TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Management Needs to Continue Monitoring Some Case Selection Issues As the Private Debt Collection Program Is Implemented

April 2006

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 26, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Management Needs to Continue Monitoring Some Case Selection Issues As the Private Debt Collection Program Is Implemented (Audit # 200530012)

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

Synopsis

Overall, the IRS has taken positive steps to effectively plan and implement certain aspects of the PDC program. The IRS has developed a draft letter and a related Publication with pertinent information to notify taxpayers their accounts are being transferred to Private Collection Agencies (PCA). Also, the draft procedures for PCAs and the IRS Referral Unit[1] appear to be sufficiently documented. The IRS established a process for implementing the PDC program. As part of the process, the IRS selected a team of executives and staff members to design and oversee implementation of the program. They conducted regular meetings to discuss issues and address concerns. Throughout the process, the team monitored progress and made changes when necessary.

At the time of our review, the IRS planned to place 45,300 cases with PCAs during June through September 2006. Initially, the distribution of these cases was to be based, in part, on the amount of the taxpayer's balance due. Upon reviewing reports obtained from the IRS for the months of June, July, and August 2005, we determined the volume of cases available was not sufficient to

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

fill this particular placement plan and provided this information to IRS management. The IRS was also evaluating the inventory levels and has since revised its placement plan, including the process used for its case selection criteria. As development of the PDC program progresses, the IRS may adjust these factors again as the volume of cases available is constantly changing. Due to these factors, the IRS should continue to monitor the volume of cases available for placement with PCAs, as it has thus far, to ensure there are enough cases to fill its placement plan.

We also determined that approximately 72 percent of the cases available for placement in the PDC program contained a balance due[2] that was over 2 years old. The IRS is now considering a revision to case selection criteria that will increase the balance-due age even further. IRS management indicated they have a long-term strategy in place to include more current cases in the PDC program. However, they stated the new Filing and Payment Compliance project[3] currently limits their ability to accomplish this strategy. As previously noted, the IRS is developing the PDC program in an ever-changing environment. Therefore, the IRS should continue to monitor its strategy of including cases with a more current balance due, as well as continue to monitor the limitations that affect implementation of the strategy.

For the initial phase of the PDC program, the IRS wants to place simpler cases with PCAs, such as those in which the taxpayer has filed all tax returns due. Although the PCAs can try to get taxpayers to file delinquent returns, they cannot obtain an Installment Agreement[4] when taxpayers have not filed all returns that are due (nonfilers). Unless PCAs are able to obtain full payment, these cases would have to be referred back to the IRS to work. This would result in less direct revenue from the PDC program and would divert IRS resources in the Referral Unit. We determined that, contrary to IRS intentions, the case selection criteria currently in place would allow certain nonfiler cases to be assigned to the PCAs. Management agreed to conduct further review of nonfiler conditions to determine whether the nonfiler cases should be excluded from inventory.

Recommendations

During the course of our audit, we discussed our concerns with IRS management, who considered our issues and made adjustments when necessary. We made no recommendations in this report. Therefore, no response was required. However, the IRS provided a response to formally address our results.

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[2] A balance due represents an unpaid assessment for which a taxpayer owes the IRS.
[3] The Filing and Payment Compliance project was initiated to address the inventory of delinquent tax debt that is not actively being collected by the IRS due to limited resources.
[4] An Installment Agreement allows taxpayers to pay tax liabilities by making regular payments to the IRS over time rather than all at once.

Response

The Commissioner, Small Business/Self-Employed Division, agreed with our concerns and reaffirmed the IRS' commitment to continue monitoring the PDC project and to make any changes that may be necessary to maximize the effectiveness of its strategy. The Commissioner also identified plans to track activities related to nonfiler cases to ascertain the PCAs' effectiveness at resolving the condition as well as the long-term benefits of assigning cases with this condition to PCAs. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report information. Please contact me at (202) 622-6510 if you have questions or Curtis W. Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Table of Contents

Background

To help address the growing tax debt inventory, the Department of the Treasury proposed that Congress pass legislation to authorize the Internal Revenue Service (IRS) to use Private Collection Agencies (PCA) to help collect tax debts for simpler types of cases.[1] The IRS refers to this effort as the Private Debt Collection (PDC) program.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004[2] that created new Internal Revenue Code Section (§) 6306 (2004) to permit PCAs to help collect Federal Government 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 from the taxpayer 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 to pay for the cost of services performed under such contract and an amount not in excess of 25 percent collected for collection enforcement activities of the IRS.

According to the IRS, the initiative to use PCAs will:

- Help reduce a significant and growing amount of tax liability deemed uncollectible due to IRS collection and resource priorities (as of September 2005, the gross accounts receivable to the IRS was $258 billion).
- Help maintain confidence in the tax system.
- Enable the IRS to focus its existing collection and enforcement resources on more difficult cases and issues.

The legislation provides that the provisions of the Fair Debt Collection Practices Act[3] shall apply to PCAs. The law also prohibits PCAs from committing any act or omission which employees of the IRS are prohibited from committing in the performance of similar services. According to the IRS, PCAs will be required to adhere to all taxpayer protections and would 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 PCAs must also adhere to all security and privacy regulations for systems, data, personnel, physical security, and taxpayer rights protections. To ensure compliance with these requirements, the IRS is responsible for providing oversight of PCA actions.

[1] Simpler types of cases are those in which the taxpayer has filed all tax returns due.
[2] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[3] 15 U.S.C. § 1601 note, 1692-1920 (2000).

During this audit, we intended to review procedures for the major segments of the PDC program. However, the IRS had not completed documentation of procedures for some areas when we concluded our audit. These areas included procedures for the Oversight Unit and the Contracting Officer's Technical Representative, as well as training for the Oversight Unit, Contracting Officer's Technical Representative, Referral Unit (RU),[4] and PCAs. As a result, we were unable to evaluate these segments and will address these areas in a subsequent review.

On March 9, 2006, the IRS awarded contracts to 3 firms from a field of 33 firms for the first phase of the PDC program. However, two of the unsuccessful bidders filed post-award protests with the Government Accountability Office claiming the IRS' evaluation of proposals was unreasonable and inconsistent with the IRS' Request for Quotation. The two post-award protests were filed on March 17 and 20, 2006. The Government Accountability Office will review the post-award protests and issue its recommendation on the protests within 100 days from the date of filing. On March 22, 2006, the IRS issued notices to each of the three awardees to suspend work based on the post-award protests.

This review was performed in the Wage and Investment Division and Small Business/Self-Employed Division at the IRS National Headquarters in Washington, D.C.; the Wage and Investment Division and Small Business/Self-Employed Division in New Carrollton, Maryland; and the Office of Filing and Payment Compliance and the Submission Processing Site in Philadelphia, Pennsylvania, during the period March 2005 through January 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.

[4] The RU is responsible for assigning cases to PCAs; maintaining cases; recalling cases; responding to inquiries from taxpayers, PCAs, and IRS staff; and handling taxpayer complaints.

Results of Review

Proper Information Is Included in the Draft Internal Revenue Service Taxpayer Notification Letter and Related Publication

The IRS will mail a notification letter and *IRS Use of PCAs* (Publication, not yet numbered) to all taxpayers whose accounts are assigned to PCAs. We reviewed the October 24, 2005, draft letter and Publication and believe they provide a clear explanation of the actions being taken on the taxpayer's account. Both documents provide a telephone number for taxpayers to contact the IRS if they have any questions, as well as how to contact the Taxpayer Advocate Service (TAS)[5] if they are experiencing problems in dealing with the IRS. Also, the Publication identifies PCA responsibilities and provides taxpayers with information on their rights.

Draft Procedures for Private Collection Agencies and the Referral Unit Appear to Be Sufficiently Documented

We reviewed draft procedures for PCAs and the RU and believe they appropriately define the steps necessary for operating under the PDC program. The draft PCA procedures dated October 6, 2005, provide general instructions for training employees, maintaining security over taxpayer information, documenting case actions, interacting with the IRS, interacting with taxpayers, and protecting taxpayer rights. The draft also includes procedures for requesting taxpayers to pay their tax liabilities, monitoring Installment Agreements (IA),[6] referring cases to the TAS, handling taxpayer complaints, reporting, and conducting program reviews. PCAs will use these as guidelines and are responsible for developing more specific instructions to meet program requirements.

The draft RU procedures, dated September 13, 2005, provide detailed instructions for validating weekly Potential New Inventory[7] files, screening cases for assignment, updating IRS systems with information on cases assigned to PCAs, processing documents received from PCAs, and reviewing IA requests. The draft also includes procedures for resolving missing payments; processing payments erroneously received by PCAs; issuing case recalls; performing quality review of RU actions; interacting with taxpayers, PCAs, and IRS staff; resolving complaints; and addressing TAS inquiries. The draft procedures provide flowcharts, break down work

[5] The TAS is an independent organization within the IRS that helps individual and business taxpayers resolve problems with the IRS.
[6] An IA allows taxpayers to pay tax liabilities by making regular payments to the IRS over time rather than all at once.
[7] The Potential New Inventory files include all cases that meet the IRS selection criteria.

assignments by employee level, and identify the related section of the Business Systems Requirements Report[8] or Statement of Work[9] upon which the procedures are based.

While the Internal Revenue Service Has Taken Positive Steps in Developing the Private Debt Collection Program, Continued Monitoring of Some Case Selection Issues Is Necessary

The IRS has established a process for implementing the PDC program. As part of the process, the IRS selected a team of executives and staff members to design and oversee implementation of the program. They conduct regular meetings to discuss issues and address concerns. To keep the course of development steady, the IRS created a schedule that identifies both major and minor tasks to be completed. The schedule identifies the timeline for completion of each task, as well as the person responsible for overseeing development. Throughout the process, the team has monitored progress and made changes when necessary. During the course of our audit, we discussed our concerns with management who considered our issues and made adjustments as appropriate. Although we are not making any recommendations, we believe management should continue to monitor the following issues as they progress in developing the PDC program.

The IRS needs to continue monitoring inventory levels to ensure the volume of cases available for placement is sufficient

In May 2005, the IRS planned to place 45,300 cases with PCAs during January through August 2006. This time period was delayed when a potential contract bidder filed a lawsuit requesting changes to the criteria used to select the PCAs. The distribution of these cases was to be based, in part, on the amount of the taxpayer's balance due. The IRS established the following Balance-Due Ranges:

- $500 to <$1,000.
- $1,000 to <$5,000.
- $5,000 to <$10,000.
- $10,000 to <$25,000.

In September 2005, we informed the IRS there were not enough cases across all the dollar ranges to fill the IRS placement plan. To obtain additional cases, we suggested the IRS consider making adjustments to the selection criteria. One example we provided was to include multiple

[8] The Business Systems Requirements Report defines the requirements that form the basis for system design, development, integration, and deployment.
[9] The Statement of Work outlines the tasks, duties, and responsibilities to be performed under a contract.

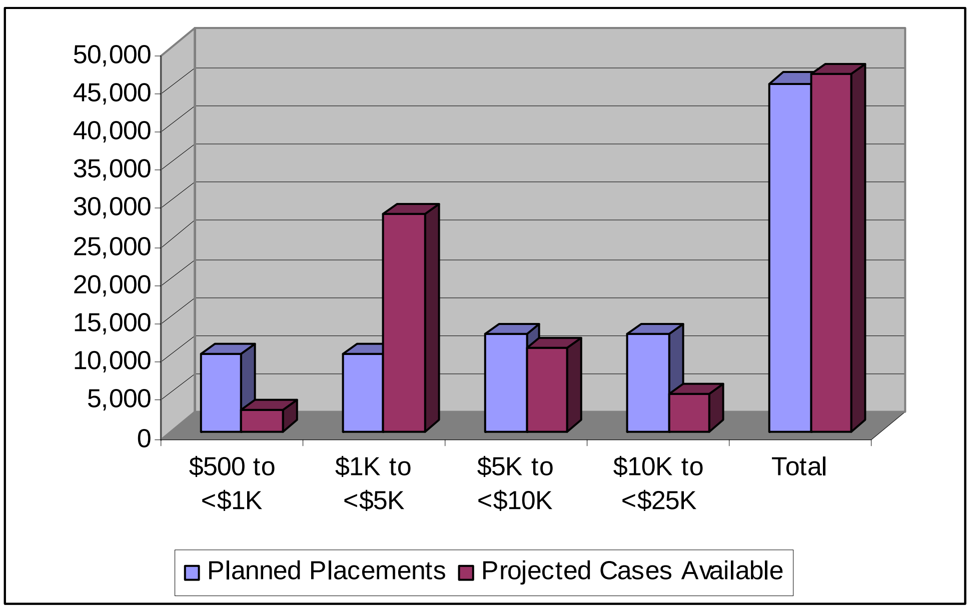
balance-due modules.[10] Another change for consideration was increasing the dollar threshold of the balance-due amount.

As of October 5, 2005, the IRS still planned to place 45,300 cases with PCAs. However, the IRS made slight changes to the volume of cases to be placed in each Balance-Due Range. In addition, the time period for placement changed to June through September 2006.

To conduct a more comparable analysis of data, we then obtained directly from the IRS reports that identified the volume of cases meeting the IRS selection criteria for inclusion in the PDC program. The reports account for the cases available during the months of June, July, and August 2005.

Based upon the data in the IRS reports, it appeared the projected volume of cases available would be sufficient, in total, to meet the placement goal of 45,300 cases. However, as illustrated in Figure 1, our analysis showed the volumes of cases in three of the four Balance-Due Ranges were not sufficient to fill the IRS' placement plan. For example, the IRS planned to place 12,650 cases in the Balance-Due Range of $10,000 to <$25,000. However, we determined there were only 4,798 cases available in this range. Having an insufficient volume of cases to fill the placement plan may limit the IRS' ability to reach its collection goals for the PDC program.

Figure 1: Volume of Cases at Each Balance-Due Range



Source: IRS October 5, 2005, placement plan and IRS June, July, and August 2005 inventory reports.

[10] A module refers to each tax return filed by a taxpayer for a specific period (year or quarter) during a calendar year for each type of tax.

While we conducted our analysis, the IRS was also in the process of evaluating data and again revised its placement plan. In addition to placement of the 45,300 cases noted above, the IRS has decided to place an additional 30,000 cases with the PCAs during October through December 2006. To attain this goal, the IRS recognized the need to revise its selection criteria to have enough cases for placement. As we suggested in September 2005, the IRS reevaluated the selection criteria and has indicated the changes it is considering will provide approximately 62,000 additional cases in any given week. The IRS is also considering changes in the future that include allowing multiple balance-due modules and increasing the dollar threshold. While it may not be feasible for the IRS to implement these two factors at this time, due to technical complexity in relation to time constraints, we believe they would enhance the IRS' efforts to reach the PDC program's long-term revenue projections.

The makeup of inventory is ever changing, and the IRS will likely make adjustments to the PDC program as it continues development. Therefore, we believe the IRS should continue to monitor the volume of cases available, as it has thus far, to ensure it has enough cases to fill its placement plan.

A majority of the cases available for placement have a balance due over 2 years old

Cases are to be selected from two IRS inventories of unassigned cases. The first is the Queue, which is the inventory from which the IRS selects cases to be assigned to field Collection function employees. The second inventory is made up of cases that have been Shelved, those that have been removed from the Queue because they are lower priority cases. The criteria for selecting PDC program cases include a factor for the age in status[11] but do not account for the age of the balance due. For example, the criterion for Shelved cases was fewer than 6 months in that status. However, many Shelved cases have been in some prior status for a number of months.

In analyzing IRS reports,[12] we determined 77 percent of the Shelved cases had a tax delinquency (date from assessment) more than 2 years old. In addition, 45 percent of the cases to be assigned from the Queue were more than 2 years old. Overall, approximately 72 percent of the cases available for placement in the PDC program were more than 2 years old.

The IRS is considering revising the selection criteria to obtain additional cases for placement. One revision being considered will increase the age threshold to 2 years in status. The current criteria are fewer than 6 months in status for Shelved cases and between 60 days and 1 year for Queue cases. The revision being considered will increase the balance-due age of the cases included in the PDC program even further.

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[11] The age in status represents the amount of time a case has been assigned to a particular inventory.

[12] Reports identified on page 5 that provide information for the cases available during the months of June, July, and August 2005.

A study conducted by Price Waterhouse reflects the older the debt, the harder it is to collect. Specifically, the study determined PCAs have a collection rate of only 1 percent on delinquent nontax Government debts over 24 months old. Including a significant number of cases with a balance due over 2 years old may limit the IRS' ability to reach its collection goals for the PDC program.

When we discussed this issue with management, they indicated they have a long-term strategy in place to include more current cases in the PDC program. However, under the initial implementation of the PDC program, they are using the Filing and Payment Compliance project. This is a new piece of the IRS modernization plan, which is just being implemented and currently limits the IRS' ability to select cases earlier in the collection process. As a result, initial inventory is more aged than they expect it will be in the future. The IRS stated that implementing the strategy to obtain more current cases is reliant upon future funding. The IRS is working under the expectation that funding will be made available and is moving forward with its vision strategy. We believe it is important the IRS continue to monitor its strategy of obtaining more current cases, as well as the limitations that may affect implementation.

Inventory selection criteria do not exclude all nonfiler cases

For the initial phase of the PDC program, the IRS wants to place simpler cases with PCAs, such as those in which the taxpayer has filed all tax returns that are due. Per established procedures, PCAs can try to get taxpayers to file delinquent returns; however, they cannot obtain an IA when taxpayers have not filed all returns that are due (nonfilers). Unless PCAs are able to obtain full payment, these cases would have to be referred back to the IRS to work. This would result in less direct revenue from the PDC program and would divert IRS resources in the RU.

To determine whether the case selection process would eliminate nonfilers as intended, we reviewed a random sample of 73 Shelved and 73 Queue cases. We determined 62 of the 73 Shelved cases and 30 of the 73 Queue cases would meet the planned selection criteria for assignment to PCAs.[13] However, we found that 34 of the 62 Shelved cases and 13 of the 30 Queue cases were for taxpayers that had not filed all required tax returns. The procedures used by the IRS did not automatically identify and eliminate all nonfiler cases. When informed of our results, IRS management pointed out there are instances when it would be appropriate to include a nonfiler case. For example, a taxpayer may not have been required to file a return. However, management agreed to conduct further review of nonfiler conditions to determine whether the nonfiler cases should be excluded from inventory.

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[13] The others would not qualify for assignment due to such factors as Invalid Taxpayer Identification Numbers or accounts frozen for various reasons such as taxpayers residing in an area declared as a natural disaster.

Recommendation

During the course of our audit, we discussed our concerns with IRS management, who considered our issues and made adjustments when necessary. We are making no recommendations in this report. Therefore, no response was required. However, the IRS provided a response to formally address our results.

> ***Management's Response*:** The Commissioner, Small Business/Self-Employed Division, agreed with our concerns and reaffirmed the IRS' commitment to continue monitoring the PDC project and to make any changes that may be necessary to maximize the effectiveness of its strategy. The Commissioner also identified plans to track activities related to nonfiler cases to ascertain the PCAs' effectiveness at resolving the condition as well as the long-term benefits of assigning cases with this condition to PCAs.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effectiveness of the Internal Revenue Service (IRS) planning and implementation of the Private Debt Collection program. To accomplish our objective, we:

I. Evaluated the process for selecting cases to be assigned to the Private Collection Agencies (PCA).

A. Interviewed IRS management to identify the inventory selection criteria.

B. Determined how the sample of cases would be assigned to the PCAs.

C. Obtained from the IRS TRCAT file[1] a download of accounts assigned to the Queue[2] and those closed as not collectible due to lack of resources (Shelved).[3] We validated the reliability of the downloaded data by comparing it to the information available through research of the Integrated Data Retrieval System.[4] We selected a random sample[5] of 73 Queue and 73 Shelved accounts to determine if IRS criteria make the best potential for success (age of case, IRS predictive result of the case, etc.).

D. Analyzed information from the IRS to approximate the universe and age of cases meeting the selection criteria.

II. Evaluated the adequacy of the draft procedures established for cases referred back to the IRS from the PCAs and the adequacy of the draft procedures for the PCAs. Also, we evaluated the draft IRS taxpayer notification letter and related Publication to determine if they are informative for the taxpayer and/or representative.

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[1] The TRCAT file is an IRS database that identifies all accounts with a balance due.
[2] The Queue is the inventory from which the IRS selects cases to be assigned to field Collection function employees.
[3] The populations of Queue and Shelved cases, respectively, were 29,716 and 18,659 as of June 26, 2005.
[4] This is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[5] We selected a random sample because we did not intend to make projections based on our results.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
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Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Collection, Small Business/Self-Employed Division SE:S:C
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Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
APR 13 2006

April 12, 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Discussion Draft Audit Report – Management Needs to Continue Monitoring Some Case Selection Issues as the Private Debt Collection Program is Implemented (Audit # 2005-30012)

We have reviewed your report and appreciate your comments on the positive steps that we have taken in planning and implementing the Private Debt Collection (PDC) project. As mentioned in your report, our executives routinely meet to monitor progress, discuss issues and make improvements as necessary.

We also appreciate your acknowledging our revisions to the case selection and placement criteria as we considered your earlier concerns about our distribution plan. Further, we agree that a large percent of older cases are currently included in the PDC inventory. As stated in your report, our long term strategy is to select more current cases. We recognize that as more information becomes available our case selection and placement criteria may require further "fine tuning."

We would like to address your concern that the inability of private collection agencies (PCAs) to formalize an installment agreement, on cases in which a taxpayer is not currently in compliance with filing requirements, might impact the success of the PDC program. We have created procedures that will permit the PCA to inquire about the status of the taxpayer's filings. If the PCA submits an agreement for review and an outstanding Tax Delinquency Investigation (TDI) module is discovered, the case will be returned to the PCA for resolution. We also plan to work with the PCAs on their internal ability to track TDI related activities so that we may ascertain their effectiveness in resolving TDIs as well as the long term benefits of assigning associated TDIs or even standalone TDIs to PCAs.

Finally, we reaffirm our commitment to continue monitoring the PDC project and to make any changes that may be necessary to maximize the effectiveness of our strategy. I assure you that the entire IRS team is fully committed to the project's success.

If you have any questions, please call me at (202) 622-0600 or Deborah Wolf, Director, Filing & Payment Compliance Modernization Office, at (609) 278-7732.