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PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
FEDERAL CONTRACTORS WHO CHEAT ON THEIR TAXES
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Good morning Chairman Coleman, Ranking Member Levin and members of the Permanent Subcommittee on Investigations. I am pleased to appear before you again to discuss a topic that I can assure you is as important to me as it is to you.

Before I turn to today's topic, I would like to update you on a subject I referenced in last year's testimony --- the tax gap. When I appeared before you last June, the IRS had developed preliminary estimates for the tax gap. The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

In February, we released final numbers based on a recently completed National Research Program review of tax year (TY) 2001 data for individual taxpayers. This data shows that our overall annual tax gap is $345 billion. Through enforcement initiatives and the collection of late payments we are able to reduce that by some $55 billion, leaving a net tax gap of $290 billion.

This is obviously a huge number in real terms, but perhaps its greatest significance is what it does to undermine the tax system as a whole. Nearly 84 percent of all taxpayers are paying what they owe on a timely basis. They expect their friends and competitors to do likewise. And, they certainly expect anyone that does business with the Federal Government to be paying their fair share.

Federal Contractors

All federal contractors should be held to high standards. Compared to contractors in the private sector, for instance, federal contractors face stiffer penalties and more regulations involving equal opportunity and other laws. Contractors receiving taxpayer dollars should not cheat these very same taxpayers by passing their tax bills on to them. While we recognize that taxpayers may have legitimate differences with the IRS regarding their tax obligations, there are specific mechanisms for addressing those differences. Simply ignoring, or actively evading, one's established tax obligations is not acceptable.

This is my third time before this subcommittee on this very issue. I first appeared in 2004 to respond to the Governmental Accountability Office (GAO) report on 47 DOD contractors who were delinquent in their taxes. I appeared again last year to discuss 50 civilian contractors that GAO had identified as also being delinquent. At that time, I pointed out the progress that the IRS had made working with the Financial Management Service (FMS), the General Services Administration (GSA), the Department of Defense (DoD), the Office of Management and Budget (OMB) and the Department of Justice. Together these agencies formed the Federal Contractor Tax Compliance (FCTC) Task Force.

My testimony this morning is designed to accomplish four objectives:

- Update you on the progress we have made working with the FCTC as well as advise you of other actions the IRS has taken since I last testified on this subject;

- Update the 122 cases (47 DoD, 50 civilian, and 25 GSA) identified by GAO;

- Advise you on some steps we hope to take to further limit future occurrences of Federal contractors not paying their total tax obligations; and

- Suggest some legislative proposals that will assist in preventing future tax evasion and assist us in reducing the tax gap.

Progress Report

The Federal Payment Levy Program (FPLP) provides an automated process for serving tax levies and collecting unpaid taxes through FMS. The FMS uses its Treasury Offset Program (TOP) to match certain types of federal payments against federal tax debt records. As a result, the program applies a portion of these federal payments to the outstanding tax liabilities. I would now like to outline the steps we have taken administratively to enhance the FPLP.

We have removed many of the operational exclusions that had prevented tax debts from being available for levy through the FPLP. Consequently, from October thru January of Fiscal Year (FY) 2006, FPLP collections have risen to over $81 million dollars as opposed to $58 million at the same time last year. Collections from all Federal contractors were also higher, but not as dramatically. In FY 2006 total FPLP contractor collections were $13 million while a year ago at this point they were $12 million.

We have also maintained our cooperative efforts with other Federal agencies. DoD, GSA and the IRS jointly implemented a TIN validation program last October to validate all TINs in the Central Contractor Registration (CCR). This program will aid in accurate information reporting and federal tax collection with respect to contractors. All TINs will be validated within 12 months of implementation. In the first two months of the program, we were able to validate over 62,000 of the 380,000 registered vendors as of December 30, 2005. We expect to validate the remaining vendors by the end of 2006.

We have also implemented a process to research FMS name/TIN mismatches. FMS provides a weekly listing of entities where the payor name and the TIN do not match. Research is conducted to match the payor name/TIN within the IRS database. When matches are determined, an "alias" name control is input to the FMS data base "Client". As of mid-February, we completed research on 82 percent of the FMS accounts. We found matches for 24 percent of the mismatches FMS had provided. This process has made an additional $84 million of tax debts available for a potential match.

The FCTC task force has also been working on the problem concerning the use of purchase cards to pay contractors. It is currently pursuing an interim procedure to match debts in TOP with the CCR database maintained by the DoD. If a match is found, the CCR would be updated with a field that the contractor is not eligible to be paid by the purchase card program and will have to be paid by a payment system currently in TOP.

We have also made progress on reducing the number of federal payment systems that do not match against Federal debts. To date, 18 of the 20 Defense Finance Accounting Service (DFAS) payment systems have been implemented in the automated process. These last two payment systems account for less then 0.03 percent of Federal payments.

In addition, a study was conducted to match individual tax debts against vendor payment files. During the early implementation of the FPLP, a decision was made not to match individual tax debts against vendor payment files to avoid the possibility of mistakenly levying a business' Federal payment to collect an unrelated individual's tax debt. This was because the FMS' payment file does not distinguish between Social Security Numbers (SSNs) and Employment Identification Numbers (EINs). Each of these numbers are 9 digits and the concern was that a vendor payment would be mistakenly levied to collect the tax debt of an unrelated individual taxpayer based on the vendor's EIN being identical to an individual's SSN. For this reason, only business tax debts were matched against vendor payment files.

The task force has revisited this issue and attempted to quantify the impact of a potential matching program utilizing the Name Control. What we found was that initially there were 4800 EINs in the data base that matched unrelated SSNs. However, if the Name Control was used in conjunction with the EIN for matching purposes, only 4 potential matches were identified. As a result, beginning last November, we began matching individual income tax debts and payroll trust fund penalties assessed on individual owners against contractor payments. This resulted in an initial match of approximately 1000 individual tax debts totaling debt balances of $240,000.

In January, we began analyzing all awarded DoD contracts from January 2005 thru November 2005 and for civilian contracts from July 2004 thru July 2005 to determine the extent to which there are non-filers being awarded federal contracts. We are now attempting to establish a system that would identify these non-filers and direct them to existing compliance systems to address the non-filing.

Enforcement has also been a high priority for us since I testified last June. I will talk about the 122 cases identified by the GAO later in my testimony. Many of these cases involve failure to pay employment taxes. Those cases can present even greater challenges for a criminal prosecutor.

It is important to understand, however, that our focus is not just on these 122 cases. We take instances of any Federal contractor not paying taxes very seriously.

We have issued notices of levy against funds in the bank accounts of Federal contractors and on accounts receivable, including accounts receivable due from federal agencies. In some cases, in order to collect 100 percent of a tax debt rather than the 15 percent collected via the FPLP, the revenue officer may block the taxpayer's inclusion in the FPLP and instead issue a paper levy directly to the federal agency.

In April 2005, we implemented the 100 percent continuous levy authority granted by the American Jobs Creation Act. Currently, we are only able to apply this 100 percent levy to Defense contractor payments. As a result, $15.4 million was collected through last January, instead of the $2 million that would have been collected under the 15 percent authority. With other Federal agencies, it is impossible to distinguish between payments for goods and services and other types of payments. We are now seeking a statutory change that will allow the 100 percent continuous levy authority for *all* Federal vendor payments, not just for "goods and services". This will allow us to impose the 100 percent levy on all Federal payments. Significant additional FPLP collections could have been made between April 2005 and January 2006 had we had that authority.

We have regularly filed notices of Federal Tax Lien to protect the government's interest in any asset owned by the taxpayer. In some cases, the Federal contractors appear to have related entities which are also being investigated and could result in the filing of nominee or alter ego liens so collection can be pursued on an asset not titled to the taxpayer.

We also issue summonses, when necessary, in order to secure information necessary to make a collectibility determination or to provide information to complete an income tax return.

The Trust Fund Recovery Penalty is also being used against Federal contractors who are delinquent on their wage withholding taxes. When this penalty is assessed against the responsible persons, those persons are personally liable and their personal assets can be attached, even though they may not be the taxpayer.

Steps are also being taken to improve the quality of our overall efforts on Federal contractor cases. Specifically, we have:

- Issued procedural guidance and made systemic changes. We have issued interim guidance to the Collection Field function containing procedures for working cases involving taxpayers who do business with the Federal government;

- Revised the group manager manual to include a requirement for the manager to maintain a list of all taxpayers in the group's inventory who are Federal contractors and to review those cases;

- Made systemic changes to the field inventory management system;

- Developed and issued "Tool Kits" for field revenue officers to increase their effectiveness in dealing with these types of cases.

GAO Cases

As you know, in 2004 the GAO cited 47 cases of DoD contractors being delinquent on their taxes. A year later, they identified another 50 civilian contractors doing business with the Federal government as having outstanding tax obligations. Recently, an additional 25 GSA cases have been identified.

I intend to update you on the status of these cases, but first I want to put the situation in context. When the 97 DoD and the civilian cases first came to the IRS, we examined them outside our normal process. Because of the Congressional hearings, these cases rightfully received significant public attention and many assumed that all or most of these Federal contractors were criminals and should be prosecuted.

As a result, all of these cases were first reviewed in IRS by our Criminal Investigation (CI) division. Under normal protocol, cases are referred to CI at the very end of the examination process, after we have examined all the facts and concluded that a potential criminal violation may exist. So, in a sense, the process was reversed for these specific cases. They were taken out of queue, if you will.

I know that there is a desire, and perhaps an expectation, by some that many of these contactors should have been subject to criminal prosecution. However, it is extremely difficult to meet the standard that would elevate these cases to a criminal prosecution. Stated another way, these cases are not a target rich environment for a criminal investigation.

The most difficult issue facing a criminal investigation on these cases is documenting sufficient evidence of affirmative acts of evasion to establish willfulness.

Willfulness is difficult to prove in employment tax cases because the government must show that the conduct was intentional and not simply a result of bad business decisions or mistakes.

Both the Department of Justice Tax Division and the United States Attorneys Offices consider overall "jury appeal" when deciding if a tax prosecution will be authorized.

Jury appeal is best demonstrated when the unpaid employment taxes inure directly to the taxpayers benefit.

Case selection is one of the key factors in determining whether a case will be successfully prosecuted. The CI division has vast experience in determining the prosecution potential of cases selected for investigation, evidenced by a 96.3% acceptance rate at the Department of Justice and 92.2% acceptance rate at the United States Attorneys Offices. The Employment Tax Program has been highly successful primarily because of the diversity and egregiousness of the high-dollar, high-impact cases selected for investigation.

With that in mind, we had experienced agents review the GAO referral information on the 47 DoD, the 50 civilian contractor and the 25 GSA cases.

Looking at the 122 total cases as a whole, 74 are now closed and no further criminal or civil action is anticipated. Nine cases have been referred for criminal investigation. These nine cases have a total of nearly $41 million in potentially collectible dollars. Two cases have been completed and are being referred to the Department of Justice for prosecution. In 5 of these cases, CI was already looking at the taxpayer prior to the GAO referral.

In 1 of those 5 cases, we have secured a conviction. A nursing home operator in California was found guilty on 47 counts of willful failure to truthfully account for and pay over payroll taxes owed to the government.

Of the remaining 74 closed cases, 12 paid their obligation in full for a total of slightly over $6 million. Eleven of the cases are in Chapter 11 bankruptcy and another 25 are out of business. Eleven more are classified as currently not collectible because of hardship, liquidation, or for other reasons. There are another 14 cases with installment agreements in place.

That leaves a total of 39 open cases. Of this total, Offers in Compromise have been made in three cases; four are in either the collection due process (CDP) appeals process or in the Automated Collection System. We have 32 cases totaling over $18 million that are with our Collection Field function (CFf) on which we are pursuing case resolution.

Of these 122 total cases, 48 are currently in the FPLP. While we make every effort to insure that all appropriate cases are referred to the FPLP, there are several reasons why a case would not be. For example, the taxpayer might have requested or entered into an installment agreement and the levy is prohibited by statute. Also prohibited by statute is the imposition of the levy on cases where an Offer in Compromise is being investigated or has been accepted. Other statutory prohibitions include where the taxpayer has filed for bankruptcy protection, and where the taxpayer has submitted a request of a CDP hearing.

Sometimes cases are not referred for operational reasons. For example, the IRS generally will not refer cases to the FPLP where there is an active criminal investigation going on, where there is a determination that the debt is uncollectible, or where the revenue officer assigned to an investigation determines that a levy might not be the best manner in which to collect the debt.

We are often asked why any of these cases would be classified as "currently not collectible". There are several reasons. First, the entity may be staying in compliance with current filing and payment requirements, but is unable to pay the back taxes, so collection is deferred until the taxpayer's ability to pay the back taxes improves. Second, the entity may have gone out of business and there never will be any collection potential. Third, the entity may that have undergone a liquidating bankruptcy. Finally, an individual taxpayer may have the debt classified as uncollectible if an analysis of income and expenses indicates no ability to pay delinquent taxes and necessary living expenses.

Future Actions

Working with the FCTC, we plan to continue to move forward on a number of initiatives in FY 2007 and beyond. We plan to make changes in the FPLP Exclusion Policy Criteria which will make more accounts available for the FPLP. Changes to this program include:

- Changing account exclusions to include modules with adjustment claims that will contain a balance due.
- Changing account exclusions criterion from 3 months to 1 month of the accounts collection statute except for SSA and Office of Personnel Management (OPM) payments.
- Including pending Installment Agreements (IA) where a levy already exits. If an existing FPLP levy preceded the pending IA request, we do not remove the account from the FPLP until the IA is approved and established.

In July, we expect to make changes to accelerate the progress of collections. These changes include:

- Federal Contractors identified from the Federal Procurement Data System—Next Generation (FPDS-NG) file in order to accelerate notice status accounts to final notice.
- Business Master File (BMF): CDP rights incorporated into the 2nd notice stage to accelerate to earlier collection stage - July 2006.

We are also still pursuing legislative changes to section 6331(h) of the Internal Revenue Code (IRC) to implement the 100 percent levy on vendor payments in addition to payments for "goods and services".

We are continuing to work with the FCTC on the problems associated with collecting debts from vendors utilizing purchase cards. The Task Force is pursuing the

implementation of a process to match debts in TOP with the CCR. If a match occurs the CCR would be updated with a field indicator that the contractor is not eligible to be paid by the purchase card program and will be re-directed to a payment mechanism currently in TOP. This only corrects new contracts and FCTC is exploring how to re-direct payments that already have contracts.

We also plan to escalate our search for non-filers. A file containing all awarded contracts from DoD and GSA for the past year was matched against IRS data to determine the non-filer universe. An analysis is being conducted on the data to determine appropriate next actions.

I know there is some desire on the part of members of this Subcommittee for us to look at ways on the front end that we can prevent contractors who are delinquent in their federal taxes from ever receiving federal contracts. Currently the only question that prospective contractors have to answer is whether they have been convicted of income tax evasion. This refers to a conviction under section 7201 (Income Tax Evasion) of the IRC and an affirmative answer could result in debarment of the contractor from receiving a Federal contract.

Some have suggested that the list of questions be broadened and that IRS become involved in verifying the answers, possibly on an annual basis. While I can certainly understand the motivation to do this, I am concerned that it could improperly involve the IRS in broader procurement policy questions and possibly raise taxpayer privacy issues.

The IRS has a defined mission. We have a set of duties, and before those duties are changed or expanded, there ought to be careful consideration of the policy implications of the specific change or expansion.

We live in an era where there is an acute sensitivity to individual privacy and we take our responsibility to protect that taxpayer privacy very seriously. We have an excellent reputation in that area. The sharing of tax information with other government agencies is a government-wide policy issue that needs to be worked in conjunction with the Administration, the Office of Management and Budget, and ultimately the Congress.

This committee has always been a strong supporter of our budget requests. The FY 2006 budget provided a $446 million increase that is allowing us to undertake several new enforcement initiatives that we believe will provide a significant return on investment. The FY 2007 budget, if fully funded, will allow us to continue the progress on those enforcement priorities while maintaining our strong focus on service. The increase in FY 2006 was done through a program integrity cap adjustment. The 2007 Budget again proposes a cap adjustment to maintain this increase.

Legislative Proposals

We believe that there are several things that can be done legislatively which will assist in collecting delinquent taxes from federal contractors. I have already mentioned one earlier in my testimony. We would like to see a change to section 6331(h) of the IRC to

allow the IRS to implement the 100 percent levy on all vendor payments not just those for goods and services. In addition, the Administration has proposed improving the FPLP program by allowing FMS to retain directly a portion of the levied funds as payment for FMS's fees, while still crediting the taxpayer's account for the full amount collected.

The President's proposed FY 2007 Budget also included five legislative initiatives designed to reduce the tax gap. Two of these can be helpful in going after contractors who fail to remit their taxes properly.

The first proposal would allow the levy to be imposed for employment tax liabilities prior to a CDP hearing in a fashion similar to levies issued to collect a federal tax liability from a state income tax refund. Taxpayers would have the right to a CDP hearing on these liabilities within a reasonable time after the levy.

The delinquency of many of the Federal contractors involves payroll taxes. Currently, we are authorized to take various collection actions including issuing Federal tax levies. However, before a tax levy can be issued, the IRS must provide the taxpayer with a notice and an opportunity for an administrative CDP hearing, and for judicial review. While the CDP rules provide important safeguards, they raise unique problems in the context of employment taxes.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for hearing and judicial review for each period, thus the need for a post levy CDP hearing.

Our second proposal would require increased information reporting for certain government payments for property and services. This proposal would authorize the Treasury Secretary to promulgate regulations requiring additional information reporting and backup withholding on non-wage payments by Federal, state and local governments to procure property and services. Certain payments would be exempt. These could include payments of wages and interest, already subject to withholding, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The President's other three proposals to reduce the tax gap are not directly related to the federal contractor issue but are important none the less. The first would increase reporting on payment card transactions. Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some businesses to accurately report their gross income, including income derived from payment card transactions, represents a significant portion of the tax gap.

Specifically, the Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding for card issuers in the event that a merchant payee fails to provide a valid taxpayer identification number to the merchant bank.

It is clear that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. Because reimbursement information is provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on card issuers. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden.

The second would clarify when employee leasing companies can be held liable for their clients' Federal employment tax. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes should be assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable if they met certain specified standards.

The third legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax preparers. Under current law, paid tax return preparers are required to sign and include their taxpayer identification number (TIN) on income tax return and related documents that they prepare for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns or related documents such as employment tax returns, excise tax returns, and estate and gift tax returns.

The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns. Further, it would impose penalties for preparing non-income tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

Conclusions

The IRS takes seriously the issue of federal contractors being delinquent on their Federal tax obligations. We have been working hard for the last two years and are continuing to work with other Federal agencies as part of the Federal Contractor Task Force to address this problem. Each agency on that task force has its own role in the process. The GSA is responsible for procurement. We are responsible for tax collection and administration. The Department of Justice is there to prosecute criminal offenses. By working together, we are making progress.

Of the 122 cases referred to us by GAO and GSA, we are still pursuing case resolution on 39 either through our civil or criminal enforcement investigative process. We have a conviction in one case and eight others remain under criminal investigation.

Our efforts in this area would be helped by enactment of the Administration's legislative proposals including the post levy CDP, extending the 100 percent levy to vendor payments other than "goods or services", and the reporting and back-up withholding of aggregate payments made by local, state and federal governments to contractors.

Thank you again for the opportunity to be here this morning and I will be happy to respond to any questions.