



*Additional Actions Are Needed to Protect  
Taxpayers' Rights and the Government's  
Interest During Bankruptcy Proceedings*

**February 20, 2009**

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

3(d) = Other Identifying Information of an Individual or Individuals



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

February 20, 2009

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Additional Actions Are Needed to Protect  
Taxpayers' Rights and the Government's Interest During Bankruptcy  
Proceedings (Audit # 200630025)

This report presents the results of our review to evaluate the controls used in the Internal Revenue Service (IRS) Centralized Insolvency Operation function to ensure that taxpayers' rights and the Government's interest are protected during bankruptcy proceedings. We conducted this review as part of our Fiscal Year 2007 Annual Audit Plan coverage.

*Impact on the Taxpayer*

The United States Bankruptcy Code's automatic stay<sup>1</sup> provision is designed to protect taxpayers from collection activities while they are in bankruptcy. Nonetheless, an estimated 495 potential taxpayer rights violations occurred between October 2005 and December 2007 because the IRS filed liens<sup>2</sup> while taxpayers were in bankruptcy. There were also 27,838 taxpayers at risk of having their rights violated because a bankruptcy freeze code was not posted to their accounts in a timely manner. The bankruptcy freeze code designates that the account is in bankruptcy status. The code is an important control component for protecting taxpayer rights during bankruptcy proceedings by helping the IRS and its Centralized Insolvency Operation function identify and address potential automatic stay violations.

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<sup>1</sup> An automatic stay is a provision under the United States Bankruptcy Code prohibiting creditors from beginning or continuing proceedings for collecting owed amounts from individuals who filed for bankruptcy.

<sup>2</sup> A claim on a taxpayer's assets for the amount of unpaid tax.



## *Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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### Synopsis

In October 2005, the IRS consolidated many of its bankruptcy processing activities performed throughout the country to a new unit called the Centralized Insolvency Operation function located at the IRS Philadelphia Campus.<sup>3</sup> By consolidating work, the IRS envisioned it would reduce operation costs, increase efficiency, and improve customer service.

The IRS process for ensuring that taxpayers' rights and the Government's interest are protected during bankruptcy proceedings relies heavily upon its automated systems and the information within these systems. Bankruptcy cases are controlled and processed by the IRS on the Automated Insolvency System. The Automated Insolvency System interfaces with the IRS Master File.<sup>4</sup> Within the Master File, the IRS records various bankruptcy actions, such as new filings, payments, and discharges, through designated status and transaction codes.

Consequently, recording the status and transaction codes in each taxpayer's Master File account accurately and in a timely manner is critical for preventing violations of the Bankruptcy Code automatic stay provision and resuming collection actions upon the discharge or dismissal of a bankruptcy case in a timely manner.

Controls need to be strengthened in two areas during the opening and closing of bankruptcy cases to ensure that taxpayers' rights and the Government's interests are protected during bankruptcy proceedings. First, the Centralized Insolvency Operation function could take better advantage of reports generated from IRS automated systems to identify and resolve potential stay violations. During our audit, we identified cases in which taxpayers' rights were violated because the IRS filed liens on 29 taxpayers' accounts while the taxpayers were in bankruptcy. Based on our statistical sample results, we estimated that 495 lien stay violations occurred between October 2005 and December 2007.

We also identified 27,838 taxpayers' accounts that were at risk of having their rights violated because a bankruptcy freeze code was not posted to their accounts in a timely manner. One factor that might have contributed to delays in posting freeze codes on taxpayers' accounts is the untimely resolution of mismatches on the Potentially Invalid Taxpayer Identification Number report. This report is generated daily and identifies cases where the bankruptcy freeze code failed to post to the taxpayer's account because Master File information (e.g., identification numbers and names) did not match the Bankruptcy Court data received and input to the Automated Insolvency System. Resolving Potentially Invalid Taxpayer Identification Number report mismatches is critical because the freeze code will never post to the Master File account until the mismatch is manually reviewed and resolved.

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<sup>3</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

<sup>4</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



## *Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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The second area where improvements are necessary involved holding managers more accountable for initiating bankruptcy closing actions in a timely manner. Failure to initiate bankruptcy closing actions in a timely manner affects the IRS' ability to collect taxes and also can place undue hardship and burden on taxpayers by withholding refunds. As of June 28, 2008, we identified 2,442 taxpayers' accounts in which closing actions had not been initiated within 30 calendar days of the Bankruptcy Courts' closing determination.

### *Recommendations*

The Operation Manager, Centralized Insolvency Operation, should 1) develop and implement guidance for the identification and correction of potential lien stay violations when establishing bankruptcy cases on the Automated Insolvency System, 2) improve the Centralized Insolvency Operation function Weekly Inventory Reports (Open and Closures) to include aging information on taxpayers accounts, 3) enhance efforts to resolve freeze codes that do not post to accounts by ensuring that managers consistently work Potentially Invalid Taxpayer Identification Number reports, and 4) evaluate the frequency, consistency, and effectiveness of team manager reviews of the quality and timeliness of bankruptcy closing actions in future operational reviews.

### *Response*

IRS management agreed with all of the recommendations. The IRS has taken action to identify bankruptcy cases where liens were filed after the bankruptcy petition date and will take immediate corrective action if any violations have occurred. The Automated Insolvency System will be programmed to generate a new report that identifies liens posted to accounts after taxpayers have filed for bankruptcy. Existing Weekly Inventory Reports will be modified and a new report has been developed to identify cases that require closing actions. New procedures for working the Potentially Invalid Taxpayer Identification Number reports have been developed and managers are reviewing completed reports to ensure that actions are accurate and taken in a timely manner. In addition, other processes have been put in place to ensure that bankruptcy cases are closed in a timely manner including the verification of team managers reviews during operational reviews. 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 Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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## *Table of Contents*

|  |         |
|--|---------|
| <b>Background</b> .....  | Page 1  |
| <b>Results of Review</b> .....   | Page 4  |
| Controls Need to Be Strengthened During the Opening and<br>Closing of Bankruptcy Cases ..... | Page 5  |
| <u>Recommendations 1 through 3</u> : .....   | Page 10 |
| <u>Recommendation 4</u> : .....  | Page 11 |
| <b>Appendices</b>  |         |
| Appendix I – Detailed Objective, Scope, and Methodology .....                                | Page 12 |
| Appendix II – Major Contributors to This Report .....  | Page 15 |
| Appendix III – Report Distribution List .....  | Page 16 |
| Appendix IV – Outcome Measure .....  | Page 17 |
| Appendix V – Management's Response to the Draft Report .....                                 | Page 19 |



*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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## *Abbreviations*

|        |   |
|--------|---|
| AIS    | Automated Insolvency System                             |
| BAPCPA | Bankruptcy Abuse Prevention and Consumer Protection Act |
| FY     | Fiscal Year   |
| IRM    | Internal Revenue Manual                                 |
| IRS    | Internal Revenue Service                                |
| PIT    | Potentially Invalid Taxpayer Identification Number      |



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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## *Background*

Bankruptcy allows individual and business debtors who can no longer pay their creditors to seek relief by resolving debts through liquidation, reorganization, or a repayment plan. The United States Bankruptcy Court (Court) provides protection to debtors and orderly distribution to creditors through Title 11 of the United States Code (Bankruptcy Code). The type of bankruptcy case is generally classified by the applicable chapter within the Bankruptcy Code. The most common bankruptcy cases are filed under Chapter 7, Chapter 11, and Chapter 13.<sup>1</sup>

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)<sup>2</sup> made it more difficult to declare bankruptcy by requiring debtors who wanted to file under Chapter 7 to meet a means test of having income below a set amount after certain expenses. It also required debt counseling and extended the repayment period for Chapter 13 bankruptcies from 3 years to 5 years. Because most BAPCPA provisions apply to cases filed on or after October 17, 2005, some debtors rushed to file before changes occurred in the Bankruptcy Code causing a spike and then a drop in Court filings.

While changes were being made to the Bankruptcy Code, the Internal Revenue Service (IRS) was redesigning the Insolvency function to improve operations and equitable treatment of taxpayers in bankruptcy. The redesign included centralization, standardization, and process improvement. As of October 1, 2005, selected processing activities performed at field insolvency locations throughout the country were consolidated at the Centralized Insolvency Operation function in the IRS Philadelphia Campus.<sup>3</sup> These activities included 1) adding, updating, and closing bankruptcy cases on the IRS' computer system, 2) resolving upfront processing issues such as potentially invalid Taxpayer Identification Numbers,<sup>4</sup> 3) processing bankruptcy payments for taxpayer debits, and 4) identifying collection activity that could violate Bankruptcy Code provisions.

By consolidating selected work, the IRS envisioned it could reduce operating costs, increase efficiency, and improve customer service. The more complex and location-specific work would still be performed by field insolvency offices throughout the country. Organizationally, the Centralized Insolvency Operation function is divided into 11 technical and 4 clerical teams each

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<sup>1</sup> Chapter 7 provides for liquidation – the sale of property and distribution of proceeds. Chapter 11 provides for reorganization – a plan usually involving a corporation or partnership to keep the business active while paying creditors over time. Chapter 13 provides for a repayment plan – a plan for possible adjustment of debt and installment payments over time, usually 3 to 5 years.

<sup>2</sup> 109 P.L. 8, 119 Stat. 23.

<sup>3</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

<sup>4</sup> A nine-digit number assigned to taxpayers for identification purposes.

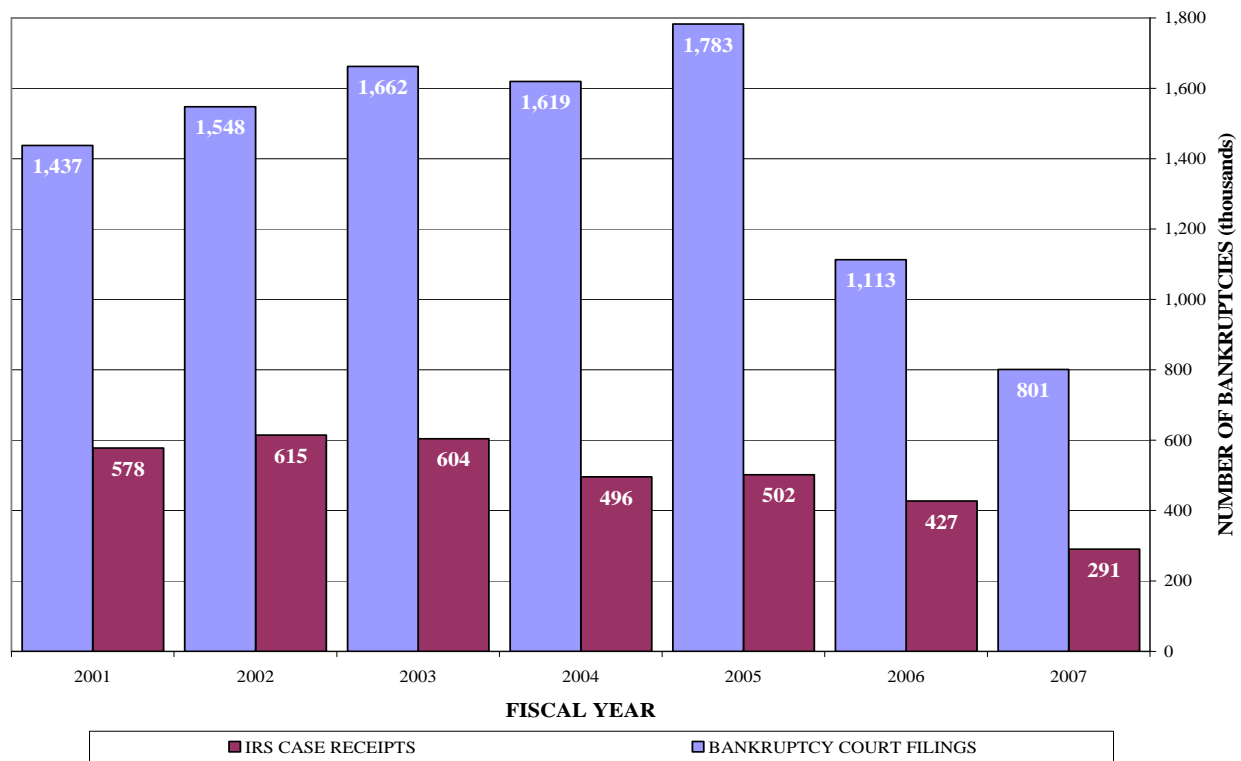


*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

with a manager and a staff of approximately 18 employees. The team managers report to one of two department managers that report to the operation manager.

It is important to recognize that the IRS is not a creditor in every bankruptcy. However, 28 to 40 percent of the annual Court filings for bankruptcies since Fiscal Year (FY) 2001 have resulted in the IRS establishing a bankruptcy case. In FY 2005, before the BAPCPA was fully implemented, there were 1,782,643 Court filings and 501,743 IRS case receipts. Bankruptcies declined after the BAPCPA with 801,269 Court filings and 290,780 IRS case receipts in FY 2007. Although FY 2008 figures are not yet available, the number of taxpayers filing for bankruptcies is expected to increase because of current economic conditions. Figure 1 provides the number of bankruptcies by Court filings and IRS case receipts since FY 2001.

**Figure 1: Number of Bankruptcies by Fiscal Year for Court Filings and IRS Case Receipts**



Source: The United States Bankruptcy Court web site and the IRS Collection Workload Indicators (RPT SYM NO-5000-23) report.

The review was performed at the Centralized Insolvency Operation function in Philadelphia, Pennsylvania, during the period February 2006 through September 2008. We conducted this performance audit in accordance with generally accepted government auditing





*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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## *Results of Review*

The IRS process for ensuring that taxpayers' rights and the Government's interest are protected during bankruptcy proceedings relies heavily upon its automated systems and the information within these systems. Bankruptcy cases are controlled and processed by the IRS on the Automated Insolvency System (AIS). The AIS interfaces with the IRS Master File.<sup>5</sup> Within the Master File, the IRS records various bankruptcy actions, such as new filings, payments, and discharges, through designated status and transaction codes. Consequently, recording the status and transaction codes in each taxpayer's Master File account accurately and in a timely manner is critical for preventing violations of the Bankruptcy Code automatic stay<sup>6</sup> provision and resuming collection actions upon the discharge or dismissal of a bankruptcy case in a timely manner.

Since standup,<sup>7</sup> Centralized Insolvency Operation function management has focused attention on developing and implementing procedures to improve bankruptcy case management practices, which in turn helps ensure that taxpayer rights and the Government's interest are protected during bankruptcy proceedings. For example, our testing of 127 bankruptcy trustee<sup>8</sup> payments received by the Centralized Insolvency Operation function found that, except for a few instances in its first year of operation, the related status and transactions codes were input in a timely manner and were accurately reflected in tax accounts within the Master File. This is an accomplishment since the Centralized Insolvency Operation function received on average over 16,000 payments per week for processing.

In addition, the Centralized Insolvency Operation function began implementing a quality review process in FY 2008 that will ultimately evaluate several hundred bankruptcy cases each year and assess the degree to which Centralized Insolvency Operation function personnel are complying with procedures for opening, monitoring, and closing bankruptcy cases, including those designed to protect taxpayers' rights and the Government's interest. Having such a review process in place is consistent with the Government Accountability Office *Standards for Internal Control in the Federal Government*,<sup>9</sup> which requires that control activities help ensure that management directives to mitigate risks are followed. While the Centralized Insolvency Operation function

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<sup>5</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>6</sup> An automatic stay is a provision under the United States Bankruptcy Code prohibiting creditors from beginning or continuing proceedings for collecting owed amounts from individuals who filed for bankruptcy.

<sup>7</sup> The standup process is defined as the establishment of a new organization with at least the minimum requirements for operation.

<sup>8</sup> A trustee is an agent of the Court that distributes periodic payments from debtors to creditors.

<sup>9</sup> GAO/AIMD-00-21.3.1, dated November 1999.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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has focused attention on improving case management practices, we found that controls need to be strengthened to help identify and prevent automatic stay provision violations and to hold managers more accountable for initiating bankruptcy closing actions in a timely manner.

### ***Controls Need to Be Strengthened During the Opening and Closing of Bankruptcy Cases***

For the IRS, the bankruptcy process begins when it receives notification from 1 of the 94 bankruptcy courts nationwide that a taxpayer filed for protection under a chapter of the Bankruptcy Code. Once the Court notifies the IRS, employees in the Centralized Insolvency Operation function are responsible for recording the bankruptcy information on the AIS. After Centralized Insolvency Operation function employees record the information, the AIS automatically verifies the accuracy of each taxpayer's identifying information with the Master File and establishes an open bankruptcy transaction code on their Master File account. Commonly referred to as a bankruptcy freeze code, it designates that the account is in bankruptcy status and is, consequently, an important control component for protecting taxpayer rights during bankruptcy proceeding by helping the IRS identify and address potential automatic stay provision violations. Establishing the bankruptcy freeze code on a taxpayer's account should occur within 5 workdays of the Court's notification. Despite the important role the freeze code has in protecting taxpayers' rights, we found that it was not as effective as it could be.

We analyzed a statistical sample of 100 of 1,998 taxpayers<sup>10</sup> whose Master File account showed the IRS filed a lien<sup>11</sup> against their property after they filed for bankruptcy between October 2005 and December 2007. Our analysis identified 29 taxpayers who had liens filed by the IRS between October 2005 and December 2007 that were potential violations of the automatic stay provision. Projecting our sample results, we estimated that 495 potential lien stay violations occurred between October 2005 and December 2007.<sup>12</sup> In 16 of the 29 cases, the violations occurred when cases were being established on the AIS. The remaining 13 of 29 violations occurred after the cases had been established on the AIS.

Admittedly, the estimated 495 lien stay violations is not large considering the IRS had 717,768 bankruptcy case receipts during FYs 2006 and 2007. However, it is important to recognize that our analysis focused only on liens. Our analysis did not include the other collection activities, such as levies,<sup>13</sup> payroll deductions,<sup>14</sup> automated direct debit (i.e., payments

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<sup>10</sup> Stratified sample with stratum one includes 50 of 1,381 individual bankruptcy cases and stratum two includes 50 of 617 business bankruptcy cases.

<sup>11</sup> A claim on a taxpayer's assets for the amount of unpaid tax.

<sup>12</sup> Estimate based on a 95 percent confidence level and a stratified sample precision of  $\pm 8.35$  percent. See Appendix IV for additional details.

<sup>13</sup> A method used by the IRS to collect outstanding taxes from sources such as bank accounts and wages.

<sup>14</sup> Amount withheld by an employer from an employee's earnings and sent to the IRS.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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from taxpayers' bank accounts) or installment agreements<sup>15</sup> that if not suspended during bankruptcy could also result in stay provision violations. In FY 2000,<sup>16</sup> we reported that stay provision violations were attributed to collection activities in 41 percent of the bankruptcy cases reviewed. We believe it is important to recognize that even one stay violation can have consequences for the IRS because it could have to pay significant monetary damages to the taxpayer affected by the violation of up to \$1,000,000.

Although IRS officials immediately withdrew the 29 liens, we identified additional steps that the Centralized Insolvency Operation function could take to better protect taxpayers' rights and the Government's interest during the opening and closing of bankruptcy cases. The Centralized Insolvency Operation function could take better advantage of reports generated from IRS systems to identify and resolve potential lien violations when bankruptcy cases are opened and better ensure that the bankruptcy closing actions are initiated in a timely manner. In addition, the IRS needs to follow through and implement the corrective action it committed to take in response to our FY 2000 report recommendation. Our prior recommendation focused on additional computer programming to identify and notify Insolvency function employees when collection action has been taken on taxpayers in bankruptcy. Because the IRS remains committed to upgrading the existing AIS at the time of our review, we are not making this recommendation again.

***The Centralized Insolvency Operation function could take better advantage of reports generated from IRS automated systems to identify and resolve potential stay violations***

IRS automated systems generate several reports to assist the Centralized Insolvency Operation function in identifying and resolving various problems related to bankruptcy case processing. On a daily basis, the Centralized Insolvency Operation function receives paper and electronic bankruptcy notices from the Courts that are used to establish bankruptcy cases on the AIS. The Potentially Invalid Taxpayer Identification Number (PIT) report is generated daily and identifies cases in which the bankruptcy freeze code failed to post to the taxpayers account because Master File information (e.g., identification numbers and names) did not match the Court data received and input to the AIS. In addition to the PIT reports, additional reports are systemically generated to assist the Centralized Insolvency Operation function in identifying potential stay provision violations. If used effectively, these reports provide a critical control to help the Centralized Insolvency Operation function identify and address stay provision violations by ensuring that bankruptcy freeze codes post to taxpayers' accounts and collection activities are suspended.

The Internal Revenue Manual (IRM) does not require Centralized Insolvency Operation function personnel to identify and resolve potential lien stay provision violations when working weekly

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<sup>15</sup> An arrangement where the IRS allows a taxpayer to pay a liability over time.

<sup>16</sup> *The Internal Revenue Service Needs to Better Address Bankruptcy Automatic Stay Violations* (Reference Number 2000-30-162, dated September 2000).



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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reports that identify taxpayers who were in collection status prior to filing for bankruptcy with the Courts. The IRM does, however, provide specific instructions for identifying and resolving other types of potential stay violations when opening bankruptcy cases. For example, the IRM instructs Centralized Insolvency Operation function employees on how to identify and initiate actions to suspend collection activities when levies exist on taxpayers' accounts.

Besides enhancing procedures for suspending collection activities when establishing new cases on the AIS, Centralized Insolvency Operation function managers need to ensure that bankruptcy freeze codes post to Master File accounts in a timely manner. Despite the requirement to establish the bankruptcy freeze code on taxpayers' accounts within 5 workdays of the Court's bankruptcy notification, the Centralized Insolvency Operation function Weekly Open Inventory Report showed that it did not meet this requirement for 27,838 of 345,429 taxpayers during the period October 1, 2005, through August 31, 2008.<sup>17</sup> We were unable to precisely quantify the extent to which Centralized Insolvency Operation function managers might have contributed to the overall number of delayed postings by not taking action to resolve potential problems. One factor that might have contributed to delays in posting freeze codes on taxpayers' accounts is the untimely resolution of mismatches on the PIT reports. Resolving PIT mismatches is critical because the freeze code will never post to the Master File account until the mismatch is manually reviewed and resolved. In our FY 2000 report, we identified problems with managers not ensuring that PIT reports were properly worked and recommended that actions be taken to correct this condition. We were unable to determine how many of the 27,838 cases were delayed due to PIT report mismatches because the reports are not retained more than a month.

In addition, we found a shortcoming in the Weekly Open Inventory Report because it does not provide aging information, meaning that the number of days to establish the freeze code on accounts is not tracked. This design flaw in the report makes it difficult to obtain a complete picture on the extent of the possible problem and for managers to identify and prioritize the accounts most in need of resolution (i.e., taxpayers with the greatest risk of incurring a stay provision violation because they have been in bankruptcy status for an extended period of time and a freeze code has yet to post to their accounts). We also believe that aging accounts would be more in line with the Government Accountability Office *Standards for Internal Control in the Federal Government*, which requires that control activities help ensure that management's directives to mitigate risks are carried out.

**Centralized Insolvency Operation function managers need to be held more accountable for initiating bankruptcy closing actions in a timely manner**

The amount of bankruptcy related tax liabilities including penalties and interest has increased from \$2.45 billion in FY 2003 to \$3.77 billion in FY 2007. Those in the debt collection business, like the IRS, recognize that the probability of collecting a delinquent account will

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<sup>17</sup> This excludes periods when IRS computer systems are not available due to annual maintenance.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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decrease as the account ages. Consequently, once a person or business is dismissed or discharged from bankruptcy owing taxes, the IRS strives to resume the process of collecting the taxes owed. The first step in this process is to initiate bankruptcy closing actions within 30 calendar days of the Bankruptcy Court's dismissal or discharge notification including removing the bankruptcy freeze codes from the taxpayers' Master File account.

The failure to initiate bankruptcy closing actions in a timely manner not only affects the IRS' ability to collect taxes, but can place undue hardship and burden on taxpayers by withholding refunds. In FY 2003,<sup>18</sup> we conducted indepth reviews of bankruptcy cases and reported that untimely bankruptcy closing actions resulted in the following:

- Delayed collection efforts on an estimated 660 accounts, including 45 taxpayers who owed around \$942,000.
- Missed opportunity to collect on an estimated 60 accounts, including 4 taxpayers who owed \$459,000 because the Collection Statute Expiration Date<sup>19</sup> expired while the account remained in bankruptcy status erroneously.
- Delayed issuance of refunds to as many as 1,041 taxpayers, including 8 taxpayers who were owed over \$24,000.

The conditions cited from our earlier review occurred because unit managers and the employees they supervised were either not using or not effectively using bankruptcy closure reports generated from IRS automated systems and taking necessary actions to close cases appearing on the reports. Although we did not review cases in this audit for these conditions, we did analyze the Centralized Insolvency Operation function's weekly inventory report on closures. Since managerial reviews and documentation of such reviews are an important part of the Centralized Insolvency Operation function's overall quality control process, we also interviewed the 10 technical team managers responsible for closing actions to determine what reviews they conduct to ensure that the employees they supervise initiate closing actions in a timely manner on the cases assigned to their units.

As of June 28, 2008, of the 8,750 cases waiting to be closed, 2,442 (28 percent) had no closing action initiated even though it had been 30 calendar days or more since the Bankruptcy Court notified the IRS of the dismissal or discharge of the bankruptcy. As with the Weekly Open Inventory Report, there is no additional information available on the Closure Inventory Report to determine the age of the cases requiring closing actions. Figure 2 provides the Centralized Insolvency Operation function's closing inventory levels for FY 2008.

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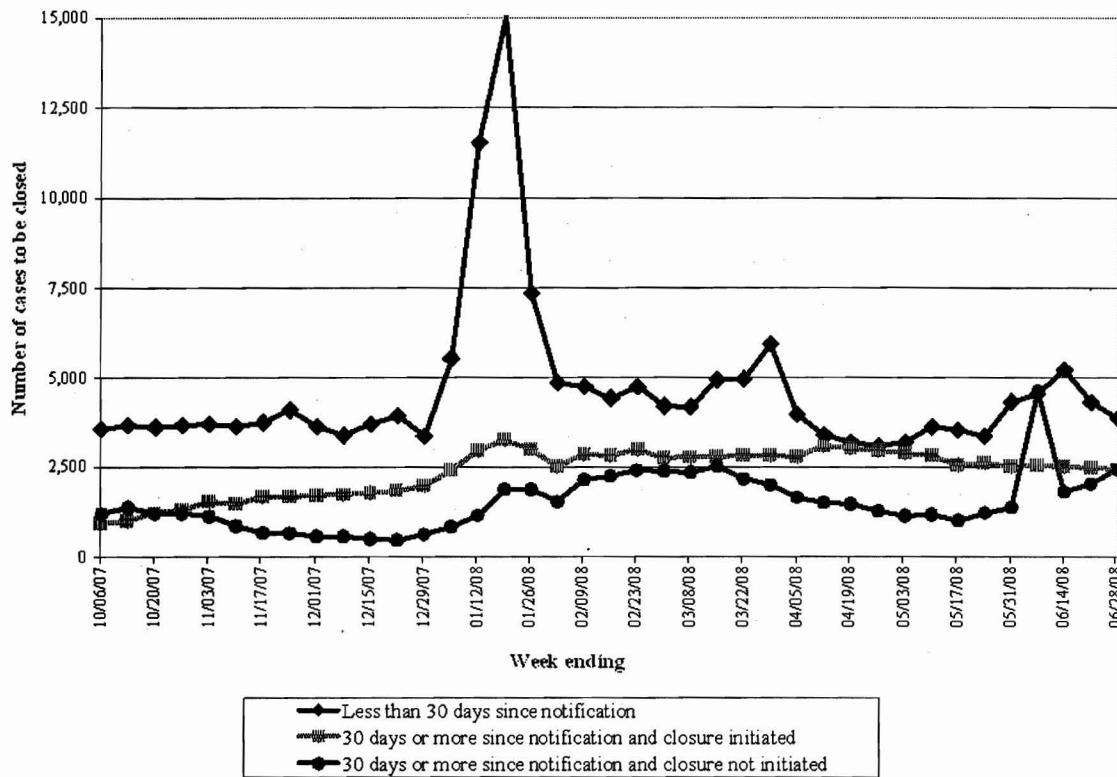
<sup>18</sup> *Bankruptcy Closing Actions Do Not Always Protect the Federal Government's Interests and Taxpayer Rights* (Reference Number 2003-30-083, dated March 2003).

<sup>19</sup> This is the last date the IRS can collect delinquent tax without filing a suit for judgment; it is usually 10 years from the tax assessment date.



**Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings**

**Figure 2: FY 2008 Inventory for Bankruptcy Court Discharge and Dismissal Notifications**



Source: The Centralized Insolvency Operation function's weekly inventory report titled "AIS-Dish & Dism Inv" as of the week ending June 28, 2008.

The managers of the 10 technical teams we interviewed stated that they have access to a weekly listing called the "30-Day Court Closure Follow up" that identifies all cases over 30 calendar days.<sup>20</sup> (b) (3)(d)

(b) (3)(d) we obtained recent listings from 8 of the 10 team managers and were able to confirm their reviews by inspecting notations made on the reports. We found this practice consistent with IRM guidelines, which instruct team managers to check work at random for quality and timeliness. However, we were unable to evaluate the frequency, consistency, or the effectiveness of these reviews because the weekly listings containing the notations are not retained beyond 2 months.

<sup>20</sup> There is one listing for Chapter 7 "no asset" cases and one listing for Chapter 13 cases assigned to the Centralized Insolvency Operation function.



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## *Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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The primary control mechanism that holds team managers accountable for conducting and documenting reviews over the work of the employees they supervise is the operational reviews of second-level managers. According to the IRM, second-level managers are required to perform an operational review of each subordinate manager at least once each year to assess work process improvement opportunities as well as to identify procedural or systemic problems that need to be addressed. Over a 2-year period, all operational reviews by department managers were not completed. Moreover, we found limited documentation in some reviews on how effectively bankruptcy closure reports, or other management reports, generated from IRS automated systems were used to ensure the quality and timeliness of bankruptcy closing actions.

### ***Recommendations***

The Operation Manager, Centralized Insolvency Operation, should:

**Recommendation 1:** Develop and implement procedures for the identification and correction of potential lien stay violations when establishing bankruptcy cases on the AIS.

**Management's Response:** IRS management agreed with this recommendation and has taken the following actions:

- On November 20, 2008, the Centralized Insolvency Operation function requested an Integrated Data Retrieval System<sup>21</sup> utility run to identify cases with open bankruptcy freezes and liens filed after the bankruptcy petition date. The Centralized Insolvency Operation function will review listing to determine if any violations occurred and, if so, take immediate correction action.
- A Work Request has been prepared to have the AIS programmed to generate a Litigation Transcript System report whenever Transaction Code 582 (lien indicator) posts after Transaction Code 520 (bankruptcy indicator).

**Recommendation 2:** Improve the Centralized Insolvency Operation function Weekly Inventory Reports (Open and Closed) to include aging information on taxpayer accounts.

**Management's Response:** IRS management agreed with this recommendation. The Weekly Inventory Reports will be modified to include the received date of the oldest dismissal/discharge. A report has been developed to identify all cases in which a dismissal or discharge has been received and the case remains open more than 7 days. Technical teams are required to print and work the report weekly.

**Recommendation 3:** Enhance efforts to resolve freeze codes that do not post in a timely manner to accounts by ensuring that managers consistently work PIT reports.

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<sup>21</sup> IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.





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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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**Management's Response:** IRS management agreed with this recommendation. Management has developed procedures for working the PIT reports, and department and team managers are reviewing completed PIT reports to ensure that actions are accurate and taken in a timely manner.

**Recommendation 4:** Evaluate the frequency, consistency, and effectiveness of team manager reviews over the quality and timeliness of bankruptcy closing actions in future operational reviews.

**Management's Response:** IRS management agreed with this recommendation. The Centralized Insolvency Operation function is utilizing the "Dismissed/Discharged" report that identifies all cases where the IRS has received a notice of dismissal or discharge that is more than 7 days old and closing action has not been taken. Technical teams are required to print and work the report weekly. During operational reviews, department managers will verify that team managers are reviewing the "Dismissed/Discharged" report. Management has also developed a process for matching closed records from the Court's automated system (PACER) against open AIS cases. The PACER match will be used to identify closed cases in which the IRS did not receive a notice of dismissal or discharge.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall audit objective was to evaluate the controls used in the IRS Centralized Insolvency Operation function to ensure that taxpayers' rights and the Government's interest are protected during bankruptcy proceedings. To accomplish this objective, we:

- I. Determined whether controls were adequate to ensure that the Centralized Insolvency Operation function properly inputs new bankruptcy cases on the AIS<sup>1</sup> and bankruptcy freeze codes were established on tax accounts in a timely manner.
  - A. Interviewed management and researched the IRM to determine Centralized Insolvency Operation function procedures for receiving bankruptcy notification, processing new cases on the AIS, and establishing bankruptcy freeze codes on tax accounts.
  - B. Reviewed the Centralized Insolvency Operation function's Weekly Open Inventory Reports for the period October 1, 2005, through August 31, 2008, to determine whether bankruptcy freeze codes were established in a timely manner.
- II. Determined whether controls were adequate to ensure that the Centralized Insolvency Operation function assists in identifying, preventing, and correcting potential Bankruptcy Code automatic stay<sup>2</sup> provision violations.
  - A. Interviewed management and researched the IRM to determine Centralized Insolvency Operation function procedures for identifying, preventing, and correcting potential stay provision violations.
  - B. Obtained and analyzed computer extracted individual and business taxpayer account information from the Master File<sup>3</sup> to identify tax liens<sup>4</sup> filed after the bankruptcy

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<sup>1</sup> This computer system is used by the Centralized Insolvency Operation function and Insolvency field offices nationwide to monitor and update the progression of bankruptcy cases.

<sup>2</sup> An automatic stay is a provision under the United States Bankruptcy Code prohibiting creditors from beginning or continuing proceedings for collecting owed amounts from individuals who filed for bankruptcy.

<sup>3</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>4</sup> A claim on a taxpayer's assets for the amount of unpaid tax.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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petition date.<sup>5</sup> The analysis was limited to tax liens filed between October 2005 and December 2007, and the taxpayer was still in bankruptcy as of December 2007.<sup>6</sup>

- C. Using information from Step II.B., reviewed a statistical sample of 50 individual and 50 business taxpayers with tax liens filed after the bankruptcy petition dates to determine whether the automatic stay provision was violated.<sup>7</sup> We researched the AIS, the Integrated Data Retrieval System,<sup>8</sup> and the Automated Lien System.<sup>9</sup> We also discussed and confirmed the exception cases with IRS officials for possible causes and effects of tax liens filed in violation of the automatic stay provision. In addition, we estimated the number of potential stay provision violations.<sup>10</sup>

III. Determined whether controls were adequate to ensure that the Centralized Insolvency Operation function properly processed trustee payments.

- A. Interviewed management, obtained statistical information, and researched the IRM to determine Centralized Insolvency Operation function procedures for processing trustee payments.
- B. Reviewed two judgmental samples<sup>11</sup> of trustee payments to determine whether the payments were posted to tax accounts accurately and in a timely manner. The first sample was 102 trustee payments received during the period January 2006 through September 2006. The second sample was 25 trustee payments received during February 2008. We discussed processing questions and case results with Centralized Insolvency Operation function officials.

IV. Determined whether controls were adequate to ensure that the Centralized Insolvency Operation function properly closed bankruptcy cases on the AIS and bankruptcy freeze codes were released on tax accounts in a timely manner.

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<sup>5</sup> The date the bankruptcy document, also known as a petition, is filed with the Bankruptcy Court to initiate a bankruptcy proceeding.

<sup>6</sup> Data validation included ensuring appropriate information was included in each field, the time period met our requirements, and extracted data were compared to source data. We determined the computer extract was sufficiently reliable for our use.

<sup>7</sup> The sample was randomly selected from a population of 1,381 individual and 617 business taxpayers.

<sup>8</sup> The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

<sup>9</sup> The IRS computer system that stores information for liens recorded, released, and withdrawn.

<sup>10</sup> Estimated calculation based on a 95 percent confidence level, a stratified error rate of 24.79 percent, and a stratified sample precision of  $\pm 8.35$  percent. See Appendix IV for additional details.

<sup>11</sup> Judgmental sampling techniques were used to conserve time and resources due to difficulties with independently determining the population and variance of the number of taxpayers within trustee payments. Trustee payment vouchers are temporarily stored according to the 34 segregated Bankruptcy Court areas, and trustees may submit 1 payment per taxpayer or 1 bulk payment for multiple taxpayers.



*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

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- A. Interviewed management, obtained inventory reports, and researched the IRM to determine Centralized Insolvency Operation function procedures for bankruptcy notification and case processing to close cases on the AIS and to release freeze codes on tax accounts.
- B. Contacted Centralized Insolvency Operation function closing groups to determine the method used to identify and initiate closing actions for cases 30 calendar days or more past the date the IRS was notified by the Bankruptcy Court.
- C. Obtained the operational reviews conducted by Centralized Insolvency Operation function department managers to determine whether the quality and timeliness of bankruptcy closing actions were included in the reviews.



*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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**Appendix II**

*Major Contributors to This Report*

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)

Frank Dunleavy, Director

Lisa M. Stoy, Audit Manager

Aaron R. Foote, Senior Auditor

Alan D. Lund, Senior Auditor

Erlinda K. Foye, Auditor



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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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, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS  
Director, Collection, Small Business/Self-Employed Division SE:S:C  
Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division  
SE:S:CLD  
Director, Advisory, Insolvency and Quality, Small Business/Self-Employed Division  
SE:S:C:AIQ  
Director, Collection Policy, Small Business/Self-Employed Division SE:S:C:CP  
Director, Campus Compliance Operations, Philadelphia, Small Business/Self-Employed Division  
SE:S:CCS:CCO:PHL  
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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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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## Appendix IV

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Taxpayer Rights and Entitlements – Potential; 495 taxpayers for whom the IRS did not comply with the automatic stay<sup>1</sup> provision by filing tax liens<sup>2</sup> after the bankruptcy petition date<sup>3</sup> (see page 5).

#### **Methodology Used to Measure the Reported Benefit:**

We computer analyzed Master File<sup>4</sup> tax accounts to identify 1,381 individual and 617 business taxpayers with active tax liens filed October 2005 through December 2007, and after the bankruptcy petition date of an active bankruptcy. To determine if automatic stay provision violations involving tax liens occurred, we selected a statistical sample of 50 individual and 50 business taxpayers and manually reviewed the AIS, the Integrated Data Retrieval System,<sup>5</sup> and the Automated Lien System.<sup>6</sup> This stratified sample determined that 9 individual and 20 business taxpayers had tax liens filed by the IRS in violation of the automatic stay provision. These cases were discussed with IRS representatives, who agreed with our conclusions and had the tax liens withdrawn. Our estimate of 495 potential taxpayer rights violations is based on the statistical information below.

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<sup>1</sup> An automatic stay is a provision under the United States Bankruptcy Code prohibiting creditors from beginning or continuing proceedings for collecting owed amounts from individuals who filed for bankruptcy.

<sup>2</sup> A claim on a taxpayer's assets for the amount of unpaid tax.

<sup>3</sup> The date the bankruptcy document, also known as a petition, is filed with the Bankruptcy Court to initiate a bankruptcy proceeding.

<sup>4</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>5</sup> The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

<sup>6</sup> The IRS computer system that stores information for liens recorded, released, and withdrawn.



*Additional Actions Are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings*

| <b>Stratified Attribute<br/>Statistical Information</b>                            | <b>Stratum 1<br/>Individual<br/>Taxpayers</b> | <b>Stratum 2<br/>Business<br/>Taxpayers</b> | <b>Total<br/>Taxpayers</b> |
|--|---|---|----------------------------|
| Population   | 1,381   | 617   | 1,998                      |
| Population Percentage  | 69.12%  | 30.88%                                      | 100.00%                    |
| Sample Cases Reviewed  | 50  | 50  | 100                        |
| Sample Cases with Exception  | 9   | 20  | 29                         |
| Exception Rate   | 18.00%  | 40.00%                                      | 24.79%                     |
| Point Estimate   | 248.58  | 246.80                                      | 495.38                     |
| <b>Determining Lower and Upper Limit Estimates for 95 Percent Confidence Level</b> |   |   |                            |
| Stratum Finite Population Correction Factor  | 0.96379                                       | 0.91896                                     | not applicable             |
| Sample Variance  | 0.00301                                       | 0.00490                                     | not applicable             |
| Stratum Variance   | 0.00290                                       | 0.00450                                     | not applicable             |
| Total Variance   | not applicable                                | not applicable                              | 0.0018                     |
| Standard Deviation   | 5.39%   | 6.71%                                       | 4.26%                      |
| Precision for 95 Percent Confidence Level  | 10.56%  | 13.15%                                      | 8.35%                      |
| Lower Limit Estimate (rounded)   | 103   | 166   | 328                        |
| Upper Limit Estimate (rounded)   | 394   | 328   | 662                        |





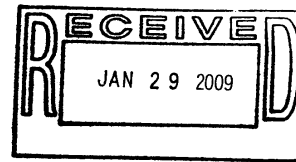
*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

**Appendix V**

*Management's Response to the Draft Report*



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



1/28/2009

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Additional Actions are Needed to  
Protect Taxpayers' Rights and the Government's Interest  
During Bankruptcy Proceedings (Audit No. 200630025)

Thank you for the opportunity to review your draft report titled, "Additional Actions are Needed to Protect Taxpayers' Rights and the Government's Interest During Bankruptcy Proceedings." We are pleased the report acknowledges our focus on developing and implementing procedures to improve bankruptcy case management practices, specifically in the area of processing bankruptcy payments. The report noted that payments were timely input and accurately reflected in tax accounts within Master File. Headquarters continues to work with the Centralized Insolvency Operation to automate and improve processes.

We agree with the findings and recommendations contained in the report as they pertain to the timeframe of the review – February 2006 through September 2008. Centralized Insolvency Operations (CIO) stood up October 1, 2005, and was immediately inundated with bankruptcy cases due to passage of "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005." CIO was unable to process all cases timely during this time of influx. Since standup, significant improvements have been made to streamline processes and automate certain tasks.

If you have any questions, please call me at (202) 622-0600 or Jeffrey Basalla, Acting Director, Campus Compliance Services, Small Business/Self-Employed Division, at (202) 283-7399.

Attachment



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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**Attachment**

**RECOMMENDATION 1:**

The Operation Manager, Centralized Insolvency Operation should develop and implement procedures for the identification and correction of potential lien stay violations when establishing bankruptcy cases on the AIS.

**CORRECTIVE ACTION:**

1. On November 20, 2008, the Centralized Insolvency Operation (CIO) requested an Integrated Data Retrieval System (IDRS) utility run to identify cases with open bankruptcy freezes and liens filed after the bankruptcy petition date. CIO will review listing to determine if any violations occurred and if so, take immediate corrective action.
2. A Work Request has been prepared to have the Automated Insolvency System (AIS) programmed to generate a Litigation Transcript System (LTS) report whenever Transaction Code (TC) 582 (lien indicator) posts after TC 520 (bankruptcy indicator).

**IMPLEMENTATION DATE:**

1. By March 15, 2009, CIO will complete the review of the listing
2. New LTS report will be available April 15, 2009

**RESPONSIBLE OFFICIAL(S):**

Director, Philadelphia Campus Compliance Operation

**CORRECTIVE ACTION MONITORING PLAN:**

The SB/SE Director, Campus Compliance Services, will monitor the corrective actions as part of our internal management control system.

**RECOMMENDATION 2:**

The Operation Manager, Centralized Insolvency Operation should improve the Centralized Insolvency Operation function's Weekly Inventory reports (Open and Closures) to include aging information on taxpayer accounts.

**CORRECTIVE ACTION:**

1. The weekly inventory reports will be modified to include the received date of the oldest dismissal/discharge.
2. A report has been developed to identify all cases in which a dismissal or discharge has been received, the case remains open and is more than seven days old. Technical teams are required to print and work the report weekly.

**IMPLEMENTATION DATE:**

1. February 15, 2009
2. Completed December 9, 2008



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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2

**RESPONSIBLE OFFICIAL(S):**

Director, Philadelphia Campus Compliance Operation

**CORRECTIVE ACTION MONITORING PLAN:**

The SB/SE Director, Campus Compliance Services, will monitor the corrective actions as part of our internal management control system.

**RECOMMENDATION 3:**

The Operation Manager, Centralized Insolvency Operation should enhance efforts to resolve freeze codes that do not post in a timely manner to accounts by ensuring that managers consistently work PIT reports.

**CORRECTIVE ACTION:**

1. HQ has developed procedures for working the Potentially Invalid TIN (PIT) reports.
2. Department and Team Managers are reviewing completed PIT reports to ensure accurate and timely actions are taken.

**IMPLEMENTATION DATE:**

1. Completed December 9, 2008
2. Completed December 9, 2008

**RESPONSIBLE OFFICIAL(S):**

Director, Philadelphia Campus Compliance Operation

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 4:**

The Operation Manager, Centralized Insolvency Operation should evaluate the frequency, consistency, and effectiveness of team manager reviews over the quality and timeliness of bankruptcy closing actions in future operational reviews.

**CORRECTIVE ACTION:**

1. Centralized Insolvency Operation (CIO) is utilizing the "Dismissed/Discharged" report that identifies all cases where the Service has received a notice of dismissal or discharge over seven days ago and closing action has not been taken. Technical teams are required to print and work the report weekly.
2. During Operational reviews, Department Managers will verify that Team Managers are reviewing the "Dismissed/Discharged" Report.



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*Additional Actions Are Needed to Protect Taxpayers' Rights and  
the Government's Interest During Bankruptcy Proceedings*

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3

3. Headquarters has developed a process for matching closed records from the bankruptcy court's automated system (PACER) against open Automated Insolvency System (AIS) cases. The PACER match will be used to identify closed cases in which the Service did not receive a Notice of Dismissal or Discharge.

**IMPLEMENTATION DATE:**

1. Completed December 9, 2008
2. Completed October 1, 2008
3. Completed October 1, 2008

**RESPONSIBLE OFFICIAL(S):**

Director, Philadelphia Campus Compliance Operation

**CORRECTIVE ACTION MONITORING PLAN:**

N/A