While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements

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DEPARTMENT OF THE TREASURY
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INSPECTOR GENERAL
for TAX
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MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements (Audit # 200230041)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has effective processes for achieving timely intervention when an underpayment or nonpayment of income taxes, Federal Tax Deposits[1] (FTD), and/or estimated taxes[2] is identified. Early intervention is critical for the IRS, as the nation's tax collection agency, because collection theory holds that the earlier a debtor is contacted for payment, the greater the likelihood that all or some of the debt will be paid. Early intervention to encourage and assist taxpayers to more promptly resolve their tax liabilities was one of the goals of the former IRS Commissioner,[3] as he tried to address the amount of outstanding tax liabilities that had grown to $287 billion as of December 2002.

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[1] Employers are required to regularly deposit the income taxes withheld from their employees' earnings, as well as the employer and employee share of Social Security and Medicare taxes, with a financial institution that is an authorized depositary for Federal taxes. A business' deposit schedule for a calendar year is determined annually from the total taxes reported on Employer's Quarterly Federal Tax Returns (Form 941) in a 4-quarter lookback period beginning on July 1 from 2 years earlier and ending on June 30 of the prior year.
[2] Estimated tax is the method used to pay taxes on income not subject to withholding. The payments are generally required on a quarterly basis.
[3] Charles O. Rossotti was the IRS Commissioner for a 5-year term that ended November 2002.

In summary, over the course of nearly the past decade, the IRS has taken a number of actions, and is planning still others, to improve its ability to react more quickly to an actual or potential tax debt. The completed actions include shortening the collection notices cycle, implementing predictive dialing technology for making outbound telephone calls on tax delinquencies, and completing a major reorganization to align with the IRS' major customer segments. Other actions in progress include migrating toward a risk-based approach to collecting delinquent taxes and modifying the FTD Alert[4] criteria to focus on fewer, better-targeted taxpayer contacts.

For two reasons, however, it is difficult, if not impossible, to assess the cumulative effect that these actions have had on the IRS' Collection operations. The first reason is the decrease in Collection function staffing. The Full-Time Equivalents (FTE)[5] allocated to Collection function operations declined from 12,950 in Fiscal Year (FY) 1997 to 11,349 in FY 2002. Second, collection enforcement activities were significantly affected by the enactment of the IRS Restructuring and Reform Act of 1998 (RRA 98).[6] Between FYs 1997 and 1999, for example, the number of liens filed declined from about 544,000 to about 168,000; the number of levies declined from almost 3.7 million to about 500,000; and the number of seizures declined from about 10,000 to only 161. Although enforcement activity was increasing by FY 2002, only the number of liens filed was approaching the pre-RRA 98 levels.

Estimated tax is the method used by individual taxpayers to pay taxes on nonwage income on a quarterly basis. About 12 million taxpayers made estimated tax payments totaling $183 billion for Tax Year (TY) 2001. However, there is significant taxpayer noncompliance with estimated tax requirements. For each tax year from 1995 through 2000, between 5.7 million and 6.8 million individual taxpayers were assessed penalties for making insufficient or late estimated tax payments. Many of these taxpayers also filed tax returns reporting unpaid taxes that resulted in the IRS having to take costly collection actions.

Five factors contribute to this noncompliance. First, the tax law does not require tax withholding on nonwage sources of income. Second, the quarterly due dates prescribed by law for making estimated tax payments do not consistently coincide with the calendar quarters and are irregularly spaced from 61 to 122 days apart. Third, the estimated tax penalty rate, which is currently only 4 percent, may not sufficiently deter payment noncompliance. Fourth, the IRS has no early intervention programs to identify taxpayers that stop making estimated tax payments or that make insufficient or untimely payments. Finally, the IRS has experienced little success (i.e., only about 1 in 200 taxpayers) in encouraging the use of electronic payment options for making estimated tax payments. Without proactive efforts by the IRS, the noncompliance with

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[4] The FTD Alert Program is an existing early intervention process which identifies taxpayers that appear to be behind in their deposits of trust fund taxes before their quarterly employment tax returns are due to be filed.
[5] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For Fiscal Year 2002, 1 FTE was equal to 2,088 staff hours.
[6] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

estimated taxes can be expected to worsen in the years to come, since the amount of income from nonwage sources of income is growing significantly faster than that from wages.

As a long-term solution to the estimated tax payment noncompliance, we recommended the Commissioners of the Large and Mid-Size Business (LMSB), Small Business/ Self-Employed (SB/SE), and Wage and Investment (W&I) Divisions explore developing a system of mandatory withholding of income taxes from nonemployee compensation paid to independent contractors by certain types of businesses for possible inclusion in a legislative proposal to the Department of the Treasury. We also recommended legislative proposals to require estimated tax payments to be made on a monthly basis and to change the manner in which the estimated tax penalty rate is determined to ensure it serves as a more effective deterrent to noncompliance with estimated tax payment requirements.

For the near term, we recommended the Directors, Compliance, SB/SE and W&I Divisions, and the Director, Customer Assistance, Relationships, and Education, W&I Division, develop an estimated tax payment reminder notice that can be sent at midyear to those taxpayers that were assessed estimated tax penalties in the prior tax year and had made no estimated tax payments for the first 6 months of the current tax year or that had made substantially smaller or untimely payments during the first 6 months. We also recommended the Director, Taxpayer Education and Communication, SB/SE Division, improve the promotion of electronic tax payments by including the enrollment form for the Electronic Federal Tax Payment System (EFTPS) in the estimated tax packages mailed to taxpayers, expanding the brief explanation of the EFTPS in *Tax Withholding and Estimated Tax* (Publication 505), and amending those IRS instructions and publications applicable to estimated tax payments that do not sufficiently emphasize that the EFTPS is offered to taxpayers as a free service by the Department of the Treasury.

Management's Response: The Commissioner, SB/SE Division, provided a detailed response to our draft report, advising that the Director, Field Specialists, LMSB Division, had agreed to explore the feasibility of developing a system of mandatory withholding of income taxes from nonemployee compensation paid to independent contractors in large and mid-size businesses. The Director, Field Specialists, will explore this action in coordination with program managers in the SB/SE and W&I Divisions and the LMSB Division Counsel. If developing a system of mandatory withholding is feasible, the Director, Field Specialists, will draft and coordinate a legislative proposal with the Office of Legislative Affairs for consideration by the Department of the Treasury.

The Commissioner, SB/SE Division, agreed with our recommendation to consider improving the promotion of the electronic tax payments. An E-Submissions Messaging Team is currently reviewing IRS products to ensure EFTPS benefits are specifically detailed and highlighted as a "free" service offered by the Department of the Treasury. This group will continue to review new ways to enhance Estimated Tax for Individuals (Form 1040-ES) taxpayer compliance, including a proposal to add a coded enrollment form for the EFTPS in the U.S. Individual Income Tax Return (Form 1040) tax package to track the number of enrollments submitted through the paper enrollment process.

The Commissioner, SB/SE Division, disagreed with our recommendation to submit a legislative proposal requiring monthly estimated tax payments on the 15^{th} day of each month. The Commissioner stated that, although there may be some benefit to establishing regular quarterly time periods for individual estimated tax payments, monthly estimated tax payments would increase burden and complexity for both compliant and noncompliant taxpayers. The Commissioner added that increasing the number of payments would increase both the complexity of Underpayment of Estimated Tax by Individuals, Estates, and Trusts (Form 2210) and the difficulty of computing estimated tax penalties for noncompliant taxpayers.

The Commissioner, SB/SE Division, disagreed with our recommendation to submit a legislative proposal to change the manner in which the estimated tax penalty rate is determined, stating the IRS had developed a legislative proposal concerning the estimated tax penalty in July 2001. The proposal recommended the Congress raise the minimum underpayment amount on which penalties are assessed for failure to make estimated tax payments. It also proposed to change the rate at which the estimated penalty is determined. The proposed changes would apply to tax years beginning after December 31, 2003.

The Commissioner, SB/SE Division, disagreed with our recommendation to develop an estimated tax reminder notice that can be sent at midyear to those taxpayers that were assessed estimated tax penalties in the prior tax year and were falling behind with estimated tax payment requirements. The Commissioner stated the IRS had initiated a project in 2000 to determine whether a “soft letter” would significantly increase FTD payment compliance. Based on the results of that study, the Commissioner believes a reminder notice would have little or no impact on estimated tax payment compliance.

Finally, the Commissioner, SB/SE Division, disagreed with our estimate that penalty and interest could be reduced by $2.1 billion over 5 years if a 25 percent increase in payment compliance was achieved, stating this percentage was not based on any empirical data. The Commissioner also disagreed with our estimate that sending reminder notices to taxpayers assessed estimated tax penalties could reduce collection costs by $12.9 million over 5 years, stating that, based on the results of the FTD “soft letter” study, there would be no collection cost savings. The Commissioner added that our estimate did not reflect the administrative cost related to adding a midyear reminder notice. Management’s complete response to the draft report is included as Appendix V.

Office of Audit Comment: Given the significant increase in nonwage income and the extensive noncompliance with making estimated tax payments, we continue to believe taxpayers could benefit from a system of regularly scheduled monthly payment dates. The fact that nearly one-third of the taxpayers that make estimated tax payments incur penalties strongly suggests the current quarterly payment system, in place since 1943, is not working effectively. Monthly payment intervals are an established and common business practice in the private sector. Most Americans are already used to making monthly payments on their home mortgages, rent, car loans, credit cards, and utilities.

In addition, many homeowners have mortgage escrow accounts set up to have money held to pay property taxes and insurance premiums so they do not have to worry about coming up with several large lump sum payments, each with different due dates, throughout the year. Also, taxpayers that cannot pay the full amount with their individual income tax returns can make arrangements with the IRS to make monthly installment payments. We believe the Commissioner's concern with the taxpayer burden associated with a monthly payment system would be alleviated with the successful promotion of electronic payments. In addition, the IRS instructions for Form 2210 state that taxpayers do not need to file Form 2210 in most cases if an estimated tax penalty is due and that, because the Form is complicated, the IRS strongly encourages the taxpayer to let the IRS figure the penalty. Finally, substantial taxpayer burden would be reduced if the monthly payment system helped taxpayers avoid estimated tax penalties.

We also believe our recommendation to change the manner in which the estimated tax penalty rate is determined has merit to ensure the penalty serves as a more effective deterrent to noncompliance with estimated tax payment requirements. The legislative proposal cited by the Commissioner, SB/SE Division, would raise the minimum underpayment amount on which penalties are assessed for failure to make estimated tax payments and would apply the underpayment rate on a daily basis. While applying the underpayment rate on a daily basis would slightly increase the amount of the penalty, the increase would not be sufficient to serve as an effective deterrent to avoiding estimated tax payments.

We believe the concept of a midyear reminder notice to taxpayers that have stopped making estimated tax payments should, at a minimum, be tested. The Commissioner, SB/SE Division, cited the results of an FTD "soft letter" project as evidence that a reminder notice would have little or no impact on estimated tax payment compliance. However, the IRS' own final report, dated March 2003, on the results of that project recommended "further study about the effectiveness of the 'soft letter' as an early intervention tool to improve filing and payment compliance may be warranted." Further, the FTD "soft letter" was directed to businesses responsible for paying employment taxes. This customer segment differs from individual taxpayers that are responsible for making estimated tax payments on their nonwage income.

While the Commissioner, SB/SE Division, is correct that there are no empirical data to support our assumption that a midyear reminder notice would improve payment compliance by 25 percent, our estimate that penalties and interest could be reduced by $412.7 million per year, or $2.1 billion over 5 years, was based on 285,400 taxpayers becoming payment compliant. These 285,400 taxpayers represented only about 5 percent of the 5.7 million noncompliant taxpayers that incurred estimated tax penalties in TY 1998. Similarly, our estimate of the cost savings that could be realized through a 25 percent improvement in payment compliance was based on avoiding collection action on 204,000 taxpayers. Our estimate of the collection cost savings was reduced by the estimated cost to mail the reminder notices.

While we still believe all of our recommendations are worthwhile, we do not intend to elevate our disagreement concerning these matters to the Department of the Treasury for resolution.

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 Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

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While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements

Background

The Internal Revenue Service (IRS) is the nation's tax collection agency. Its mission is to provide America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Collecting taxes due the Federal Government has always been a challenge for the IRS, but in recent years the challenge has grown. In various testimonies and audit reports, the General Accounting Office (GAO)[1] and Treasury Inspector General for Tax Administration (TIGTA)[2] have highlighted large and pervasive declines in the IRS Compliance and Collection programs. Between Fiscal Years (FY) 1996 and 2001, these programs generally experienced larger workloads, less staffing, and fewer numbers of cases closed per employee. By the end of FY 2001, the IRS was deferring collection action[3] on about one out of every three tax delinquency cases assigned to the Collection program.[4]

As of December 2002, the total amount of outstanding tax liabilities was $287 billion. Approximately $13 billion of this total has been designated as uncollectible due to the IRS' collection and resource priorities, although many of these accounts could be collected if the taxpayers were contacted and offered the opportunity to pay either in full or in installments.

Collection theory holds that the earlier a debtor is contacted for payment, the greater the likelihood that all or some of the debt will be paid. Early intervention to encourage and

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[1] *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers* (GAO-02-674, dated May 2002); and *Major Management Challenges and Program Risks: Department of the Treasury* (GAO-03-109, dated January 2003).
[2] *Trends in Compliance Activities Through Fiscal Year 2002* (Reference Number 2003-30-078, dated March 2003).
[3] Deferring collection action means the delinquent account was closed as currently not collectible although conditions could reopen collection action, such as receipt of information that the taxpayer had additional assets that could help to pay off the tax debt.
[4] GAO-03-109, January 2003.

assist taxpayers to more promptly resolve their tax liabilities was one of the goals of the former IRS Commissioner.[5]

To perform this audit, we interviewed management officials in the Small Business/Self-Employed (SB/SE) Division offices in New Carrollton, Maryland, and Oxon Hill, Maryland; analyzed taxpayer account information; reviewed various IRS reports and studies; and sent questionnaires to nine state governments concerning their tax collection techniques and early intervention practices. The responses received did not reveal any unique practices or techniques that would benefit the IRS operations.

The audit was performed from November 2002 through March 2003 and in accordance with *Government Auditing Standards.* Some of the data used in this report came from various IRS reports. We did not verify the accuracy of the information from those sources. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Numerous Changes Have Been Made to Achieve Earlier Intervention With Delinquent Taxpayers

Historically, delinquent accounts have generally followed the same treatment path at the IRS. The collection process generally began with a series of notices that were sent to taxpayers that did not pay all of their tax liabilities when they filed their tax returns.[6] If the unpaid taxes were not resolved during the notice process, the case was sent to the Automated Collection System (ACS)[7] function where Customer Service Representatives (CSR) initiated and responded to telephone and/or correspondence contacts with the taxpayers and third parties, filed liens, and/or took levy actions to resolve the delinquencies. If the ACS function

[5] Charles O. Rossotti was the IRS Commissioner for a 5-year term that ended November 2002.
[6] The IRS collection process also includes those taxpayers that did not file their tax returns. However, the scope of this audit was limited to those taxpayers that filed returns but did not pay all of their taxes.
[7] The ACS function is a computerized inventory system that maintains certain balance due accounts and return delinquency investigations. It is located at 14 call sites in the SB/SE and Wage and Investment (W&I) Divisions.

was unable to resolve the delinquencies, the cases were moved to the Collection Field function (CFf) where, when resources became available, they were assigned to revenue officers for face-to-face contact with the taxpayers.

Over the course of nearly the past decade, the IRS has taken a number of actions, and is planning still others, to improve its ability to respond more quickly to an actual or potential tax debt. For two reasons, however, it is difficult, if not impossible, to assess the cumulative effect these actions have had on the effectiveness of the IRS Collection operations.

The first reason is the decrease in Collection function staffing. For example, the Full-Time Equivalents (FTE)[8] allocated to the Collection function declined from 12,950 in FY 1997 to 11,349 in FY 2002. Second, collection enforcement activities were significantly affected by the enactment of the IRS Restructuring and Reform Act of 1998 (RRA 98).[9] Between FYs 1997 and 1999, for example, the number of liens filed declined from about 544,000 to about 168,000; the number of levies declined from almost 3.7 million to about 500,000; and the number of seizures declined from about 10,000 to only 161. Although enforcement activity was increasing by FY 2002, only the number of liens filed was approaching the pre-RRA 98 levels.

<u>A formal Early Intervention Program was implemented</u>

In January 1995, the IRS implemented in the ACS function a formal Early Intervention Program that used both a shortened notice process and earlier taxpayer contact. In the Early Intervention Program, the collection process was shortened by eliminating two notices for taxpayers filing individual income tax returns and by eliminating one notice

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[8] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2002, 1 FTE was equal to 2,088 staff hours.
[9] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

for taxpayers filing business returns. At each ACS call site, special teams of CSRs were designated to work the Early Intervention Program inventory. For cases with telephone numbers, the procedures for the Early Intervention Program required that up to four outbound calls be made by the second week.

Later in Calendar Year (CY) 1995, the ACS function resources were reduced and applied to other priority work and, as a result, a *formal* Early Intervention Program no longer exists. However, the IRS has maintained the same shorter notice process that the Early Intervention Program used, and outbound call attempts are still being made on most new cases that have an available telephone number.

Predictive dialing technology was deployed for making outbound telephone calls

The IRS began testing a predictive dialer[10] at its ACS call site in Buffalo, New York, in CY 1996. The IRS' evaluation showed the predictive dialer increased outgoing call productivity and decreased the inventory in the ACS Contact function.[11] In June 1999, the Buffalo site began supporting the outbound call "campaigns"[12] from other ACS call sites. This consolidation was completed in January 2000, and in February 2002, a weekly rotational schedule was implemented that provided for outbound calls to be made for each of the ACS call sites.

[10] A predictive dialer automatically makes outbound calls on a predetermined inventory of accounts without an attending CSR on the originating telephone line. The system retrieves the taxpayer's telephone number from the ACS function database, dials the number, and, when a "live" contact is detected, automatically transfers the call to an available CSR. If there is no answer or if a busy signal is reached, the dialer records that information and reschedules the call. The predictive dialer increases ACS function productivity by more efficiently using the CSRs' time (e.g., removing the need to dial telephone numbers and eliminating the time spent waiting for taxpayers to answer), thereby allowing for more contacts during a work shift.
[11] The ACS Contact function handles taxpayer telephone calls.
[12] A "campaign" is a small, manageable workload group (generally 500 to 1,000 taxpayer accounts) used to prioritize the work (e.g., by dollar value, age of case, type of tax).

The IRS still uses its original predictive dialer system for making outbound calls on new cases coming into the ACS function and for making outbound calls as a last attempt to contact taxpayers prior to issuing a Notice of Levy. A vendor provides telephone number research for cases coming into the ACS function. A recent analysis showed approximately 57 percent of these incoming cases have a telephone number. During FY 2002, the ACS function used the predictive dialer to make 1.3 million outbound call attempts on 1.2 million taxpayer accounts.

The current IRS predictive dialer system is outdated, is no longer supported by the vendor, and is beginning to experience frequent downtime. In a separate audit report,[13] we recommended the IRS (1) pursue additional human capital or reallocate Compliance resources to enable the operation of present and future predictive dialer systems at full capacity, and (2) pursue a budget solution that would allow the IRS to replace the current predictive dialer system with a state-of-the-art system with sufficient capacity.

The IRS completed a major reorganization based on customer segments

The RRA 98 mandated that the IRS do a better job of meeting the needs of its customers. To comply with this Congressional mandate, the IRS revised its mission statement to refocus its emphasis on helping taxpayers understand and meet their tax responsibilities. On October 2, 2000, the IRS also modernized its organizational structure from one that was based on function and geography to one that is aligned with its major customer segments. Four new customer-focused business operating divisions[14] were created with full end-to-end responsibility for serving distinct groups of taxpayers with similar needs.

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[13] *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers* (Reference Number 2003-30-132, dated June 2003).

[14] The IRS' four new operating divisions are the Large and Mid-Size Business Division, the SB/SE Division, the Tax Exempt and Government Entities Division, and the W&I Division.

The new organizational structure is designed to provide more-focused customer service and enhance accessibility to IRS information and personnel that can resolve issues more quickly and consistently within that operating division. The new structure was built around specific taxpayer needs that will enable the IRS to tailor its products, services, and compliance approaches to business practices and strategies. In this way, the IRS can develop a comprehensive and focused approach to tax administration, allocate the necessary resources, and shift to problem prevention and early intervention initiatives.

In October 2001, the SB/SE Division implemented changes to the inventory delivery system to alter the mix of cases assigned to revenue officers. The changes delivered younger, predominately in-business trust fund[15] cases to revenue officers to be worked as the highest priority. The expected benefits of this plan were:

- Higher collectibility than other cases.
- High compliance impact with opportunities to stop the noncompliance since the taxpayers are still in business.
- Significant potential for revenue protection by preventing pyramiding[16] through early intervention.

Through the reorganization, the IRS expects to achieve, over time, improved compliance through faster intervention in collection and through a more effective risk-based approach in all Compliance activities. This approach will allow the IRS to more clearly differentiate between those

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[15] A trust fund tax liability includes income tax withheld from wages, including tips, supplemental unemployment compensation benefits, and third-party payments of sick pay, Social Security, and Medicare taxes. Businesses use the Employer's Quarterly Federal Tax Return (Form 941) to report these trust fund taxes. Employees that have taxes withheld from their wages expect the withheld funds to be properly deposited and credited to their accounts, and employers expect their competitors to pay their trust fund taxes.

[16] Pyramiding is the accumulation of delinquent employment tax liabilities.

taxpayers that are attempting to comply but need assistance and those that potentially require enforcement action (a smaller segment).

The IRS is migrating toward a risk-based approach to collecting delinquent taxes and contracting out the collection of some delinquent taxes

Under this approach, taxpayer characteristics are analyzed to determine the most appropriate treatment rather than having all delinquent accounts follow the same treatment path. While some cases may follow the normal treatment path, others may be accelerated to the ACS function or the CFf.

For example, a Filing and Payment Compliance (F&PC) Model in the Business Systems Modernization effort has a goal to shorten the payment compliance life cycle to 6 months.[17] All balance due cases will receive the statutory first notice. However, cases will not receive a "one size fits all" compliance approach but rather a tailored treatment, as the taxpayer may receive one notice or a series of notices. Outbound calls will also be emphasized.

Although a pilot was planned for April 2004, the Office of Management and Budget has not approved further funding due to budgetary constraints. At the time we completed our review, the project remained on hold.

Another initiative is a legislative proposal to contract with private agencies to assist in the IRS' collection of delinquent taxes. This proposal, which requires the approval of the Congress, would expand the IRS' capacity to collect delinquent taxes by authorizing private tax collection agencies to pursue lower-priority, less-complex, unresolved tax delinquency cases that accumulate in inventory and might not otherwise be addressed because of limited resources. At the time we completed our review, the Congress had not acted on this proposal.

[17] The F&PC Model is part of the IRS' effort to modernize its technology and processes in the filing and payment compliance area.

The FTD Alert criteria are being modified

The Federal Tax Deposit[18] (FTD) Alert Program is an existing early intervention process which identifies taxpayers that appear to be behind in their deposits of trust fund taxes before their quarterly employment tax returns are due to be filed. The FTD Alerts are computer generated on a quarterly basis for those businesses that appear to be making insufficient FTD payments when compared to those made in prior quarters. The FTD Alerts are assigned to revenue officers in the CFf for contact with the business taxpayers.

FTD Alerts can protect the Federal Government's interest by the early identification of potential delinquent employment tax accounts. They also serve the taxpayers' interests by allowing IRS involvement before enforced collection action or bankruptcy become the two remaining alternatives.

During CY 2002, 135,187 FTD Alerts were created. Of these, 45,675 were mandatory alerts and 89,512 were optional alerts.[19] Due to resource limitations and workload priorities, the CFf did not work all of the mandatory alerts and did not work any of the optional alerts.

At the time we performed this review, the IRS was in the process of significantly changing the FTD Alert Program to address recommendations from internal research studies and audit reports issued by the former IRS Inspection function[20]

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[18] Employers are required to regularly deposit the income taxes withheld from their employees' earnings, as well as the employer and employee share of Social Security and Medicare taxes, with a financial institution that is an authorized depositary for Federal taxes. A business' deposit schedule for a calendar year is determined annually from the total taxes reported on Forms 941 in a 4-quarter lookback period beginning on July 1 from 2 years earlier and ending on June 30 of the prior year.

[19] Taxpayers that appear to be making tax deposits in an amount lower than expected are computer selected and scored against a set of criteria to determine which cases will receive field contact.

[20] *Service Procedures for Monitoring Federal Tax Deposits* (Reference Number 085105, dated August 14, 1998).

and the TIGTA.[21] The IRS expected to complete the testing of the new FTD Alert criteria by January 2004.

The IRS has delayed taking action on one previous audit recommendation to look at alternate functions, such as the ACS function, for working FTD Alerts. The IRS was evaluating the feasibility of issuing a "soft letter"[22] to taxpayers on some FTD Alert cases and expected a decision by August 2003.

Actions Are Needed to Prevent Noncompliance With Estimated Tax Payment Requirements

Approximately 12 million taxpayers made estimated tax[23] payments totaling $183 billion for Tax Year (TY) 2001. The tax law generally requires taxpayers to make estimated tax payments if (1) they expect to owe at least $1,000 in tax, after subtracting their withholding and credits, and (2) they expect their withholding and credits to be less than the smaller of 90 percent of the current year tax liability or 100 percent of the prior year tax liability.[24] The estimated tax system supports the "pay as you go" concept of paying taxes on nonwage sources of income. For estimated tax purposes, the year is divided into four payment periods with specific payment due dates.[25]

The IRS may assess an estimated tax penalty if a taxpayer did not pay enough taxes through withholding or estimated tax payments. An estimated penalty may also be assessed if a taxpayer does not pay enough tax by the due date of each of the four quarterly payment periods.

[21] *Consolidated Report on Opportunities for the Internal Revenue Service to Improve Service to Business Taxpayers* (Reference Number 2000-30-015, dated December 1999).
[22] A "soft letter" could advise taxpayers the IRS has identified a decrease in their FTD payments and ask for an explanation, such as if they no longer have employees. The letter could advise taxpayers to call the IRS for help in meeting their business tax deposit requirements.
[23] Estimated tax is the method used to pay taxes on income not subject to withholding. The payments are generally required on a quarterly basis.
[24] There are exceptions to the general rule for farmers, fishermen, and certain higher-income taxpayers.
[25] Estimated tax payments are due on April 15, June 15, and September 15 of the current year and January 15 of the following year. The payment due dates would be different for taxpayers that file on a fiscal, rather than calendar, year basis.

There is significant noncompliance with estimated tax payment requirements

Understanding estimated tax payments is one of the most serious problems encountered by taxpayers, according to the National Taxpayer Advocate FY 2001 Annual Report to Congress. The estimated tax penalty is the second most frequently assessed penalty against individual taxpayers.

An IRS study[26] showed 31 percent of the taxpayers that either made, or were required to make, estimated tax payments for TY 1999 were assessed the estimated tax penalty. In contrast, only about 3.2 percent of individual taxpayers that had not made estimated tax payments were penalized for the late filing of returns or the late payment of taxes in TY 1998.[27]

Figure 1 shows that, for each tax year from 1995 through 2000, the IRS penalized between 5.7 million and 6.8 million taxpayers for making late or insufficient estimated tax payments. For these 6 years, the net[28] estimated tax penalties totaled almost $7.5 billion and averaged more than $1.2 billion per year.

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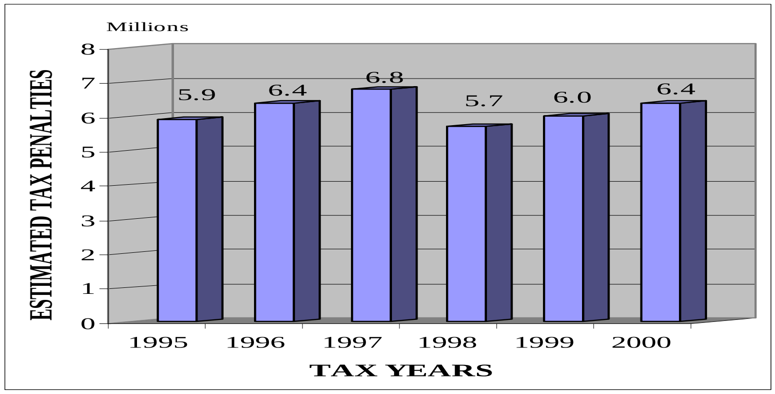
[26] Project Report: *Profile of 1040-ES Filers*, Project 1.48A, Wage & Investment Research Group 4, dated November 2001.
[27] The analysis of taxpayers that were penalized for the late filing of returns or the late payment of taxes was available only for TY 1998.
[28] Total estimated tax penalty assessments less abatements.

Figure 1: Number of Estimated Tax Penalties: TYs 1995 - 2000



Source: IRS Data Books, 1996-2001 (Publication 55B).

Noncompliance with estimated taxes is costly for the Federal Government

Not only is noncompliance with estimated tax payment requirements costly for those taxpayers assessed penalties, it also delays the flow of tax revenues to the Federal Government and often requires the IRS to take costly collection actions. For example, we analyzed the accounts of more than 2 million of the 5.7 million individual taxpayers that were assessed estimated tax penalties for TY 1998. Approximately 58 percent of these taxpayers had made no estimated tax payments. These 2 million taxpayers had tax liabilities totaling $5.9 billion that were not fully paid when their tax returns were filed, resulting in the issuance of 2.7 million collection notices for more than 1.5 million taxpayers. About 331,000 of these accounts ultimately reached Taxpayer Delinquent Account (TDA)[29] status that often requires the IRS to take stronger, more labor-intensive actions to collect the debts.

We estimate the IRS incurred more than $18 million in collection costs for these 1.5 million noncompliant taxpayers. Approximately 1 million of these taxpayers were self-employed.

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[29] A TDA involves unpaid taxes, penalties, and/or interest on a tax return that has been filed.

Several factors contribute to taxpayer noncompliance in making estimated tax payments

Several factors contribute to the significant noncompliance with estimated tax requirements:

- At the root of the issue is that the tax law does not require payers to withhold taxes from nonwage payments. Nonwage sources of income continue to grow as a proportion of total income.
- The potential risk for skipped or late estimated tax payments is also increased because the quarterly due dates prescribed by law for making the payments do not consistently coincide with the calendar quarters.
- The estimated tax penalty is based on the Federal Government short-term interest rate, which is at its lowest level in 45 years, and may not provide a sufficient deterrent to noncompliance with estimated tax payment requirements.
- While the IRS is working on improving its alert system for employment tax deposits, there are no parallel early intervention programs to identify individual taxpayers that stop making quarterly estimated tax payments or that may be making insufficient or untimely payments.
- The IRS has experienced little success in encouraging taxpayers to use electronic payment options for making estimated tax payments.

Nonwage income is not subject to mandatory tax withholding

The law requires employers to withhold income taxes and Social Security/Medicare contributions from their employees' wages and send the withheld taxes to the IRS. Withholding is a fundamental premise of the voluntary compliance system for individual taxpayers in that it provides for a gradual and systematic method to pay taxes.

In 1999, the GAO reported[30] the tax compliance rate for wage earners was 99 percent. However, the compliance rate is much lower for taxpayers with nonwage sources of income, such as self-employment, capital gains, interest, and dividends, for which taxes are generally not withheld.

When there is no withholding, taxpayers are required to make quarterly estimated tax payments. Self-employed taxpayers must make sufficient estimated tax payments to cover both their income taxes and Social Security/Medicare taxes, which since TY 1990 have been 15.3 percent of the net self-employment income.[31]

IRS Statistics of Income (SOI) data for individual income tax returns filed during 1997 showed 2.3 million (26 percent) of the 8.8 million unpaid balance due returns involved taxpayers that had no withholding. An IRS analysis of the 122 million individual income tax returns filed in CY 1998 found that over 30.5 million (25 percent) involved insufficient tax prepayments and reported a balance due with filing. In 1999, the GAO reported[32] the compliance rate for self-employed individuals was 80 percent. As of December 31, 2000, self-employed taxpayers[33] owed the IRS approximately $25 billion in delinquent taxes, interest, and penalties.

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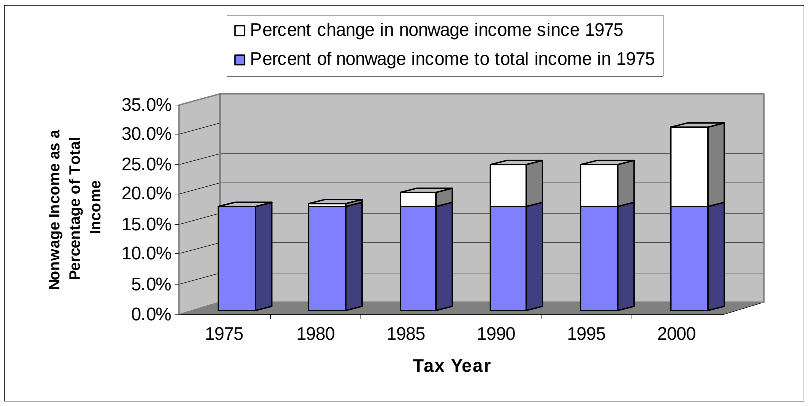
[30] *Tax Administration: Billions in Self-Employment Taxes Are Owed* (GAO/GGD-99-18, dated February 1999).
[31] Taxpayers are not required to pay self-employment taxes if their net income from self-employment is less than $400. For 2002, the maximum amount of self-employment income subject to Social Security taxes was $84,900.
[32] GAO/GGD-99-18, February 1999.
[33] Self-employed taxpayers include sole proprietors and workers that have been classified as independent contractors. The IRS has adopted 20 common law rules for classifying workers. The degree of control a business has over a worker largely determines whether a worker should be classified as an employee or independent contractor.

Nonwage income continues to increase as a percentage of total income

In 1996, the GAO reported[34] nonwage income had been a growing proportion of individual taxpayers' total incomes from 1970 through the 1980s, peaking in 1989. As shown in Figure 2, the percentage of nonwage income to total income leveled off between 1990 and 1995 but had significantly increased by 2000, the last year for which information was available.

Figure 2: Growth in Nonwage Income from 1975 to 2000



Source: SOI Bulletins, Fall 1995 and Summer 2001 (Publication 1136) and SOI, Individual Income Tax Returns, 2000 (Publication 1304).

Between 1975 and 2000, nonwage income grew significantly, from 17.4 percent of total income ($167 billion) to 30.6 percent of total income (nearly $2 trillion). This represents a 76 percent increase in the proportion of nonwage income to total income and an approximately 12-fold growth in total nonwage income.

As shown in Figure 3, the growth of nonwage income can also be illustrated by the increase in the percentage of individual income tax returns filed that report *only* nonwage income. Overall, the returns reporting only nonwage income increased from 10.6 percent (8.7 million of 82 million income tax returns filed in 1975) to 14.8 percent

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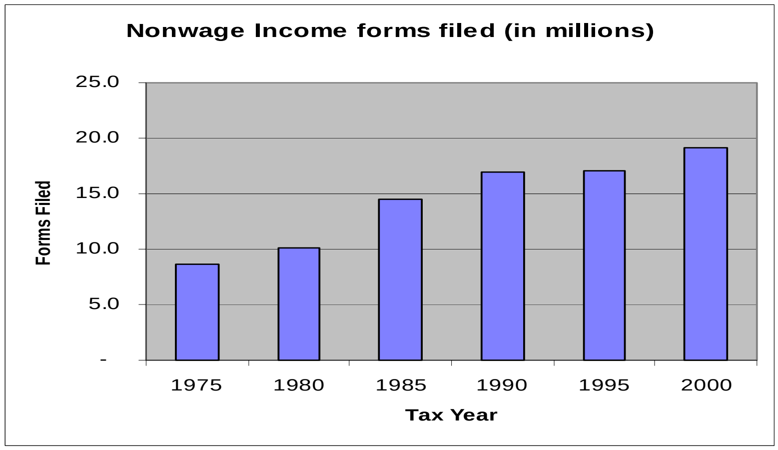
[34] *Tax Administration: Tax Compliance of Nonwage Earners* (GAO/GGD-96-165, dated August 1996).

(19.2 million of 129 million income tax returns filed in 2000).

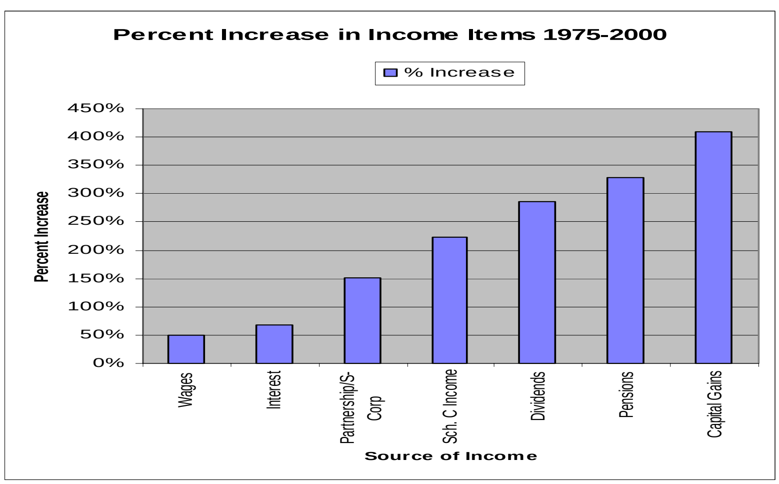
Figure 3: Growth of Tax Returns With Only Nonwage Income



Source: SOI Bulletins, Fall 1995 and Summer 2001 (Publication 1136) and SOI, Individual Income Tax Returns, 2000 (Publication 1304).

Figure 4 compares the growth in the largest nonwage sources of income to the growth in income from wages for the 25-year period from 1975 to 2000. Except for interest, each nonwage source had increased from about three to eight times more than wages.

Figure 4: Growth in Tax Returns With Wages and Nonwage Income



Source: SOI Bulletin, Fall 1995 (Publication 1136) and SOI, Individual Income Tax Returns, 2000 (Publication 1304).

Past efforts to mandate withholding on nonwage sources of income have failed

As early as 1979, the GAO concluded noncompliance among independent contractors was serious enough to warrant some form of tax withholding on the payments made to them.[35] During the 1990s, at least two GAO reports[36] and Congressional testimonies[37] suggested withholding taxes from payments to independent contractors. To support this position, the GAO cited various IRS studies and data that showed a significantly lower level of compliance among independent contractors as compared to employees.

A 1992 report[38] by the Joint Committee on Taxation also acknowledged the revenue loss associated with the lower compliance rates of independent contractors and made suggestions to improve compliance and enforcement. One suggestion was to require businesses to withhold income and employment taxes from payments to independent contractors.

In 2001, we reported[39] that, for TYs 1995 through 1998, the IRS had received about 9.6 million Statements for Recipients of Miscellaneous Income (Form 1099-MISC), reporting approximately $204 billion in nonemployee compensation to independent contractors, that either did not

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[35] Hearing on Compliance Problems of Independent Contractors Before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, dated July 17, 1979.
[36] *Tax Administration: Approaches for Improving Independent Contractor Compliance* (GGD-92-108, dated July 1992); and *Tax Administration: Tax Compliance of Nonwage Earners* (GAO/GGD-96-165, dated August 1996).
[37] *Tax Administration: Issues Involving Worker Classification* (GAO/T-GGD-95-224, dated August 2, 1995); and *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors* (GAO/T-GGD-96-130, dated June 20, 1996).
[38] *Present Law and Issues Relating to Misclassification of Employees and Independent Contractors for Federal Tax Purposes* (JCX-27-92, dated July 22, 1992).
[39] *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Reference Number 2001-30-132, dated August 2001).

contain a Taxpayer Identification Number (TIN) for the payee or match the IRS records of assigned TINs. Consequently, the IRS could not use these information documents in its computer-matching programs to determine whether the recipients of this compensation filed tax returns and/or reported all of the income.

Our report recommended the IRS propose changes to the tax law to require the mandatory withholding of income taxes on nonemployee compensation payments. However, the IRS took no action on this recommendation. The IRS responded it had previously submitted proposals for legislative changes to the Department of the Treasury that would require mandatory withholding of income taxes on nonemployee compensation payments and, in the past, the Department of the Treasury had chosen not to forward these proposals to the Congress.

The due dates for making estimated tax payments do not consistently coincide with the calendar quarters

The Current Tax Payment Act of 1943[40] established the statutory requirements for making estimated tax payments. At the time this law was enacted, the due date for filing individual income tax returns was March 15. The Congress originally established the estimated tax payment due dates as the 15th day of the third month of each quarter (i.e., March 15, June 15, September 15, and December 15).

The Congress amended the law the following year to change the due date for the fourth estimated tax payment to January 15, to provide taxpayers the opportunity to file their returns with payment in lieu of making a fourth quarterly estimated tax payment.[41] In 1954, the Congress amended the tax code to change the due date for filing an individual income tax return and for making the first estimated tax payment from March 15 to April 15.[42] However, the

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[40] Pub. L. No. 78-68, 57 Stat. 143 (1943).
[41] Pub. L. No. 78-315, 58 Stat. 243 (1944) and H.R. Rep. No. 78-655, 78th Cong., 2nd Session, 11 (1944).
[42] Pub. L. No. 83-591, 68A Stat. 749 and 758 (1954) and H.R. Rep. No. 83-1337, 83rd Cong., 2nd Session, A401 (1954).

Congress did not revise the due dates for the other quarterly estimated tax payments to coincide with this change.

Thus, for nearly 50 years, taxpayers have been required to comply with the confusing estimated tax payment schedule shown in Table 1.

Table 1: Estimated Tax Payment Schedule

Payment Due Date	For Income Received	Calendar Days Since Last Payment Due Date
April 15	January 1 through March 31	90
June 15	April 1 through May 31	61
September 15	June 1 through August 31	92
January 15	September 1 through December 31	122

Source: Tax Withholding and Estimated Tax (Publication 505).

The risk for skipped or late estimated tax payments is increased because the quarterly due dates prescribed by law for making the payments do not consistently coincide with the calendar quarters. As a result, two estimated payments are required to be made during the second quarter (i.e., April - June) of each year while none are required to be made during the fourth quarter (i.e., October - December). In addition, the number of calendar days between the estimated tax payment due dates ranges from 61 to 122.

In 2002, the IRS conducted a series of focus groups[43] with practitioners to gather suggestions for improving communication with taxpayers and practitioners and for reducing the burden on small business taxpayers. When asked about the most burdensome tax issues facing the small business taxpayer, several participants stated:

[43] *2002 Tax Forum Focus Groups – Reducing Taxpayer Burden for Small Businesses*, SB/SE Research, Brooklyn/Hartford & Seattle/ San Jose, dated October 2002.

> *The timing of the estimated payments does not make sense. The due dates create problems for a business working on a quarterly basis. It is difficult to estimate taxes before a quarter has ended. For example, estimating the appropriate payment on June 15, when earnings will continue until June 30, presents a dilemma for the taxpayer.*

The estimated tax penalty is not providing a sufficient deterrent to payment noncompliance

The estimated tax penalty is computed by applying an underpayment rate to the amount of the underpayment for the period of the underpayment. The estimated tax penalty amount is equivalent to the dollar amount of interest on the unpaid amount for the period of the underpayment. The Internal Revenue Code (I.R.C.) specifies that the underpayment rate is the sum of the Federal Government short-term interest rate plus three percentage points.[44] The rate of interest is determined on a quarterly basis.

For TY 1999, when an IRS study[45] showed 31 percent of the taxpayers that either made, or were required to make, estimated tax payments were assessed estimated tax penalties, the penalty rate was 8 percent. The study also showed 60 percent of the taxpayers that were assessed estimated tax penalties for TY 1999 were charged less than $100.

The estimated tax penalty rate, which has subsequently dropped to very low levels, may not provide a sufficient deterrent for not making timely, appropriate estimated tax payments. As of October 1, 2003, the Federal Government short-term interest rate was only 1 percent, its lowest level in 45 years. Therefore, the penalty for missing an estimated tax payment for the October 1 through December 31, 2003, quarter would have been 4 percent of the underpaid amount for the 3-month period.

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[44] I.R.C. § 6621 (2002).
[45] *Profile of 1040-ES Filers*, November 2001.

There are no early intervention programs to identify taxpayers that are not making estimated tax payments

The significant noncompliance in making quarterly estimated tax payments on nonwage income, evidenced by the millions of estimated tax penalties assessed by the IRS each year and the amount of unpaid taxes that requires costly collection action by the IRS, demonstrates that the current system is not adequately serving taxpayers or the IRS. We believe these taxpayer and Federal Government costs could be significantly reduced if the IRS used its available taxpayer account information to more timely assist taxpayers in properly making their estimated tax payments.

The IRS runs computer programs at different times of the year to identify the approximately 20.8 million[46] taxpayers that are sent estimated tax payment vouchers by mail.

- In January of each year, the IRS conducts an annual mail-out of estimated tax packages to about 16 million taxpayers that, for the previous tax year, made estimated tax payments and/or were assessed estimated tax penalties. The packages include 4 payment vouchers the taxpayers should use for the 4 payment periods during the next 12 months.
- In March, the IRS performs a similar mail-out of estimated tax packages to about 300,000 taxpayers that may have filed their tax returns late and, thus, were not identified for the earlier annual mail-out.
- In June, the IRS mails estimated tax packages to about 1.5 million taxpayers that did not make estimated tax payments for the last tax year but submitted a generic, over-the-counter, estimated tax payment voucher during the first payment period for the current tax year. This mail-out includes the payment vouchers the taxpayers should use for the following three payment periods.

[46] The number of taxpayers is based on the IRS' most recent mail-outs and would vary from year to year.

- In September, the IRS mails estimated tax packages to about 3 million taxpayers that did not make estimated tax payments for the last tax year but submitted a generic, over-the-counter, estimated tax payment voucher during the second payment period for the current tax year. This mail-out includes payment vouchers the taxpayers should use for the following two payment periods.

While the IRS makes significant efforts to ensure estimated tax payment vouchers are provided to those taxpayers that need them, it takes no action to monitor payment compliance until the taxpayers file their returns 12 to 15 months later. If the taxpayers misplace the annual estimated tax package with the four payment vouchers, forget to make the estimated tax payments throughout the year, do not know in advance the amount of their final tax liability, or do not know how much they paid in estimated taxes the previous year, they will likely be penalized for skipped, late, or insufficient estimated tax payments.

In 1999, the GAO recommended the IRS test the feasibility of sending reminder notices to self-employed taxpayers that were assessed an estimated tax penalty in the prior year and had made no estimated tax payments in the current year. The IRS initially requested computer programming to develop the reminder notices for 2000, but, due to limited resources, management decided to delay implementation until 2001. The IRS subsequently closed this recommendation without any action based on information from a June 2000 initiative that tested the effect of a prefiling notice on repeat high-income nonfilers. Currently, there are no reminder notices sent for estimated taxes.

Sending reminder notices shortly before the estimated tax payments are due was also suggested to the IRS during a July 2001 study[47] to determine taxpayer attitudes toward paying estimated tax payments through electronic methods. Focus group participants were asked about anything

[47] Project Report: *Focus Group Study of Form 1040-ES Customers*, Project 1.32, Wage & Investment Research Group 4, dated July 2001.

additional the IRS could do to encourage use of automatic funds withdrawal or credit cards to pay estimated taxes. One of their suggestions stated:

> *The participants in our focus groups like to be notified of upcoming liability payments of any kind. Therefore, complete a cost benefit analysis to determine the most effective way to send taxpayers a reminder notice about their upcoming quarterly estimated tax payments. Reminder notices could be accomplished through direct mailings, newspapers, public service announcements, advertisements in retirement magazines and reminders in bank or stockbroker statements to name a few.*

At the time we completed our review, the IRS had taken no action toward adopting this suggestion.

We believe the IRS should reconsider the reminder notice concept as a strategy for improving estimated tax payment compliance and reducing its collection costs. Based on our computer analysis of the TY 1998 accounts of 2,025,189 taxpayers that had been assessed estimated tax penalties, we believe 1,141,599[48] (56 percent) of these taxpayers could have benefited from midyear reminder notices from the IRS as a potential means to prevent or minimize future estimated tax penalties, future balance due returns, and future accounts receivables. These 1,141,599 taxpayers owed $3.8 billion in taxes after filing their TY 1998 returns and had been assessed estimated tax penalties totaling $412 million, other penalties totaling $756 million,[49] and interest totaling $732 million.[50] These 1,141,599 taxpayers included:

- 603,533 taxpayers that were assessed estimated tax penalties for TY 1997 but made no estimated tax payments for TY 1998.

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[48] The remaining 883,590 taxpayers generally did not meet the criteria for receiving the annual mail-out of estimated tax packages.
[49] Total includes assessed Delinquency Penalties and Failure to Pay (FTP) Penalties as well as accrued FTP Penalties.
[50] Total includes both assessed and accrued interest.

- 111,913 taxpayers that made estimated tax payments for TY 1997 but made none for TY 1998.
- 154,731 taxpayers that made substantially smaller estimated tax payments for TY 1998 than for TY 1997.
- 271,422 taxpayers that made untimely estimated tax payments for TY 1998.

The IRS' cost for the current annual mail-out of estimated tax packages each January is approximately $5 million. We estimate the additional IRS costs to mail estimated tax payment reminder notices to the 1,141,599 taxpayers in our sample that could have benefited from a reminder notice would have been $194,000. Assuming that 25 percent of these taxpayers became payment compliant as a result of the reminder notice, these taxpayers could avoid approximately $413 million in penalties and interest and the IRS could reduce its collection costs by $2.6 million. See Appendix IV for details.

<u>Compliance could be improved by encouraging more taxpayers to make estimated tax payments electronically</u>

The IRS encourages taxpayers to pay their taxes through electronic funds withdrawals and credit cards as alternatives to writing checks and mailing payment vouchers. However, IRS data show the overwhelming majority of the estimated tax payments the IRS receives are in the form of traditional paper payment vouchers and taxpayer checks. For example, a profile[51] of taxpayers that made estimated tax payments for TY 1999 showed less than one-half of 1 percent (i.e., 1 in 200) of the 13 million taxpayers had used electronic methods for making their payments. A second profile[52] for TY 2001 showed 38,766,000 (99.9 percent) of the 38,819,000 estimated tax payments received were made via paper.

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[51] *Profile of 1040-ES Filers*, November 2001.
[52] *Profile of Taxpayers Who Made Estimated Payments for Form 1040 in TY 2001*, Project 01.02.002.03, located on the IRS Intranet (file last modified on May 5, 2003).

The IRS has studied how to increase taxpayer usage of electronic estimated tax payments. For example, a focus group study[53] was performed in July 2001 to determine taxpayer attitudes toward paying estimated taxes through electronic methods. The general consensus across the group of participants was that they would not use credit cards to make their estimated tax payments as long as the credit card companies continued to charge a convenience fee.

For the past several years, the IRS has also provided taxpayers with an Electronic Federal Tax Payment System (EFTPS) for making tax payments electronically using the Internet, computer software, or telephone. The EFTPS is offered free by the Department of the Treasury to both business and individual taxpayers.

Taxpayers must enroll in the EFTPS. Estimated tax filers may call a toll-free number to request an Individual Enrollment Form for EFTPS (Tax Form 9783) or enroll through the Internet. Within 15 business days, the taxpayer is mailed a Personal Identification Number and confirmation materials that include instructions on obtaining a password for secure use of the EFTPS Internet site. At least 1 calendar day prior to the estimated tax payment due date, the taxpayer can access the EFTPS by telephone or on-line. The system will prompt the taxpayer for the necessary information to complete the payment. The system processes the information and, once the tax payment is accepted, a withdrawal is initiated from the taxpayer's bank account, the funds are transferred to the Treasury account, and the payment information is reported to the IRS to update the taxpayer's account.

Until recently, however, taxpayers could use the EFTPS to schedule only one estimated tax payment at a time. In July 2003, the IRS enhanced the EFTPS so taxpayers can schedule all four quarterly estimated tax payments at the same time.

Information about the EFTPS is contained in the general tax package instructions and several other IRS publications.

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[53] *Focus Group Study of Form 1040-ES Customers*, July 2001.

However, the fact that the EFTPS is offered as a "free" service by the Department of the Treasury is not covered in several key IRS publications such as the Estimated Tax for Individuals (Form 1040-ES and Form 1040-ES/V (OCR)) instructions and *Tax Withholding and Estimated Tax* (Publication 505). The EFTPS is only briefly described in these documents. For example, in Publication 505 (Rev. December 2002), the reference to the EFTPS is limited to two sentences on page 24.

Recommendations

To address the significant noncompliance in paying estimated taxes, the Commissioners, Large and Mid-Size Business (LMSB), SB/SE, and W&I Divisions, should work with the IRS Office of Legislative Affairs to:

1. Explore the development of a system of mandatory withholding of income taxes from nonemployee compensation paid to independent contractors for possible inclusion in a legislative proposal, similar to the one we previously recommended[54] in 2001, for submission to the Department of the Treasury. To avoid placing undue burden on small businesses, the IRS should limit the requirement to withhold taxes on nonemployee compensation to large and mid-size businesses.[55]

Management's Response: The Director, Field Specialists, LMSB Division, agreed to explore the feasibility of developing a system of mandatory withholding of income taxes from nonemployee compensation paid to independent contractors in large and mid-size businesses. The Director, Field Specialists, will explore this action in coordination with program managers in the SB/SE and W&I Divisions and the LMSB Division Counsel. If developing and implementing a system of mandatory withholding for these

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[54] *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Reference Number 2001-30-132, dated August 2001).
[55] The IRS defines large and mid-size businesses as those with $10 million or more in assets.

taxpayers is feasible, the Director, Field Specialists, will draft and coordinate a legislative proposal with the Office of Legislative Affairs for consideration by the Department of the Treasury.

To minimize taxpayer confusion with the estimated tax payment due dates and increase the effectiveness of the estimated tax penalty as a deterrent to payment noncompliance, the Commissioners, SB/SE and W&I Divisions, should work with the IRS Office of Legislative Affairs to:

2. Develop a legislative proposal, for submission to the Department of the Treasury, to change the estimated tax payment due dates from the current irregular schedule, which requires 4 payments that are spaced from 61 to 122 days apart, to a regular monthly schedule with payments due on the 15th day of each month and with the last payment due January 15. We believe this change would promote payment compliance by evenly spacing the due dates approximately 90 days apart, requiring smaller individual payments by the taxpayer, and encourage use of the EFTPS for making electronic payments. The increased frequency of estimated payments would also expedite the flow of revenue into the Treasury in comparison to the existing system. Taxpayers would also benefit because the estimated tax penalty for a skipped or late monthly payment would be less than that for a skipped or late payment under the existing system.

<u>Management's Response</u>: The Commissioner, SB/SE Division, disagreed with this recommendation, stating that, although there may be some benefit to establishing regular quarterly time periods for individual estimated tax payments, monthly estimated tax payments would increase burden and complexity for both compliant and noncompliant taxpayers. The Commissioner added that increasing the number of payments would increase both the complexity of Underpayment of Estimated Tax by Individuals, Estates, and Trusts (Form 2210) and the

difficulty of computing estimated tax penalties for noncompliant taxpayers.

<ins>Office of Audit Comment</ins>: Given the significant increase in nonwage income and the extensive noncompliance with making estimated tax payments, we continue to believe taxpayers could benefit from a system of regularly scheduled monthly payment dates. The fact that nearly one-third of the taxpayers that make estimated tax payments incur penalties strongly suggests the current quarterly payment system, in place since 1943, is not working effectively. Monthly payment intervals are an established and common business practice in the private sector. Most Americans are already used to making monthly payments on their home mortgages, rent, car loans, credit cards, and utilities. Many utility companies establish fixed monthly billing dates whereby their customers pay the same amount on the same date of each month through an even billing process. In addition, many homeowners have mortgage escrow accounts set up to have money held to pay property taxes and insurance premiums so they do not have to worry about coming up with several large lump sum payments, each with different due dates, throughout the year. Also, taxpayers that cannot pay the full amount with their individual income tax returns can make arrangements with the IRS to make monthly installment payments.

We believe the Commissioner's concern with the taxpayer burden associated with a monthly payment system would be alleviated with the successful promotion of electronic payments. In addition, the IRS instructions for Form 2210 state that taxpayers do not need to file the Form in most cases if an estimated tax penalty is due and that, because the Form is complicated, the IRS strongly encourages the taxpayer to let the IRS figure the penalty. Finally, substantial taxpayer burden would be reduced if the monthly payment system helped taxpayers avoid estimated tax penalties. Under a monthly system, 12 smaller payments would be spread out over a year. Therefore, the estimated tax penalty for one skipped or late monthly payment would be less than that for a skipped or late quarterly payment under the existing system, which requires larger payment amounts and longer intervals between payments.

3. Develop a legislative proposal, for submission to the Department of the Treasury, to change the manner in which the estimated tax penalty rate is determined to ensure it serves as a more effective deterrent to noncompliance with estimated tax payment requirements.

Management's Response: The Commissioner, SB/SE Division, disagreed with this recommendation, stating that, in July 2001, the IRS had developed a legislative proposal recommending the Congress raise the minimum underpayment amount on which penalties are assessed for failure to make estimated tax payments and change the rate at which the estimated penalty is determined. The proposed changes would apply to tax years beginning after December 31, 2003. The Commissioner stated the proposal has been incorporated into Section 201 of Senate Bill (S.) 882, Tax Administration Good Government Act, and, therefore, the IRS does not believe developing an additional legislative proposal is required.

Office of Audit Comment: We continue to believe our recommendation has merit. The legislative proposal cited by the Commissioner, SB/SE Division, was referred to the Senate Committee on Finance on April 10, 2003, and had not been acted on as of January 15, 2004. While applying the underpayment rate on a daily basis would increase the amount of the estimated tax penalty, the increase would not, in our opinion, be sufficient to effectively deter taxpayers from avoiding estimated tax payments. By our calculations, for example, a taxpayer who missed making a $5,000 estimated tax payment for the October - December 2003 quarter would face an increased penalty of only 66 cents under the proposed tax law change.

To assist in promoting the IRS' goals to provide prefiling taxpayer assistance, potentially reduce the significant number of taxpayers that are incurring estimated tax penalties and/or filing balance due returns, and potentially reduce the IRS' eventual collection costs, the Directors, Compliance, SB/SE and W&I Divisions, and the Director, Customer Assistance, Relationships, and Education, W&I Division, should coordinate to:

4. Develop and send educational midyear reminder notices to those taxpayers that were assessed estimated tax penalties in the prior tax year and had made no estimated tax payments during the first 6 months of the current tax year or had made substantially smaller payments or untimely payments during the first 6 months. This notice would remind taxpayers of the estimated tax requirements and potentially help them avoid significant penalties before they fall too far behind in their estimated tax payment obligations.

Management's Response: The Commissioner, SB/SE Division, disagreed with this recommendation, stating that, in early 2000, the IRS had initiated a "soft letter" project to determine whether a "soft letter" would significantly increase FTD payment compliance. The Commissioner advised that, based on the results of that study, a reminder notice would have little or no impact on payment compliance.

The Commissioner also disagreed with our estimate that penalty and interest could be reduced by $2.1 billion over 5 years by assuming the midyear reminder notice could result in a 25 percent increase in payment compliance, stating that the percentage was not based on any empirical data. The Commissioner also did not agree that sending reminder notices to taxpayers assessed estimated tax penalties would reduce collection costs by $12.9 million over 5 years, stating that, based on the results of the FTD "soft letter" study, there would be no collection cost savings and that our estimate did not reflect the administrative cost of adding a midyear reminder notice.

Office of Audit Comment: We believe the concept of a midyear reminder notice to taxpayers that have stopped making estimated tax payments should, at a minimum, be tested. The Commissioner, SB/SE Division, cited the results of an FTD "soft letter" project as evidence that a reminder notice would have little or no impact on estimated tax payment compliance. However, the IRS' own final report, dated March 2003, on the results of that project recommended "further study about the effectiveness of the 'soft letter' as an early intervention tool to improve filing and payment compliance may be warranted." Further, the report on the FTD "soft letter" project stated sending a "soft letter" to the taxpayer helped to "winnow out" earlier in the collection pipeline some cases that did not need further contact. Finally, the FTD "soft letter" was directed to businesses responsible for paying employment taxes. This customer segment significantly differs from individual taxpayers that are responsible for making estimated tax payments on their nonwage income.

While the Commissioner, SB/SE Division, is correct that there are no empirical data to support our assumption that a midyear reminder notice would improve payment compliance by 25 percent, our estimate that penalties and interest could be reduced by $412.7 million per year, or $2.1 billion over 5 years, was based on 285,400 taxpayers becoming payment compliant. These 285,400 taxpayers represented only about 5 percent of the 5.7 million noncompliant taxpayers that incurred estimated tax penalties in TY 1998. Similarly, our estimate of the cost savings that could be realized through a 25 percent improvement in payment compliance was based on avoiding collection action on approximately 204,000 taxpayers. Our estimate of the collection cost savings was reduced by the estimated cost to mail the reminder notices. Our methodology in arriving at these estimates is presented in detail in Appendix IV.

To improve compliance by promoting electronic payment options for making estimated tax payments, the Director, Taxpayer Education and Communication, SB/SE Division, should:

5. Consider including Tax Form 9783 in the estimated tax packages mailed to taxpayers, expanding the brief explanation of the EFTPS in Publication 505, and amending those IRS instructions and publications applicable to estimated tax payments that do not

sufficiently emphasize the EFTPS is offered to taxpayers as a free service by the Department of the Treasury.

Management's Response: The Commissioner, SB/SE Division, agreed with this recommendation, stating an E-Submissions Messaging Team was created in August 2003 to ensure information concerning IRS payment options is available and consistent in IRS tax products. The group is currently reviewing small business publications, notices, and IRS tax packages to ensure electronic payment options are displayed prominently and EFTPS benefits and uses are specifically detailed. The proper messages emphasize the EFTPS as the preferred payment option and highlight it as a "free" service offered by the Department of the Treasury.

This group will continue to review new ways to enhance Form 1040-ES taxpayer compliance. Proposals under consideration include 1) adding a coded Form 9783 in the U.S. Individual Income Tax Return (Form 1040) tax package to track the number of enrollments submitted through the paper enrollment process, and 2) providing an information insert describing the benefits and use of the EFTPS and directing taxpayers to the applicable web site for electronic enrollment.

Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine if the Internal Revenue Service (IRS) has effective processes for achieving timely intervention when an underpayment or nonpayment of income taxes, Federal Tax Deposits[1] (FTD), and/or estimated taxes[2] is identified.

To meet this objective, we:

I. Evaluated the use of outbound calls and timely intervention activities performed by the Automated Collection System (ACS) function.[3]

   A. Evaluated the types of cases worked at the ACS call sites and determined whether management believes the early intervention method may not be productive.

   B. Analyzed the types of cases for which the ACS function makes outbound calls and determined whether the outbound calls are successful in collecting funds and closing cases.

   C. Obtained and analyzed the entire population of 1,136 cases from an "ACS Over $25,000 Case Analysis Study" completed by the Wage and Investment Division to compare the cases closed by the ACS function with outbound calls and the cases closed without outbound calls.

   D. Determined the status of the Small Business/Self-Employed Division's Collection Process Improvement study that addresses the use of the predictive dialer as a method for working more ACS function cases.

   E. Evaluated the feasibility of the predictive dialer process to perform additional outbound calls for the ACS function.

[1] Employers are required to regularly deposit the income taxes withheld from their employees' earnings, as well as the employer and employee share of Social Security and Medicare taxes, with a financial institution that is an authorized depositary for Federal taxes. A business' deposit schedule for a calendar year is determined annually from the total taxes reported on Employer's Quarterly Federal Tax Returns (Form 941) in a 4-quarter lookback period beginning on July 1 from 2 years earlier and ending on June 30 of the prior year.
[2] Estimated tax is the method used to pay taxes on income not subject to withholding. The payments are generally required on a quarterly basis.
[3] The ACS function is a computerized inventory system that maintains certain balance due accounts and return delinquency investigations. It is located at 14 call sites in the Small Business/Self-Employed and Wage and Investment Divisions.

F. Analyzed the status of the Business Systems Modernization project for Filing and Payment Compliance that includes a model to shorten the payment compliance life cycle.

II. Evaluated the effectiveness of the FTD Alert Program that is designed to prevent delinquencies for small business taxpayers.

A. Identified the objectives and goals of the FTD Alert Program and determined whether there is a system to measure Program results.

B. Evaluated the status of IRS management's corrective actions for five audit recommendations on FTD Alerts contained in an audit report issued by the former IRS Inspection function (*Service Procedures for Monitoring Federal Tax Deposits* (Reference Number 085105, dated August 14, 1998)).

C. Evaluated the status of IRS management's corrective actions for a recommendation on FTD Alerts contained in an audit report issued by the Treasury Inspector General for Tax Administration (*Consolidated Report on Opportunities for the Internal Revenue Service to Improve Service to Business Taxpayers* (Reference Number 2000-30-015, dated December 1999)).

D. Evaluated the current FTD Alert process and the status of IRS Research Projects on the development and testing of a new FTD Alert model.

E. Considered methods to improve the FTD Alert Program, e.g., moving the alerts from the Collection Field function to a predictive dialer for outbound calls.

III. Evaluated the need for a delinquency prevention program for individual taxpayers required to make estimated tax payments.

A. Identified the objectives and goals of the estimated tax program.

B. Analyzed an IRS Individual Master File (IMF)[4] extract of all Tax Year 1998 individual income tax accounts for which the taxpayers had (1) filed a return after its Calendar Year (CY) 1999 due date or (2) filed a timely return in CY 1999 but had not paid all taxes due by the regular April 15 return due date. The extract identified 2,025,189 taxpayers that were assessed the estimated tax penalty.[5]

C. Considered methods to improve the estimated tax process, such as sending reminder notices to previous estimated tax filers if they do not make any estimated tax payments in the first two payment periods and/or making outbound calls to these taxpayers.

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[4] The IMF is the IRS database that stores transactions or records of individual tax accounts.

[5] Due to the selection criteria used for the IMF extract, the results from the analysis of 2,025,189 accounts cannot be projected to the universe of 5.7 million taxpayers assessed estimated tax penalties.

IV. Evaluated early intervention programs employed by state tax agencies.

A. Sent questionnaires to nine[6] state governments to inquire about their collection techniques and early intervention practices.

B. Evaluated the six[7] questionnaire responses received and determined whether there are best practices that would benefit the IRS operations.

[6] Questionnaires were sent to the California, Connecticut, Illinois, Michigan, New Jersey, New York, Ohio, Pennsylvania, and South Carolina state governments.

[7] Questionnaire responses were received from the Illinois, Michigan, New Jersey, New York, Ohio, and Pennsylvania state governments.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Deputy Director, Compliance Policy, Small Business/Self-Employed Division SE:S:C:CP
Director, Payment Compliance, Small Business/Self-Employed Division SE:S:C:CP:PC
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    Commissioner, Large and Mid-Size Business Division SE:LM
    Commissioner, Small Business/Self-Employed Division SE:S
    Commissioner, Wage and Investment Division SE:W

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $412.7 million; over 5 years, $2.1 billion in reduced penalty and interest assessments against taxpayers currently being assessed estimated tax penalties (see page 9).
- Inefficient Use of Resources – Potential; $2.6 million; over 5 years, $12.9 million in reduced collection costs for the Internal Revenue Service (IRS) by improving payment compliance through the development of a midyear reminder notice for estimated tax payments (see page 9).

Methodology Used to Measure the Reported Benefit:

We analyzed an IRS Individual Master File (IMF)[1] extract that included all Tax Year (TY) 1998 individual income tax accounts for which the taxpayers had (1) filed a return after its Calendar Year (CY) 1999 due date or (2) filed a timely return in CY 1999 but had not paid all taxes due by the regular April 15 return due date. This extract identified 2,025,189 taxpayers that were assessed the estimated tax penalty. The following methodologies were used to estimate the reported benefits:

Taxpayer Rights and Entitlements: We analyzed all 2,025,189 taxpayer accounts extracted from the universe of 5.7 million taxpayers assessed estimated tax penalties. Our analysis showed 1,141,599 of the 2,025,189 taxpayers could have benefited from midyear reminder notices from the IRS as a potential means for improving payment compliance and reducing collection costs.[2] We assumed a 25 percent improvement in payment compliance from the reminder notice and determined these taxpayers could avoid $412.7 million in penalties and interest.

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[1] The IMF is the IRS database that stores transactions or records of individual tax accounts.
[2] The remaining 883,590 taxpayers generally did not meet the criteria for receiving the annual mail-out of estimated tax packages.

As shown in Table 1, these 1,141,599 taxpayers were assessed nearly $1.7 billion in penalties and interest for TY 1998:

Table 1: Total Penalty and Interest Assessments on Selected Taxpayers

Assessment	Amount
Failure to Pay Penalty	$ 299,290,163
Estimated Tax Penalty	412,302,451
Accrued Penalty	207,345,154
Interest	446,318,951
Accrued Interest	285,584,279
Total	$1,650,840,998

Source: The Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File data.

Assuming that sending midyear estimated tax payment reminder notices potentially would result in a 25 percent improvement in taxpayer payment compliance, the reduced penalty and interest would be $412,710,250 ($1,650,840,998 X .25) per year, or nearly $2.1 billion over 5 years for 285,400 taxpayers (1,141,599 X .25).[3] The estimated outcomes are based on achieving payment compliance by only 5 percent (285,400/5.7 million) of the taxpayers assessed estimated tax penalties.

Inefficient Use of Resources: We analyzed 2,025,189 taxpayer accounts from the universe of 5.7 million taxpayers assessed estimated tax penalties. Our analysis indicated 1,141,599 of the 2,025,189 taxpayers could have benefited from midyear reminder notices from the IRS as a potential means to prevent or minimize future estimated tax penalties, future balance due returns, and future accounts receivable.[4] These included:

- 603,533 taxpayers that were assessed estimated tax penalties for TY 1997 but made no estimated tax payments for TY 1998.

[3] Due to the selection criteria used for the IMF extract, the potential avoidance of penalty and interest from an estimated tax reminder notice cannot be projected to the universe of 5.7 million taxpayers assessed estimated tax penalties. All estimated avoidance of penalty and interest is limited to the 1,141,599 taxpayers identified in our analysis that we believe could have benefited from a midyear reminder notice. Assuming a 25 percent improvement in taxpayer compliance from a midyear reminder notice, 285,400 taxpayers (1,141,599 X .25) would be affected. Thus, the estimated outcomes are based on achieving payment compliance by only 5 percent (285,400/5.7 million) of all taxpayers assessed estimated tax penalties.

[4] The remaining 883,590 taxpayers generally did not meet the criteria for receiving the annual mail-out of estimated tax packages.

- 111,913 taxpayers that made estimated tax payments for TY 1997 but made none for TY 1998.
- 154,731 taxpayers that made substantially smaller estimated tax payments for TY 1998 than for TY 1997.
- 271,422 taxpayers that made untimely estimated tax payments for TY 1998.

Our analysis showed 324,928 of the 1,141,599 taxpayers fully paid their taxes when they filed their returns, and the IRS subsequently sent 1 or more collection notices for delinquent taxes and/or penalties and interest to the remaining 816,671 taxpayers. In addition, the accounts of 143,497 taxpayers eventually reached the Taxpayer Delinquent Account[5] (TDA) status in the Automated Collection System (ACS)[6] function inventory, and 26,580 of these were ultimately referred to the Collection Field function (CFf) for resolution.

Table 2 shows our estimate of the IRS collection costs[7] on these 816,671 taxpayer accounts:

Table 2: Estimated Collection Costs

Category	Number	Unit Cost	Total Estimated Cost
Collection Notices	646,594	$ 2.02	$ 1,306,120
ACS TDAs	143,497	14.44	2,072,097
CFf TDAs	26,580	291.10	7,737,438
Total	816,671		$11,115,655

Source: TIGTA analysis of IRS Master File data and IRS cost data.

[5] A TDA involves unpaid taxes, penalties, and/or interest on a tax return that has been filed.
[6] The ACS function is a computerized inventory system that maintains certain balance due accounts and return delinquency investigations. It is located at 14 call sites in the Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Divisions.
[7] The estimated IRS collection costs for notices, ACS TDAs, and CFf TDAs were based on an average of the SB/SE Division's costs and the W&I Division's costs, as shown in the Business Systems Modernization Prime Program *Tax Administration Modernization Filing and Payment Compliance Milestone 2/3 Organizational Transition Plan Appendix* (August 19, 2002).

Assuming that sending a midyear estimated tax payment reminder notice potentially would result in a 25 percent improvement in taxpayer compliance, the reduced annual IRS collection costs would be $2,778,914 ($11,115,655 X .25) for 204,168 taxpayers (816,671 X .25).[8] We estimate the IRS' mailing costs to send midyear estimated tax payment reminder notices to 1,141,599 taxpayers would be $194,072 (1,141,599 notices @ $.17 each).

The reduced IRS collection costs of $2,778,914 would be offset by increased mailing costs of $194,072. Thus, the potential net saving would be $2,584,842 per year, or $12.9 million over 5 years.

[8] Due to the selection criteria used for the IMF extract, the potential collection savings from an estimated tax reminder notice cannot be projected to the universe of 5.7 million taxpayers assessed estimated tax penalties. All estimated collection cost savings and potential mailing costs are limited to the 1,141,599 taxpayers identified in our analysis that we believe could have benefited from a midyear reminder notice. We determined 816,671 of these 1,141,599 taxpayers received Collection notices or advanced to TDA status. Assuming a 25 percent improvement in taxpayer compliance from a midyear reminder notice, 204,168 taxpayers (816,671 X .25) would be affected. Thus, the estimated outcomes are based on achieving payment compliance by only 4 percent (204,168/5.7 million) of all taxpayers assessed estimated tax penalties.

Appendix V

Management's Response to the Draft Report

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
JAN 23 2004

JAN -7 2004

MEMORANDUM FOR GORDON C. MILBOURN III
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT
(SMALL BUSINESS AND CORPORATE PROGRAMS)

FROM: Dale F. Hart *Dale F. Hart*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – While Progress Towards Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements (Audit #200230041)

I have reviewed your report evaluating the IRS' processes for achieving timely intervention when we identify an underpayment or nonpayment of income taxes, Federal Tax Deposits, or estimated taxes. While we do not agree with all of your recommendations, we believe that we have already taken a number of actions, and plan others, that will improve our ability to react more quickly to an actual or potential tax debt.

To facilitate estimated tax payment compliance, the IRS and Financial Management Service (FMS) are exploring ways to increase the volume of electronic payments and encourage those taxpayers who file electronically to pay electronically. In addition, we are marketing the Electronic Federal Tax Payment System (EFTPS) to the Form 1040-ES market segment and to the tax professional community. A cross-functional task force is also considering inclusion of complete information about EFTPS and all payment options in small business forms and publications.

For the reasons cited in our attachment we disagree with the Statement of Outcome Measures and Monetary Benefits found in Appendix IV of the report. Appendix IV significantly overstates the benefits that may be associated with implementing your recommendations and does not take into consideration some of the costs associated with implementation of these recommendations, nor the increase in taxpayer burden.

Our detailed response to your recommendations is attached. If you have any questions concerning this matter, please contact me or have a member of your staff contact Bobby Hunt, Director, Taxpayer Education and Communication, Small Business/Self-Employed Division at (202) 283-0222.

Attachment

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ATTACHMENT

The Service response to your specific recommendations follows:

RECOMMENDATION 1

Explore the development of a system of mandatory withholding of income taxes from non-employee compensation paid to independent contractors for possible inclusion in a legislative proposal for submission to the Department of the Treasury. To avoid placing undue burden on small businesses, the requirement to withhold taxes on non-employee compensation should be limited to large and mid-size businesses.

CORRECTIVE ACTIONS:

The Director, Field Specialists (Large and Mid-Sized Business Operating Division) agrees to explore the feasibility of developing a system of mandatory withholding of income taxes from non-employee compensation paid to independent contractors in large and mid-size businesses. The Director, Field Specialists will explore this action in coordination with program managers in the Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Business Operating Divisions and the LMSB Division Counsel. If developing and implementing a system of mandatory withholding for these taxpayers is feasible, the Director, Field Specialists will draft and coordinate a legislative proposal with Legislative Affairs for consideration by the Department of the Treasury.

If the proposed system of mandatory withholding is not considered feasible, the Director, Field Specialists will prepare and submit to the Office of Management Controls under the Director, Assistance and Review (Chief Financial Officer) a formal status update, closing the audit corrective action and stating the reasons for the management decision.

IMPLEMENTATION DATE:

August 15, 2004 – Submit legislative proposal to Treasury or close audit corrective action with rationale for the management decision.

RESPONSIBLE OFFICIAL:

Director, Field Specialist, Large and Mid-Sized Business Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Field Specialists will do the following:

- Arrange meetings, as necessary, to address the audit recommendation in coordination with SB/SE and W&I divisions, Chief Counsel, and Legislative Affairs.

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- Report the progress of the corrective actions to the Management Controls Coordinator in Management and Finance (LMSB:MF).

RECOMMENDATION 2

Develop a legislative proposal, for submission to the Department of the Treasury, to change the estimated tax payment due dates from the current irregular schedule, which requires four payments that are spaced from 61 to 122 days apart, to a regular monthly schedule with payments due on the 15th day of each month, and with the last payment due January 15.

CORRECTIVE ACTION

Although we agree that there may be some benefit to establishing regular quarterly timeframes for individual estimated tax payments, we do not agree with this recommendation since it would quadruple the taxpayer burden associated with making estimated tax payments. This is because it increases the number of annual payments from the current four quarterly payments to twelve monthly payments. The recommended change increases burden and complexity for both compliant taxpayers and non-compliant taxpayers.

There is no evidence to support the statement, "taxpayers would benefit because the estimated tax penalty for a skipped or monthly payment would be less than for a late payment under the existing system." Also, it is not clear that reducing the amounts of incremental penalty for twelve payment periods would decrease the aggregate amount of estimated tax penalty for non-compliance. In addition, increasing the number of payments would increase both the complexity of Form 2210, "Underpayment of Estimated Tax By Individuals, Estates and Trusts" and the difficulty of computing estimated tax penalty for non-compliant taxpayers.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 3

Develop a legislative proposal, for submission to the Department of the Treasury, to change the manner in which the estimated tax penalty rate is determined to ensure that it serves as a more effective deterrent to noncompliance with estimated tax payment.

CORRECTIVE ACTION

In July 2001, we developed a legislative proposal concerning estimated tax penalty to recommend that Congress raise the minimum underpayment amount on which penalties are assessed for failure to make estimated tax payments. It also proposed to change the rate at which estimated penalty is determined. The proposed changes would apply to tax years beginning after December 31, 2003. This legislative proposal has been incorporated into Section 201 of Senate Bill (S.) 882, "Tax Administration Good Government Act" and, as such, we do not believe that developing an additional legislative proposal is required.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

Develop and send educational mid-year reminder notices to those taxpayers who were assessed estimated tax penalties in the prior tax year and had made no estimated tax payments during the first six months of the current tax year or had made substantially smaller payments or untimely payments during the first six months.

CORRECTIVE ACTION

In early 2000, we initiated a "soft letter" project for Federal Tax Deposits (FTD). The objective of this project was to determine whether or not a "soft letter" would significantly increase payment compliance. Results of the study did not support that hypothesis. Based on the results of this study, we believe that a reminder notice would have little or no impact on payment compliance.

As part of a joint effort with Financial Management System (FMS), the IRS is exploring ways to increase the volume of electronic payments and encourage those taxpayers

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who electronically file to pay electronically as well. Estimated taxes can be paid not only through EFTPS but also through the use of credit cards.

IRS and FMS are continuously working together in promoting EFTPS to the Form 1040-ES market segment and to the tax professional community. IRS coordinated with FMS during 2002 to develop and issue direct mail correspondence and reminder notices to taxpayers and tax professionals. These communications were sent to promote, educate and enhance compliance by using EFTPS for making quarterly estimated tax payments electronically. The direct mail pieces educate taxpayers and tax professionals on the use and benefits of EFTPS. The mailing advises that EFTPS is a free service offered by the Department of Treasury, and explains how paying taxes electronically eliminates the assessment of costly penalties and enhances the taxpayers experience in making their estimated tax payments.

We are coordinating development of new Form 1040-ES instructions for taxpayers who pay estimated taxes electronically. Information on Form 1040-ES has also been included in internal and external websites and in numerous tax packages.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATON 5

Consider including Tax Form 9783 in the estimated tax packages that are mailed to taxpayers, expanding the brief explanation of EFTPS in Publication 505, and amending those IRS instructions and publications applicable to estimated tax payments that do not sufficiently emphasize that the EFTPS is offered to taxpayers as a free service by the Department of Treasury.

CORRECTIVE ACTION

An E-Submissions Messaging Team was created in August 2003 to ensure that information concerning IRS payment options is available and consistent in IRS tax products. The group is currently reviewing small business publications, notices and IRS tax packages to ensure that electronic payment options are displayed prominently, and that EFTPS benefits and uses are specifically detailed. The proper messages emphasize EFTPS as the preferred payment option and highlight it as a "free" service offered by the Department of Treasury.

The group will continue to review and discuss new ways to enhance Form 1040-ES taxpayer compliance. Proposals under consideration include: 1) adding a coded Form 9783, "EFTPS Individual Enrollment Form" in the Form 1040 tax package to track the number of enrollments submitted through the paper enrollment process and 2) providing an information insert describing benefits and use of the EFTPS system and directing taxpayers to the eftps.gov website for electronic enrollment.

IMPLEMENTATION DATE

May 31, 2004

RESPONSIBLE OFFICIAL

Director, TEC Business Marketing Services, Small Business/Self Employed Division.

CORRECTIVE ACTION MONITORING PLAN

The SB/SE Director, Business Marketing Services will do the following:

- Address ways to enhance Form 1040-ES.
- Provide findings for W&I consideration.
- Correct deficiencies in e-submissions messages in small business materials.

OUTCOME MEASURES AND MONETARY BENEFITS

We do not agree with the Statement of Outcome Measures and Monetary Benefits found in Appendix IV of the report. The statement significantly overstates the benefits that may be associated with implementing your recommendations.

Under the "Taxpayer Rights and Entitlements" section, the report states that penalty and interest assessments could be reduced by $2.1 billion over 5 years by assuming a 25% increase in payment compliance. This percentage is not based on any empirical data.

Since the report emphasizes pre-filing intervention, it should identify indicators of pre-filing payment non-compliance. For this reason, only estimated tax penalty amounts should have been included in Table 2. This is because estimated tax penalty is computed on underpayments during four quarterly periods prior to the filing due date. Failure to pay penalty, accrued penalty, interest and accrued interest are computed on tax remaining unpaid after the return due date. Only $412,302,451 of the total $1,238,538,547 penalty and interest cited in Table 2 is attributable to estimated tax penalty and may be used in computing benefits of estimated tax payment compliance.

Under the "Inefficient Use of Resources" section, the report indicates that collection costs could be reduced, creating a potential savings of $12.9 million over 5 years. In addition, the report states that 603,533 taxpayers were charged estimated tax penalties in TY 1997 and made no estimated tax payments during TY 1998. Since assessing the penalty did not compel these taxpayers to make subsequent estimated tax payments, soft notices would be unlikely to motivate estimated tax payment compliance. Further, based on results of the FTD "Soft Letter" Study, there would be no savings in collection costs.

Without more detailed taxpayer data in the analysis under "Inefficient Use of Resources", we cannot accept the conclusion that 548,066[1] of the 1,141,599 taxpayers would benefit or avoid penalties by receiving estimated tax payment reminders. It is also possible that the 111,913 taxpayers who made no estimated tax payments in TY 1998 and the 154,731 taxpayers who made smaller estimated tax payments in TY 1998 may have changed filing status or adjusted their payments due to decreased income or tax law changes during 1998. It is possible that the 271,422 who made untimely estimated tax payments during TY 1998 may have been unable to compute accurate payment amounts or may not have annualized tax accurately during that year. Sending estimated tax reminders to such taxpayers would have increased administrative cost and taxpayer burden without improving payment compliance.

The report does not compute taxpayer burden related to Recommendation 2. We estimated this burden by calculating taxpayer time expenditures for computing and preparing tax forms annually. The Office of Tax Forms and Publications calculates taxpayer burden based on a computation developed by the Arthur D. Little Company in 1988. The instructions for Form 1040-ES, "Estimated Tax for Individuals," explain that the estimated average times for computing and filing estimated tax payments is currently 138 minutes. The total taxpayer burden associated with computing and preparing four quarterly estimated tax payments is currently 94,394,096 hours annually. Current estimates are that the total taxpayer burden would increase by 188,788,192 hours annually if the number of estimated tax payments was increased to twelve monthly payments.

The instructions for Form 2210, "Underpayment of Estimated Tax By Individuals, Estates and Trusts", state that the estimated average time for computing and filing this form is currently 87 to 218 minutes annually, per taxpayer. We project that increasing the number of estimated tax payments to twelve would increase burden, add complexity to the process and increase the potential for error by both compliant and non-compliant taxpayers required to compute twelve monthly estimated tax penalty increments using Form 2210.

Finally, the measures do not reflect the administrative cost related to Recommendation 4. Adding a mid-year reminder notice would substantially increase administrative costs to the Service.

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[1] We added 111,913 (ES in '97 but not in '98) + 154,731 (smaller '98 ES payment than in '97) + 271,422 (untimely ES in '98) = 548, 066.