



*The Internal Revenue Service Needs to
Emphasize Limited Use of a Collection
Suspension Code That Can Allow
Inappropriate Refunds*

February 26, 2008

Reference Number: 2008-30-060

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:

1 = Tax Return/Return Information

2(e) = Law Enforcement Procedure(s)

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

Phone Number | 202-622-6500

Email Address | inquiries@tigta.treas.gov

Web Site | <http://www.tigta.gov>



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 26, 2008

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to
Emphasize Limited Use of a Collection Suspension Code That Can
Allow Inappropriate Refunds (Audit # 200630035)

This report presents the results of our review of the Internal Revenue Service's (IRS) use of a collection suspension code that can allow inappropriate refunds.

[Redacted] 1,3(d)

The overall objective of this review was to determine the extent and effect of this potential internal control weakness.

Impact on the Taxpayer

Issuing refunds to taxpayers who still owe taxes for other tax years ultimately delays the collection of the taxes owed. As accounts in the IRS inventory of accounts receivable get older, the likelihood of them being collected decreases, and the nation's tax gap increases.¹

Synopsis

The IRS' inventory of accounts receivable can include a significant number of taxpayer accounts in which specific tax years are suspended from active collection activity for many different reasons. For example, active collection action may be suspended if a taxpayer files a claim to adjust his or her taxes and/or locate payments on a balance-due account. Generally, when this

¹ Defined as the difference between what is paid in taxes and what should be paid according to the tax laws.



***The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds***

occurs, specific transaction codes² (suspension codes) are used to temporarily suspend collection activity while the IRS conducts research and takes necessary actions. Although active collection action is suspended, credits from a taxpayer's other tax years are generally not refunded but are used to offset all or part of what the taxpayer owes in the suspended tax year.



While the problem does not appear to be widespread, we believe the specific collection suspension code^{3(d)} is not always used correctly, which has resulted in refunds being sent to other taxpayers when they still owed taxes for other tax years. Although we did not identify many instances of refunds being released because of use of this suspension code, there is the potential for more refunds.

Recommendation

We recommended the Commissioner, Small Business/Self-Employed Division, reemphasize the importance of selecting the proper collection suspension code and add to the Internal Revenue Manual cautions that advise employees of the potential for issuance of inappropriate refunds when^{2(e)} is used.

Response

IRS management agreed with the recommendation. The Director, Campus Compliance Services, Small Business/Self-Employed Division, will issue a Servicewide Electronic Research Program alert to campus⁴ personnel reemphasizing the importance of selecting the appropriate collection suspension code. The Director, Collection, Small Business/Self-Employed Division, and the

² These codes are used to identify transactions being processed and to maintain a history of actions posted to taxpayers' accounts.

³ 2(e), 3(d)

⁴ 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.



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Director, Examination, Small Business/Self-Employed Division, will issue a memorandum to field personnel to reemphasize this issue. The Director, Campus Compliance Services, the Director, Collection, and the Director, Examination, will review and revise the Internal Revenue Manual to advise employees of the potential for issuance of inappropriate refunds when the incorrect transaction and closing codes are used. 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 recommendation. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Table of Contents

Background	Page 1
Results of Review	Page 2
Use of a Transaction Code That Suspends Collection Actions and Prevents Offsetting Credits to an Account Should Be Limited	Page 2
<u>Recommendation 1</u> :	Page 3
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 5
Appendix II – Major Contributors to This Report	Page 6
Appendix III – Report Distribution List	Page 7
Appendix IV – Management’s Response to the Draft Report	Page 8



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Abbreviations

IRS

Internal Revenue Service

TIGTA

Treasury Inspector General for Tax Administration



***The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds***

Background

The Internal Revenue Service's (IRS) inventory of accounts receivable can include a significant number of taxpayer accounts in which specific tax years are suspended from active collection activity for many different reasons. For example, active collection action may be suspended if a taxpayer files a claim to adjust his or her taxes and/or locate payments on a balance-due account. Generally, when this occurs, specific transaction codes¹ (suspension codes) are used to temporarily suspend collection activity while the IRS conducts research and takes necessary actions. Although active collection action is suspended, credits from a taxpayer's other tax years are generally not refunded but are used to offset all or part of what the taxpayer owes in the suspended tax year.



As a result, we initiated this audit to determine the extent of the potential problem with use of this collection transaction code. Our review was performed at the IRS office in Holtsville, New York, during the period February through September 2007 and included analyses of taxpayer accounts nationwide. We discussed policy and procedures with IRS personnel from the Small Business/Self-Employed Division Compliance and Collection functions at the Compliance Center in Holtsville, New York. We conducted this performance audit in accordance with generally accepted government auditing 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.

¹ These codes are used to identify transactions being processed and to maintain a history of actions posted to taxpayers' accounts.





***The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds***

Results of Review

Use of a Transaction Code That Suspends Collection Actions and Prevents Offsetting Credits to an Account Should Be Limited

While the problem does not appear to be widespread, we believe the specific collection suspension code ^{1.3(d)} is not always used correctly, which has resulted in refunds being sent to other taxpayers when they still owed taxes for other tax years. While the instances of refunds sent to taxpayers were few, there is the potential for more refunds to be sent to taxpayers who still owe taxes.

As previously mentioned, when the IRS processes a taxpayer claim to adjust taxes and/or locate payments on a balance-due account, specific transaction codes (suspension codes) are generally used to temporarily suspend collection activity while the IRS conducts research and takes necessary actions. Although active collection action is suspended, credits from a taxpayer's other tax years are generally allowed to offset all or part of what the taxpayer owes in the suspended tax year.

For this specific collection suspension code, however, credits are not allowed to offset what the taxpayer owes in the suspended tax year. This code is supposed to be used only when it is expected that an adjustment is necessary that will fully pay the tax for the suspended tax year. For example, if an IRS tax collector discovers an obvious error created a balance-due condition in one tax year, and an adjustment will reduce the balance due to zero, the tax collector can request the necessary tax adjustment and also request this collection suspension code be entered for the specific tax year. This will ensure collection action is suspended while the adjustment is made and overpayments for other tax years will not be used to pay the questioned tax.

If, however, the suspension code is used incorrectly when adjustments may not be appropriate or when an adjustment does not eliminate the balance due, credits from a taxpayer's other tax years will refund rather than be used to pay the amount still owed for the suspended tax period.

Our research of IRS data showed 3,930 taxpayer accounts with balances due contained this code, and the taxpayers owed a total of \$96.2 million. We reviewed a statistically valid sample of 187 of these taxpayer accounts. Because the collection suspension code can be applied more than once to more than 1 tax year, the sample contained 232 uses of the code on the 187 taxpayer accounts.



**The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds**

The suspension code was used inappropriately in 69 of the 232 suspension code transactions.³ For 31 (45 percent) of the 69 cases, we could find no evidence of any adjustment activity up to the time of our review. The periods of apparent adjustment inactivity averaged 32 weeks. The other 38 of 69 cases contained a variety of indicators that the suspension code was not warranted, such as taxpayer requests for installment agreements and/or offers in compromise.⁴

In an additional 137 cases, we determined that use of the suspension code was questionable. Although the suspension code should be used only when it is expected that an adjustment will resolve the entire liability for a particular tax year, we found in these 137 cases the taxpayers still owed a total of about \$470,000 at the time of our review. In our sample, we also found the IRS released 8 refunds totaling \$14,185 to taxpayers who still had unresolved balances due. In each case, the pending claim did not reduce the outstanding liability in the suspended tax year to zero.

IRS employees may not always be aware of the consequences of incorrectly using a ^{2(e)} [redacted] ^{2(e)} [redacted]. Many IRS functions use this Transaction Code in their work; however, except in a few instances, the Internal Revenue Manual does not specify the consequences of using the code. Because this collection suspension code can prevent a taxpayer's credits from paying liabilities, more cautions are needed to ensure it is used only when necessary.

Although we did not find many instances of refunds being released because this suspension code was used, there is the potential for more refunds. ^{1,3(d)} [redacted]

Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, should reemphasize the importance of selecting the proper collection suspension code and add to the Internal Revenue Manual cautions that advise employees, who either enter the code or request entry of the code, of the potential for issuance of inappropriate refunds when ^{2(e)} [redacted] ^{2(e)} [redacted] is used.

Management's Response: IRS management agreed with this recommendation. The Director, Campus Compliance Services, Small Business/Self-Employed Division, will

³ We based our determinations on the information contained in tax records on the IRS' databases.

⁴ This is an agreement between a taxpayer and the Federal Government that settles a tax liability for payment of less than the full amount owed.



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

issue a Servicewide Electronic Research Program alert to reemphasize the importance of selecting the appropriate collection suspension code. The Director, Collection, Small Business/Self-Employed Division, and the Director, Examination, Small Business/Self-Employed Division, will issue a memorandum to field personnel to reemphasize this issue. In addition, the Director, Campus Compliance Services, the Director, Collection, and the Director, Examination, will review and revise the Internal Revenue Manual to advise employees of the potential for issuance of inappropriate refunds when the incorrect transaction and closing codes are used.



**The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds**

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this audit was to determine the extent and effect of a potential internal control weakness^{1,3(d)} [redacted] To accomplish our objective, we:

- I. Determined the extent and effect of the control weakness involving use of [redacted]^{2(e)} [redacted] which denotes a taxpayer who has a pending adjustment that will fully pay the tax year balance.
 - A. Extracted all Individual Master File¹ taxpayer accounts with balances due for Tax Years 2002 through 2005 using the files in the TIGTA Data Center Warehouse.² We then extracted those with a balance due in excess of \$1,000³ and a [redacted]^{2(e)} [redacted] on the account. We identified 3,930 taxpayer accounts.
 - B. Selected a statistically valid sample of 187 of the taxpayer accounts identified in Step I.A. These 187 taxpayer accounts included 232 specific tax years containing a [redacted]^{2(e)} [redacted] Our sample was based on a 95 percent confidence level, a projected 50 percent error rate, and a precision of +/- 7 percent.
 - C. Reviewed the taxpayer accounts to determine whether use of these Codes together appeared justified, based on any adjustment or other activity in the accounts. We determined whether any refunds were issued inappropriately during the time the accounts were suspended.
 1. Researched the Integrated Data Retrieval System⁴ and requested returns, if appropriate, to determine the extent of the internal control weakness. We determined the causes for the problem identified.
 2. Determined, where possible, the amount of taxes due that should have been available for collection activity but remained in suspended status. We also determined any other effects of the problem cases and the impact or potential impact of the internal control weakness identified.

¹ The IRS database that maintains transactions or records of individual tax accounts.

² The TIGTA Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.

³ This is not an IRS tolerance level. The dollar amount was chosen for this audit because it is a significant amount.

⁴ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Appendix II

Major Contributors to This Report

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

Kyle R. Andersen, Director

Robert K. Irish, Audit Manager

Bernard F. Kelly, Audit Manager

Carol Gerkens, Lead Auditor

John J. Chiappino, Senior Auditor

Margaret F. Filippelli, Senior Auditor



*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
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, Examination, Small Business/Self-Employed Division SE:S:E
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 Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W



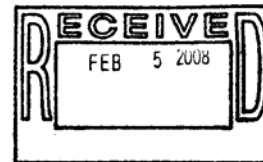
*The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds*

Appendix IV

Management's Response to the Draft Report



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



January 29, 2008

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – "The Internal Revenue Service Needs to
Emphasize Limited Use of a Collection Suspension Code That
Can Allow Inappropriate Refunds" (Audit #200630035)

We have reviewed the above referenced draft report, and appreciate your acknowledgement that there does not appear to be a widespread problem of refunds being sent to taxpayers when they still owe taxes on other years. Nonetheless, we do acknowledge in those instances when the incorrect Transaction and Closing Codes are used we miss an opportunity to offset a taxpayer's credits to pay other liabilities.

We agree with your recommendation to reemphasize the importance of selecting the proper collection suspension code and to add cautions to the Internal Revenue Manual. Attached is a detailed response outlining our corrective actions.

If you have any questions, please contact me or Fred Schindler, Director, Collection Policy, Small Business/Self-Employed Division, at (202) 283-7650.

Attachment



***The Internal Revenue Service Needs to Emphasize
Limited Use of a Collection Suspension Code That Can Allow
Inappropriate Refunds***

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division, should reemphasize the importance of selecting the proper collection suspension code and add to the Internal Revenue Manual cautions that advise employees, who either enter the code or request entry of the code, of the potential for issuance of inappropriate refunds when 2(e) is used.

CORRECTIVE ACTIONS:

- 1) SB/SE will issue a memorandum to field personnel to reemphasize the importance of selecting the appropriate collection suspension code.
- 2) SB/SE will review and revise the IRM to advise employees of the potential for issuance of inappropriate refunds when the incorrect Transaction and Closing Codes are used.
- 3) A Servicewide Electronic Research Program (SERP) alert will be issued to reemphasize the importance of selecting the appropriate collection suspension code.

IMPLEMENTATION DATES:

- 1) SB/SE memorandum: April 15, 2008
- 2) SB/SE IRM review for appropriate updates: June 15, 2008
- 3) SERP alert: April 15, 2008

RESPONSIBLE OFFICIALS:

- 1) SB/SE memorandum:
 - Director, Collection, Small Business/Self-Employed Division, and
 - Director, Examination, Small Business/Self-Employed Division
- 2) SB/SE Internal Revenue Manual review for appropriate updates:
 - Director, Collection, Small Business/Self-Employed Division;
 - Director, Campus Compliance Services, Small Business/Self-Employed Division;
 - Director, Examination, Small Business/Self-Employed Division
- 3) SERP alert:
 - Director, Campus Compliance Services, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

- 1) The Director, Collection, SB/SE, will advise the SB/SE Commissioner of any delays in implementing this corrective action.
- 2) The Directors, Collection, Campus Compliance Services, and Examination, SB/SE, will advise the SB/SE Commissioner of any delays in implementing this corrective action.
- 3) The Director, Campus Compliance Services, SB/SE, will advise the SB/SE Commissioner of any delays in implementing this corrective action.