implemented numerous physical security controls. Examples include requiring employees to wear photo identification badges, controlling entry through key cards, securing the work area with an alarm system, positioning video cameras at entrances, installing slab-to-slab perimeter walls, and requiring visitors to obtain authorization prior to entering the work area. Although several strong controls were in place, we identified a number of concerns at each contractor worksite that we believe weakened physical security. Appendix IV includes a list of the specific concerns.

In developing and implementing physical security controls, contractor management simply overlooked these particular factors while focusing on other security measures. However, contractor management immediately addressed our physical security concerns as we identified them. By the time we had concluded our onsite reviews and briefed IRS management on our results, all but one of the concerns had been addressed. Because contractor management believed differentiating identification badges posed a security risk for their employees, they deferred the issue to the IRS for its consideration and agreed to implement any changes the IRS deemed necessary. Differentiating identification badges is not a requirement. However, due to the existence of a secondary, unmonitored entrance, we believe implementing this action would strengthen access controls. We were later informed by management of the respective contractor that they had resolved this issue.

Recommendations

The Director, Collection, Small Business/Self-Employed Division, should:

Recommendation 1: Include in the Request for Quotation¹³ a requirement for PCAs to maintain Federal tax information on a separate, dedicated server when the IRS expands the Program to include additional contractors.

Management's Response: The IRS agreed with the recommendation. The Director, Collection, Small Business/Self-Employed Division, will include in the next Request for

¹³ A Request for Quotation is a formal solicitation to sources outside of the Federal Government for offers to provide products or services.



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Quotation, a requirement for PCAs to maintain Federal tax information on a separate, dedicated server.

Recommendation 2: Follow up to ensure the contractors have completed their efforts to resolve computer and physical security concerns including implementing Secure Shell prior to the activation of Telnet when transmitting data, loading encryption software onto laptops, disabling the unnecessary service on the router, tracking system issues, protecting audit logs, applying access control lists, labeling backup tapes as Federal tax information and storing them separately, developing an email policy, timely disabling user accounts, and using differentiated identification badges.

Management's Response: The IRS agreed with the recommendation. The Director, Collection, Small Business/Self-Employed Division, will follow-up with the PCAs to ensure all computer and physical security issues listed in the recommendation have been resolved.

Handbooks and Guides Were Revised to Address Most Concerns Regarding Procedural Consistency and Completeness

The IRS developed several handbooks and guides for the Program. These documents provide the procedures necessary to carry out the requirements of the Program contract. In reviewing the procedures, we noted the following areas that needed to be strengthened and/or clarified.

Security procedures for handling taxpayer complaints could be strengthened

Taxpayer complaints regarding a contractor may be received either verbally or in writing from a taxpayer or third party, self identified by a contractor, or identified by an IRS employee.

In evaluating draft procedures to determine whether the IRS had developed effective steps to handle taxpayer complaints, we identified some noncritical areas that needed to be addressed by management. The IRS was still in the process of perfecting the procedures at the time we reviewed them.

- Despite Referral Unit¹⁴ procedures to inform taxpayers that someone from the IRS will contact them regarding complaints, the COTR procedures identify only one occasion when taxpayers will be contacted. The COTR will respond to taxpayers if a written complaint is received for a Type One¹⁵ complaint. However, there were no procedures

¹⁴ The IRS Referral Unit is responsible for assigning cases to contractors; maintaining cases; recalling cases; responding to inquiries from taxpayers, contractors, and IRS staff; and handling taxpayer complaints.

¹⁵ Complaints are assigned a type code, based on the severity of the allegation(s). Rude behavior would be a Type One complaint, intimidation would be a Type Two complaint, and a violation of the Fair Debt Collection Practices Act would be a Type Three complaint.



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for contacting taxpayers when verbal complaints are received or when written Type Two or Type Three taxpayer complaints are received.

- The COTR procedures did not identify a time period for forwarding taxpayer complaints to the contractors.
- Procedures for the Telephone Monitoring and Case Action Reviews conducted by the IRS did not provide specific steps for reviewers to identify and report taxpayer complaints. Also, if a reviewer identifies an error or problem, which would include a taxpayer complaint, the procedures directing the reviewer to forward issues to the COTR once a week were not consistent with other procedures to forward complaints to the COTR either immediately or within 24 hours of receipt.

The Government Accountability Office *Standards for Internal Control in the Federal Government* require significant events to be clearly documented. At the time we conducted our review, IRS management was already in the process of revising procedures for the Telephone Monitoring and Case Action Reviews to include steps for reviewers to identify and handle taxpayer complaints. However, procedures still do not direct reviewers to immediately forward taxpayer complaints to the COTR. Also, recently revised COTR procedures do not address the issues noted above. If procedures are not updated, these conditions could result in untimely suspension of contractor collection action, unsatisfactory customer service, and unidentified or untimely identified taxpayer complaints.

The IRS clarified contractor procedures for suspending collection

The draft PCA Policy and Procedures Guide did not provide procedures to suspend contractor collection action when the following conditions occur:

- During Referral Unit review of installment agreement¹⁶ requests within the contractor's authority.
- When a taxpayer appeals a rejected installment agreement.
- When a contractor receives a verbal threat(s) from a taxpayer.
- Upon receipt of a taxpayer lawsuit referencing an account assigned to a contractor.

These conditions are identified as events warranting suspension of PCA collection action in various other IRS Program procedure guides. Without clarification of procedures, contractors may not suspend collection action timely on accounts with these conditions. However, after we presented this information to IRS management, the PCA Policy and Procedures Guide was revised to resolve all four issues.

¹⁶ An installment agreement allows taxpayers to pay tax liabilities by making regular payments to the IRS over time rather than all at once.



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Recommendation

Recommendation 3: The Director, Collection, Small Business/Self-Employed Division, should update the COTR procedures to identify a time period for forwarding taxpayer complaints to the PCAs and for contacting taxpayers regarding verbal taxpayer complaints and written Type Two and Type Three taxpayer complaints. Also, the Telephone Monitoring and Case Action Review procedures should be updated to direct analysts to immediately forward taxpayer complaints to the COTR.

Management's Response: The IRS agreed with the recommendation. The Director, Collection, Small Business/Self-Employed Division, will update the COTR and Quality Assurance Handbooks to incorporate instructions for responding to taxpayer complaints to address the issues identified in the recommendation.

Contractors Were Not Required to Have Scripts for Employees to Use When Contacting Taxpayers

The Request for Quotation did not require the contractors to have a script to direct employees through telephone conversations with taxpayers. However, if the contractor used an initial contact script, the IRS reviewed and approved the questions and procedures. One contractor used an initial contact script that provided its employees with a very specific set of questions to ask the taxpayer. Another contractor used a series of general questions and a checklist of specific items for the employees to consider. The third contractor did not use an initial contact script and relied upon training provided to employees to ask the appropriate questions.

The IRS reviewed the initial contact scripts for the two contractors and asked one of the contractors to change the script and it was appropriately changed. We reviewed the changed scripts and determined the questions were appropriate and none of the questions violated taxpayers' rights. However, we believe taxpayer rights would be better protected if the Request for Quotation required the contractors to use a script for all types of telephone contacts and provide them to the IRS, which could then review and approve the scripts for every contractor. This would also result in consistent approaches that the contractors take in contacting taxpayers and better allow the IRS to perform a more consistent quality review, including the monitoring of telephone calls. The IRS plans to expand the Program and issue a new Request for Quotation in May 2007 soliciting more contractors.

Recommendation

Recommendation 4: The Director, Collection, Small Business/Self-Employed Division, should include in the Request for Quotation a requirement for PCAs to provide a copy of scripts for all telephone contacts with taxpayers to the IRS, which will then review and approve them.



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Management's Response: The IRS agreed with the recommendation. The Director, Collection, Small Business/Self-Employed Division, will include in the next Request for Quotation a requirement for PCAs to provide a copy of scripts for all telephone contacts with taxpayers to the IRS for review and approval.

The Internal Revenue Service Should Continue Monitoring Revenue Projection Goals

The Department of the Treasury budget process requires annual revenue estimates for tax proposals.¹⁷ A revenue estimate serves as a benchmark for measuring the effects of tax law changes and is generally over a 10-year period. In July 2004, the Department of the Treasury calculated a \$1.4 billion estimate in revenue over the next 10 years (Fiscal Years 2006-2015) for the tax proposal that permits contractors to help collect Federal tax debts.

The IRS hired a contractor to develop a revenue model and used this model to calculate projected revenue based on the inventory the IRS plans to place with contractors. The IRS continuously compared its inventory plans and revenue estimates to the Department of the Treasury estimates through February 2006. The IRS revenue model estimates many factors, including:

- Standard Collection Curve – The model applies a standard collection industry curve for each case placement over a 12-month period to determine the number of cases on which some or all tax due was collected.
- Referrals for Enforcement – Estimated number of cases returned to the IRS for enforcement action.
- Unresolved Service Accounts (Recalls) – Estimated number of cases returned to the IRS due to other reasons (e.g., hardship,¹⁸ innocent spouse¹⁹).
- Administrative Resolutions – Estimated number of cases returned to the IRS due to death or bankruptcy of the taxpayer.
- Initial Ramp Up – The model shows a gradual increase in the assigned collection rate²⁰ to allow the IRS and contractors to reach optimum performance and productivity.

We evaluated the revenue model to determine whether the IRS' plans based on the model were sufficient to achieve the goals set by the Department of the Treasury. The IRS is in the process of updating the model and the revenue projection goals. To ensure revenue estimates are accurate, we believe management should consider the following three issues when updating the revenue projection goals.

¹⁷ A tax proposal is a bill considering a change or modification to a provision of the Internal Revenue Code.

¹⁸ A hardship means the taxpayer currently has no ability to pay the taxes.

¹⁹ An innocent spouse is a taxpayer that can be relieved of responsibility for paying tax, interest, and penalties if his or her spouse (or former spouse) improperly stated or underpaid the tax.

²⁰ The collection rate represents the percentage of dollars collected in comparison to the total balance due of the cases placed with the contractors.



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Revenue projection does not account for the impact of taxpayers who opt out of the Program

The IRS will be sending letters notifying taxpayers that their accounts have been assigned to a contractor. Included with these letters is *What You Can Expect When the IRS Assigns Your Account to a Private Collection Agency* (Publication 4518), which informs taxpayers they may submit a written request to opt out of the Program if they do not wish to work with a PCA.

The revenue model does not include a factor to estimate the number of taxpayers who will elect to opt out of the Program. The IRS indicated the ability for taxpayers to opt out is a unique factor that has never been accounted for by either Federal Government agencies or private industry. Therefore, there are no historical data on which to base an estimate to include in the model.

Until the cases are assigned, the impact of taxpayers who elect to opt out of the Program cannot be predicted. Therefore, as the IRS expands into assigning other types of cases to contractors, the impact of taxpayers who opt out of the Program should be reexamined. While few taxpayers have initially opted out, the number may increase as accounts assigned to contractors become more complex.

Criterion has been adjusted to include older cases in the contractor inventory

The IRS has been continuously monitoring inventory levels for initial implementation of the Program. The contractor provided the IRS with an interactive revenue model used for long-range planning. The revenue model allows the IRS to change the inventory selection criteria and determine the impact to projected revenue. The IRS reexamined inventory options and changed case criteria to maximize revenue projections and make sure it has enough inventory available to meet the capacity of the contractors. One change to the contractor inventory involved increasing the age a case has been in an IRS collection status. The initial Program criterion called for cases that had been in collection status for less than 1 year; however, the age in status was increased to 2 years and then to 3 years.

The amount of time a case is in an IRS collection status is not the true age of the account liability; it is the length of time the account has been assigned to that particular collection status. We previously reported²¹ that, when the criterion for age in collection status was less than 1 year, 72 percent of the cases available for placement in the Program were more than 2 years old. Now that the length of time in collection status has been increased, the cases being assigned are probably even older. We reported that older debts are frequently more difficult to collect; thus the change in case age criterion may limit the IRS' ability to reach the Department of the Treasury's revenue goals for the Program. Management agreed the cases being assigned to the

²¹ *Management Needs to Continue Monitoring Some Case Selection Issues As the Private Debt Collection Program Is Implemented* (Reference Number 2006-30-064, dated April 2006).



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contractors may be older but stated the contractors are willing to work the cases being assigned while the IRS does not have the resources to work them.

The collection rate used by the IRS is higher than the industry standard

During the research phase of the Program, the IRS visited some Federal and State Government agencies that have used contractors, to assess their best practices for tax collection. The Federal Government agencies visited were the Department of the Treasury Financial Management Service and the Department of Education; the State agencies included some in New Jersey, Michigan, Georgia, Maryland, and Virginia. During the visits, the IRS obtained data from the Department of Education and the Financial Management Service on their collection rates with contractors; these data reflect an average collection rate of less than 3 percent. The IRS did not request collection rate figures from the State agencies. However, the State of California has announced it has referred more than \$2 billion to private debt collection companies over the past 17 years, and \$50 million (less than 3 percent) was actually recovered.²² Our research of the Department of Education and Financial Management Service confirmed the collection rate of 3 percent.²³

The IRS discussed the potential inventory selected for assignment with subject-matter experts to determine the estimated collection rates used in its revenue model. The revenue model starts with a lower collection rate and gradually increases it to a range of 10 percent to 15 percent of the contractor inventory. This “ramp-up” factor, as previously stated, allows the IRS and contractors time to reach optimum performance and productivity. As of December 31, 2006, the contractors had collected \$11.4 million of the \$105 million in liabilities placed with them by the IRS. This represents a collection rate of 10.5 percent. Based on the ramp-up factor, this rate should continue to increase.

Other Federal and State Government agencies work balance-due cases for approximately 180 calendar days before turning them over to contractors; however, the IRS is being very selective in the cases it assigns to contractors. For the initial phase, the cases placed are individual taxpayers who have filed a tax return with a balance due.

Considering these factors, the IRS contractor collection rate should be higher than that achieved by other Federal and State Government agencies. Management plans to adjust the collection rate once the cases are worked by the contractors and data are available to determine a true collection rate for types of cases. The IRS recognizes it will need to continuously monitor the collection rate as it expands the types of cases assigned to contractors to work.

²² *The Tax Man and the Debt Collector Team Up* (MSN Money, September 2005).

²³ Department of Education data relate to contractor performance from contract inception through June 2002. Financial Management Service data relate to contractor referrals and collections as of April 2003.



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Recommendation

Recommendation 5: As data become available, the Director, Collection, Small Business/Self-Employed Division, should continue updating and/or modifying the revenue model to ensure the IRS appropriately accounts for the impact of taxpayers who opt out of the Program, the age of the balance due, and the actual collection rate achieved.

Management's Response: The IRS agreed with the recommendation. The Director, Collection, Small Business/Self-Employed Division, will begin a review of the revenue model in July 2007 and either construct a new revenue model or update the existing model based on actual performance. The updated or revised model will be available in November 2007.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effectiveness of the IRS' implementation of the Private Debt Collection program (Program). To accomplish this objective, we:

- I. Evaluated the revenue projection goals and determined if the IRS' plan was sufficient to achieve the goals.
- II. Identified the methods established to transmit Federal tax information and evaluated the procedures used to transmit data between the IRS and the contractors.
- III. Evaluated controls established to ensure taxpayer rights are protected.
 - A. Determined if and how contractor employees were trained on the applicable laws and regulations and if the contractors certified in writing that the required training had been provided.
 - B. Obtained and evaluated the Quality Assurance program established to monitor contractor activities to ensure there are no violations.
 - C. Determined if the IRS developed an effective program to handle taxpayer complaints.
 - D. Identified situations in which contractors are required to stop collection action and determined if procedures were in place.
- IV. Evaluated the proposed physical and data security controls over Federal tax information.
 - A. Determined if a background investigation had been conducted on all contractor personnel working on the contract and if any employee who failed the background investigation had been barred from working on the contract with the IRS.
 - B. Made physical visits to each of the three contractor worksites. At two of the worksites, we evaluated the adequacy of the physical security to be provided over Federal tax information. At the third worksite, we sat in as third-party observers while the IRS evaluated the adequacy of the physical security.
 - C. Determined if the contractors implemented effective physical security safeguards to ensure protection of the information technology system. We determined if the computer systems processing, storing, and transmitting Federal tax information met or exceeded controlled access protection audit trails, identification/authentication controls, and access controls.



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- D. Analyzed the IRS' plan to review the physical and data security at the contractors' worksites.
- V. Determined the method the IRS developed to monitor the quality of work being performed by the contractors and evaluated the adequacy of the proposed IRS oversight over the Program.



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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Parker F. Pearson, Director
Amy L. Coleman, Audit Manager
Todd M. Anderson, Lead Auditor
Christina M. Dreyer, Senior Auditor
Michelle Griffin, Senior Auditor
Denise M. Gladson, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Collection, Small Business/Self-Employed Division SE:S:C
Project Director, Filing and Payment Compliance Modernization, Small Business/Self-Employed
Division SE:S:C:FPCMO
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Physical Security Concerns

Prior to placement of cases with the contractors, we identified the following physical security concerns during our onsite reviews of contractor worksites. Except where noted, each concern is specific to one contractor. Management of each contractor immediately addressed our physical security concerns as we identified them.

1. Perimeter doors did not have adequate locking mechanisms.
2. Two rooms were not wired to the alarm system.
3. The main entrance to the IRS work area was not monitored by a receptionist.
4. Identification badges of employees working on the contract were not differentiated from identification badges of unauthorized employees that work across the hall.
5. At both contractor worksites, the visitor log was not reviewed to determine each visitor's need for access.
6. Six employees had keys to the IRS work area; one did not have a need for access to Federal tax information.
7. On a couple of occasions, private mail service companies inappropriately delivered IRS contract-related mail to the contractor's headquarters office located in the building next door.
8. Employees were permitted to use their desk telephones for personal calls.
9. Vendors were provided escorted access to the collection room.
10. There were plans to provide one employee with control over both the unassigned key cards and the system that controls the access levels of the key cards.
11. One employee was responsible for control over misdirected remittances.
12. Procedures for handling significant conditions or situations that affect business operations had not been updated for computer security and had not been developed for physical security.

Concerns 1-6 represent a weakness in restricting access. Concerns 6-9 represent a weakness in preventing unauthorized disclosure. Concerns 10 and 11 represent a weakness in providing a separation of duties. Concern 12 represents a weakness in handling security breakdowns.

Contractors are required to provide secured collection office facilities and equipment to perform tasks under the private debt collection contract. The specified area shall be restricted to authorized IRS and contractor employees, and the area shall be physically separated from other activity with walls and secured access per IRS security requirements. The facility must have a locked and alarmed perimeter. Additionally, access to the space must provide an audit trail such as a sign-in log, card reader, or computerized mechanical lock.



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Appendix V

Management's Response to the Draft Report




SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
MAR 26 2007

March 23, 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:  Kathy K. Petronchak
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Private Debt Collection Program Was Effectively Developed and Implemented, but Some Follow-up Actions Are Still Necessary
(Audit No. 200630022)

We have reviewed the draft report titled, "The Private Debt Collection Program Was Effectively Developed and Implemented, but Some Follow-up Actions Are Still Necessary."

I am pleased the report acknowledges our efforts to establish a productive Private Debt Collection (PDC) program that conforms to security standards and meets our high customer service expectations. The report confirms that we adequately prepared the Private Collection Agencies (PCA) to handle federal tax information and to work with taxpayers to resolve balance due accounts. We have been diligent in our efforts to hold the PCAs to high standards for the protection of taxpayer rights and privacy.

This project is already delivering positive results and exceeding expectations. On September 7, 2006, we transferred our first cases to the PCAs. As of February 2007, we had placed 30,622 cases with the PCAs and they have collected over \$14 million. Using conservative projections, the IRS is on track to recover the costs of developing and implementing this program in 2008.

The recommendations in this report are consistent with our ongoing efforts to perfect our policies and procedures. We agree with all recommendations and will include them in our planned enhancements. We will address security issues in the next contract negotiations and PCA security reviews; update policies to provide consistent and complete instructions regarding taxpayer complaints; strengthen control of taxpayer contacts; and address TIGTA's concerns in the revised revenue model.



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Attached is a detailed response outlining our planned corrective actions. If you have any questions, please contact me at (202) 622-0600 or Deborah Wolf, Project Director, Filing and Payment Compliance Modernization, Small Business/Self-Employed, at 609-278-7732.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Collection, Small Business/Self-Employed Division should include in the Request for Quotation a requirement for PCAs to maintain Federal tax information on a separate, dedicated server when the IRS expands the program to include additional contractors.

CORRECTIVE ACTION:

We agree that requiring PCAs to maintain Federal tax information on a separate, dedicated server will enhance data security. In the next Request for Quotation, we will include a requirement for PCAs to maintain Federal tax information on a separate, dedicated server.

IMPLEMENTATION DATE:

July 15, 2007

RESPONSIBLE OFFICIAL(S):

Director, Filing & Payment Compliance Modernization Office

CORRECTIVE ACTION MONITORING PLAN:

We will monitor the corrective action as part of our internal management control system.

RECOMMENDATION 2:

The Director, Collection, Small Business/Self-Employed should follow-up to ensure the contractors have completed their efforts to resolve computer and physical security concerns including implementing Secure Shell prior to the activation of Telnet when transmitting data, loading encryption software onto laptops, disabling the unnecessary service on the router, tracking system issues, protecting audit logs, applying access control lists, labeling backup tapes as Federal tax information and storing them separately, developing an email policy, timely disabling user accounts, and using differentiated identification badges.

CORRECTIVE ACTION:

We agree the IRS should validate that all physical and security issues identified by IRS and TIGTA have been resolved. We will follow-up with the PCAs to ensure all computer and physical security issues listed in this recommendation have been resolved.

IMPLEMENTATION DATE:

May 15, 2007

RESPONSIBLE OFFICIAL(S):

Director, Filing & Payment Compliance Modernization Office



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CORRECTIVE ACTION MONITORING PLAN:

We will monitor the corrective action as part of our internal management control system.

RECOMMENDATION 3:

The Director, Collection, Small Business/Self-Employed Division, should update the COTR procedures to identify a time period for forwarding taxpayer complaints to the PCAs, and for contacting taxpayers regarding verbal taxpayer complaints and written Type Two and Type Three taxpayer complaints. Also, the Telephone Monitoring and Case Action review procedures should be updated to direct analysts to immediately forward taxpayer complaints to the COTR.

CORRECTIVE ACTION: We agree comprehensive instructions for responding to taxpayer complaints should be included in the COTR and Quality Assurance Handbooks.

1. We will update the COTR Handbook to include a time period for forwarding complaints to the PCA.
2. We will update the COTR Handbook to include instructions on handling verbal taxpayer complaints and written Type Two and Type Three taxpayer complaints.
3. We will update the Quality Assurance Handbook to include procedures on forwarding taxpayer complaints identified during Telephone Monitoring and Case Action reviews to the COTR.

IMPLEMENTATION DATE:

June 15, 2007

RESPONSIBLE OFFICIAL(S):

Director, Filing & Payment Compliance Modernization Office

CORRECTIVE ACTION MONITORING PLAN:

We will monitor the corrective action as part of our internal management control system.

RECOMMENDATION 4:

The Director, Collection, Small Business/Self-Employed Division, should include in the Request for Quotation a requirement for PCAs to provide a copy of scripts for all telephone contacts with taxpayers to the IRS, who will then review and approve them.

CORRECTIVE ACTION:

We agree that the use of approved telephone scripts by the PCAs would improve customer service and ensure consistent taxpayer treatment. We will include in the next Request for Quotation a requirement for PCAs to provide a copy of



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scripts for all telephone contacts with taxpayers to the IRS for review and approval.

IMPLEMENTATION DATE:

July 15, 2007

RESPONSIBLE OFFICIAL(S):

Director, Filing & Payment Compliance Modernization Office

CORRECTIVE ACTION MONITORING PLAN:

We will monitor the corrective action as part of our internal management control system.

RECOMMENDATION 5:

As data become available, the Director, Collection, Small Business/Self-Employed Division, should continue updating and/or modifying the revenue model to ensure the IRS appropriately accounts for the impact of taxpayers who opt out of the Program, the age of the balance due, and the actual collection rate achieved.

CORRECTIVE ACTION:

We agree that the revenue model should be updated and/or modified as new information becomes available and as changes are made in PCA case inventory. We will begin a review of the revenue model in July 2007 and either construct a new revenue model or update the existing model based on actual performance. Inherent in the collection rate used in the modeling are factors such as opt outs and age of the balance due. The updated or revised revenue model will be available November 2007.

IMPLEMENTATION DATE:

November 15, 2007

RESPONSIBLE OFFICIAL(S):

Director, Filing & Payment Compliance Modernization Office

CORRECTIVE ACTION MONITORING PLAN:

We will monitor the corrective action as part of our internal management control system.