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United States General Accounting Office
Washington, DC 20548

July 23, 2003

The Honorable Mark W. Everson
Commissioner of Internal Revenue

Subject: *Management Report: Improvements Needed in Controls over IRS's
Excise Tax Certification Process*

Dear Mr. Everson:

The Internal Revenue Service (IRS), along with other components of the Department of the Treasury, collects and distributes excise tax receipts to government trust funds. As the nation's tax collector, IRS plays a critical role in this process. Consequently, trust funds and their administrators depend on IRS to have sound procedures and controls over this process to ensure that excise taxes are appropriately distributed.

This report is a follow-up to two reports we recently issued discussing procedures we performed to assist the Department of Transportation's Office of Inspector General (Transportation IG) in ascertaining whether the net excise tax collections and excise tax certifications reported by IRS for the fiscal year ended September 30, 2002, were supported by underlying records.¹ The agreed-upon procedures, along with our audit of IRS's fiscal year 2002 financial statements,² provided a sufficient basis to assist the Transportation IG in forming an opinion on the departmentwide financial statements and the financial statements of the trust funds administered by the department, including the Highway Trust Fund and the Airport and Airway Trust Fund.³

In our reports discussing the results of the agreed-upon procedures we performed in fiscal year 2002, we described errors we identified in the certification and distribution process. However, we did not discuss the underlying internal control weaknesses

¹U.S. General Accounting Office, *Applying Agreed-Upon Procedures: Highway Trust Fund Excise Taxes*, GAO-03-360R (Washington D.C.: Jan. 23, 2003) and *Applying Agreed-Upon Procedures: Airport and Airway Trust Fund Excise Taxes*, GAO-03-361R (Washington D.C.: Jan. 23, 2003).

²U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington D.C.: Nov. 15, 2002).

³Because GAO is responsible for auditing IRS's financial statements, we performed agreed-upon procedures to assist the Transportation IG in assessing whether the net excise tax revenues distributed to the two trust funds for fiscal year 2002 were supported by underlying records. These agreed-upon procedures, in conjunction with additional testing by the Transportation IG, provided Transportation's IG sufficient basis to opine on the department's financial statements.

that allowed these errors to go undetected, nor did we discuss actions needed to address these weaknesses.⁴ This report discusses these weaknesses and presents our recommendations for corrective action.

Results in Brief

IRS's internal controls over its process for certifying excise taxes for distribution to federal government trust funds are not fully effective in ensuring that the appropriate amounts are distributed to the trust funds. Our work identified several internal control issues that affected the amounts distributed to trust funds quarterly and that could have affected total fiscal year distributions if IRS had not corrected errors resulting from these control issues after we brought them to its attention. The issues we identified include the following:

- IRS lacked effective procedures to timely detect errors made by employees when entering excise tax return information into its information systems. IRS did not detect such errors until months after they occurred. As a result, IRS understated certified collections to the Highway Trust Fund for the quarters ended December 31, 2001, and March 31, 2002. Although IRS subsequently identified and corrected the errors, it would not have had adequate time to correct them if these errors had occurred later in the fiscal year. Had that been the case, the amount of excise taxes distributed to the Highway Trust Fund would have been less than it should have been for fiscal year 2002.
- IRS lacked effective supervisory review to timely detect errors made in the preparation of excise tax certifications. As a result, amounts certified to trust funds were misstated for certain quarters during both fiscal years 2002 and 2001. IRS corrected the errors in the certifications after we brought them to its attention. Had we not identified the errors during our review and notified IRS, the amounts distributed to the Highway Trust Fund would have been approximately \$81 million less than they should have been during fiscal year 2002 and approximately \$1 million less than they should have been during fiscal year 2001.
- IRS did not effectively coordinate with other components of Treasury involved in the excise tax distribution process when it implemented changes to its method for recording excise tax credits in fiscal year 2002. As a result, IRS's system-generated certification data were not in a format usable by the Financial Management Service (FMS) or the Bureau of the Public Debt (BPD) to facilitate the recording of adjustments to trust funds. To make the data usable to FMS and BPD, IRS had to add steps to its certification process to generate the information in the previous reporting format. These added steps made IRS's already complex certification process even more cumbersome, increasing both the likelihood that errors could be made and that they could go undetected by supervisory review.

⁴In performing the agreed-upon procedures, we conducted our work in accordance with attestation standards established by the American Institute of Certified Public Accountants. These standards stipulate that reporting on such engagements be in the form of procedures and findings only.

In addition to these issues, we continued to find that IRS did not promptly certify excise tax collections to the trust funds. Under IRS's current certification process, excise tax receipts for the fourth quarter of the fiscal year, which ends September 30, are not certified until the following March. Because the Department of Transportation's financial statements are currently required to be issued by February 1 of the following year,⁵ adjustments to initial distributions of excise tax receipts for the last quarter of the fiscal year, based on IRS's certification, are not recorded in time to be reflected in the trust funds' financial statements. However, this lag time in making final adjustments will become more of an issue this year. Beginning with its fiscal year 2004 accountability report, the Department of Transportation, along with the other CFO Act agencies, will be required to issue its report, including its audited financial statements, by November 15, 2004.⁶

To help the transition to this earlier reporting date, the department is planning to accelerate the issuance of its fiscal year 2003 accountability report to December 2003. If the Department of Transportation accelerates its reporting date to December 2003 or earlier, certifications for the third and fourth quarters of the fiscal year would be completed too late for any adjustment to distributions resulting from the certifications to be made and reflected on the trust funds' financial statements under IRS's existing process. As a result, the amount of annual excise tax revenue distributed to the trust funds may not reflect the true amount that should have been distributed, potentially resulting in significantly inaccurate distributions and, in the case of the Highway Trust Fund, incorrect allocations of revenues to states.⁷

IRS has taken some actions to improve controls over the excise tax certification process, but additional action is needed to address the internal control issues we identified. We are making recommendations to further strengthen IRS's verification and review procedures to help ensure that trust funds receive the appropriate allocation of revenue in a timely manner and to assist IRS in considering changes to its procedures to accelerate the timing of its excise tax certifications.

In its comments, IRS generally agreed with our recommendations and described actions it was taking or planned to take to address the internal control issues described in this report. At the end of our discussion on each of these issues, we have summarized IRS's related comments and provided our evaluation.

⁵The Chief Financial Officers Act of 1990 (CFO Act), as expanded by the Government Management Reform Act of 1994, requires the Department of Transportation to annually submit audited financial statements to the Office of Management and Budget (OMB). OMB requires agencies to submit financial statements for fiscal year 2003 no later than February 1, 2004.

⁶Office of Management and Budget, Memorandum for Chief Financial Officers and Inspectors General (Washington D.C.: Oct. 18, 2002).

⁷The Transportation Equity Act for the 21st Century, Pub. L. No. 105-178, 112 Stat. 107 (1998), requires highway program funds to be distributed to states on the basis of annual Highway Account receipts information.

Background

The federal government levies excise taxes on entities and individuals for the purpose of financing general federal activities and specific government programs. Several bureaus and offices within Treasury collected a total of about \$69 billion in excise taxes in fiscal year 2002. IRS accounted for the majority, collecting about \$52 billion in excise taxes on the purchase, use, or inventory of various types of goods and services, such as gasoline and airline tickets. The processing of excise tax returns is centralized at IRS's Cincinnati Campus. The various excise taxes accounted for by IRS are deposited into the general fund⁸ of the Treasury and subsequently into seven different trust funds, which are administered by six federal agencies or entities. The largest of these trust funds are the Highway Trust Fund and the Airport and Airway Trust Fund, both of which are administered by the Department of Transportation. For fiscal year 2002, the Highway Trust Fund received about \$32.2 billion in excise tax revenues and the Airport and Airway Trust Fund received about \$8.9 billion.

Because it collects federal tax revenue and then distributes it to these government trust funds, Treasury is considered a servicing organization by trust fund administrators as well as by the auditors of these agencies. Consequently, the trust fund administrators and their auditors need to rely on Treasury, through its various bureaus and offices, including IRS, to properly account for and distribute amounts transferred from the government's general fund to their trust funds.

Payers of excise taxes generally are required to make semimonthly deposits to cover their quarterly tax liability. The excise taxes are deposited into the general fund as they are received. Taxpayers are not required to provide information at the time they make their excise tax payments that would allow Treasury to immediately apply the payments to the appropriate trust fund based on amount owed and paid. The information that ultimately determines how these receipts are distributed is generally submitted by taxpayers on Form 720, Quarterly Federal Excise Tax Return.⁹ Because data are not available to allocate excise taxes to the appropriate trust funds when taxpayers make their excise tax deposits, Treasury uses a process to estimate the initial distribution of excise taxes.

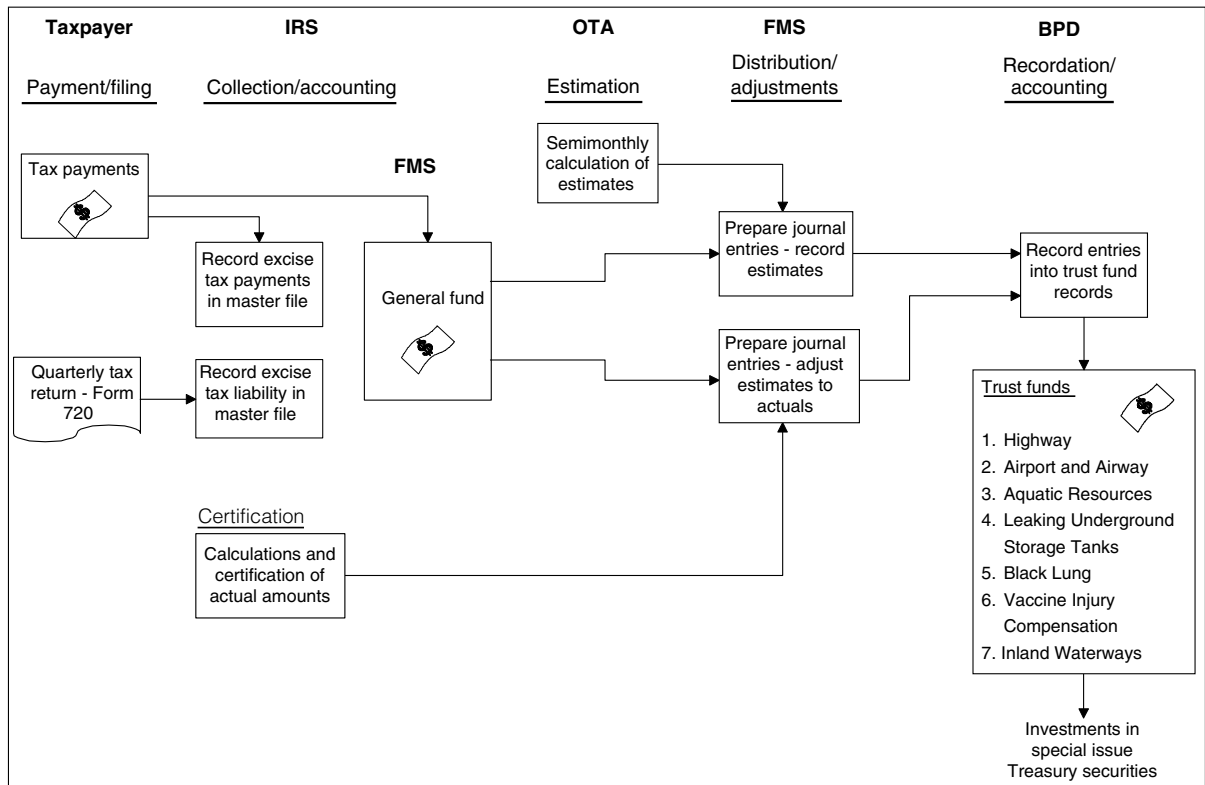
Treasury's Office of Tax Analysis (OTA) prepares semimonthly estimates based on historical IRS certification data and actual total current excise tax revenue collections. FMS uses these estimates to prepare entries for the initial distributions to the trust funds, which are recorded by BPD in the books and records of the trust funds maintained by Treasury. Subsequent to this initial distribution, IRS certifies

⁸The general fund accounts for receipts that are not earmarked by law for specific purposes, the proceeds of general borrowing, and the expenditure of these moneys for the general support of federal government activities.

⁹Taxpayers file the quarterly excise tax return to report their excise tax liability. Form 720 is generally due 30 days following the end of the quarter.

quarterly the amounts that should have been distributed to the excise tax–related trust funds based on the tax returns. FMS then uses these certifications to prepare adjustments to the initial trust fund distributions for each quarter, and BPD records the amounts on the trust fund books and records. Figure 1 provides an overview of the entire process of collecting, distributing, and certifying excise tax revenue reported to trust funds.

Figure 1: Overview of the Process for Distribution of Excise Tax Revenue to Trust Funds



Source: GAO.

IRS currently certifies collections for each quarter approximately 5 and one-half months after the end of the quarter. IRS relies on a combination of manual and automated procedures to prepare its certification of excise taxes to be distributed to the trust funds. This process is complex and cumbersome. IRS calculates the trust fund distributions based on assessment, credit,¹⁰ and payment information in the master file.¹¹ When taxpayers make their excise tax deposits, IRS enters payment information into the taxpayers' master file accounts. As quarterly excise tax returns are received, IRS enters the liability amounts by type of excise tax, such as gasoline tax, into taxpayers' master file accounts. The tax types are identified by certain

¹⁰An assessment represents the taxes owed by a taxpayer for a given period for a given tax. Typically, for excise taxes, this is the amount reported by the taxpayer on the Form 720 excise tax return. Taxpayers are allowed to claim excise tax credits for certain situations. For example, due to IRS's method for taxing fuel, there are situations when fuel could be taxed more than one time. Taxpayers are allowed to claim a credit for the second time the fuel is taxed.

¹¹The master file is a detailed database of taxpayer accounts.

numbers preprinted on the Form 720. IRS uses one set of numbers for tax assessments, referred to as abstracts, and another set for tax credits, referred to as credit reference numbers. For example, abstract 62 represents gasoline tax, and credit reference number 362 represents a credit claimed on gasoline tax. IRS uses these numbers to identify excise tax type information in its master file, and it is these numbers that ultimately determine how amounts are distributed to the appropriate trust funds.

IRS electronically transmits excise tax information from the master file to its Collection Certification System. The Collection Certification System uses the information to prorate¹² collections among the different excise taxes. The system then summarizes the amount of prorated collections, by tax type, on the Report of Excise Tax Collection. IRS uses the information from these reports as the basis for calculating the gross certified amount¹³ for each type of tax. IRS analysts enter the information from the Reports of Excise Tax Collection onto a series of interconnected electronic spreadsheets, which further combine prorated collection data and then allocate the gross prorated amount, for each type of tax, among the general fund, trust funds, and trust fund accounts.¹⁴ Analysts then record the allocated amount for each tax onto excise tax distribution certification letters.

IRS submits the certification letter to FMS, which uses it to prepare adjustments to the initial distributions to bring them in line with the IRS-certified amounts.¹⁵ FMS sends these adjustments to BPD, which records the entries in the books and records of the trust funds maintained by Treasury. Figure 2 shows IRS's process for certifying trust fund distributions.

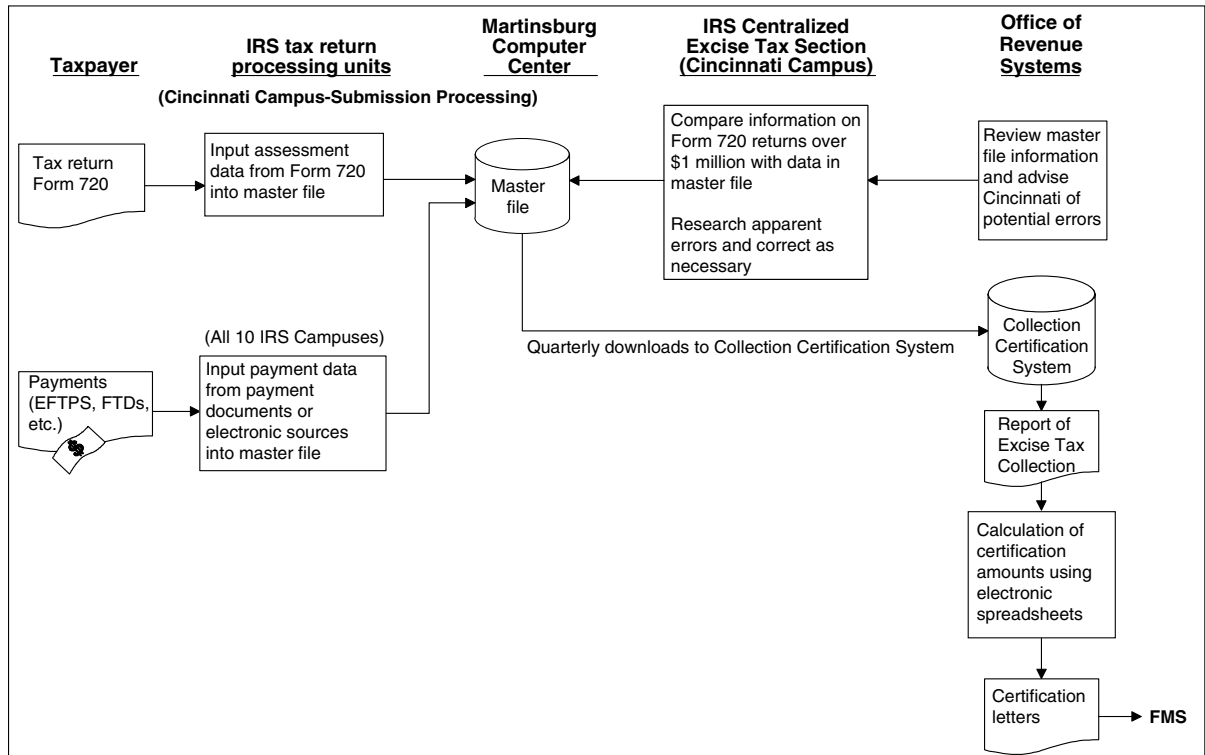
¹²IRS certifies to trust funds the amount of excise taxes actually collected. Because there are occasions on which taxpayers have not paid their full tax liability at the time of IRS's certification, IRS must allocate the amount of payments actually received among the different excise taxes reported on the taxpayer's return. IRS's Collection Certification System prorates a taxpayer's payments among all taxes reported owed on the tax return. For example, if a Form 720 indicates that the taxpayer owes \$4 million for gasoline tax, \$2 million for diesel fuel tax, and \$1 million for gasohol tax, but the taxpayer has paid IRS only \$3.5 million at the time IRS performs its certification, the program prorates the \$3.5 million in the following manner: \$2 million to gasoline tax, \$1 million to diesel fuel tax, and \$500,000 to gasohol tax.

¹³This is the total amount of certified collections for each tax (e.g., gasoline) prior to distribution between the general fund and trust fund.

¹⁴The tax amounts for certain taxes, such as some motor fuel taxes, are allocated among the general fund, the Highway Account of the Highway Trust Fund, and the Mass Transit Account of the Highway Trust Fund.

¹⁵This adjustment is determined by taking the IRS-certified amount and subtracting from it the initial distribution amount derived from the OTA estimate. If the resulting amount is positive, it is transferred from the general fund to the trust fund. If the resulting amount is negative, it is transferred out of the trust fund to the general fund.

Figure 2: Overview of IRS Process for Certifying Excise Tax Collections



Source: GAO.

In addition to its certification of excise tax receipts to trust funds, IRS performs a quarterly reclassification of excise tax refunds and credits. As part of its normal processing procedures, IRS initially records some excise tax refunds and credits as personal or corporate refunds and credits. These are refund and credit claims made by corporations or individuals who do not normally file excise tax returns but are entitled to claim excise tax-related credits on their corporate or personal income tax returns.¹⁶ IRS must subsequently reclassify these credit claims to properly reflect them as excise tax credits. IRS refers to these reclassifications as the excise tax refund/credit certification. IRS compiles the certification based on information from submission processing campus¹⁷ systems. IRS submits refund/credit certification letters to BPD, which uses them to prepare adjustments to reduce distributions to trust funds.

¹⁶Petroleum producers, who usually are assessed fuel excise taxes and pay them to IRS, pass on these taxes to consumers in the form of higher prices. Consumers who use the fuel for a tax-exempt purpose, such as farming, can claim a credit for the excise taxes on their personal or corporate income tax return.

¹⁷IRS has 10 submission processing campuses, which receive and process tax returns.

Objectives, Scope, and Methodology

The objective of the agreed-upon procedures work was to assist the Transportation IG in ascertaining whether the net excise tax collections and excise tax certifications reported by IRS for the fiscal year ended September 30, 2002, were supported by the underlying records. The objectives of this report are to (1) discuss the underlying internal control issues that allowed errors identified in the agreed-upon procedures work to occur, (2) discuss timing issues that have the potential to affect the accuracy of excise tax distributions, and (3) provide recommendations for effectively addressing these issues.

We conducted our work primarily from March 2002 through January 2003, with some follow-up work through April 2003, in accordance with U.S. generally accepted government auditing standards. We requested comments on a draft of this report from the Commissioner of IRS. We received written comments from the Deputy Commissioner for Operations Support and have reprinted the comments in enclosure I of this report. Further details on our scope and methodology are contained in enclosure II of this report.

Data Entry Errors Continue to Go Undetected

In conducting the agreed-upon procedures review for fiscal year 2002, we found that IRS made data entry errors affecting the accuracy of taxpayer account information in IRS's master file, and that these errors were not detected by existing review procedures. The lack of effective review procedures over the entry of excise tax data increases the risk that erroneous information will be used to prepare the quarterly excise tax certifications, resulting in incorrect distributions to trust funds.

GAO's *Standards for Internal Control in the Federal Government* requires agencies to implement internal control procedures to ensure the accurate and timely recording of transactions and events.¹⁸ It also states that internal controls should be designed to ensure that ongoing monitoring occurs in the course of normal operations.

In a previous review,¹⁹ we reported weaknesses in IRS's procedures for detecting data entry errors related to information reported on Form 720 excise tax returns. We recommended that IRS establish review procedures to ensure the accuracy of excise tax information entered into the master file. In response, IRS established post-input review procedures for excise tax returns that report a tax liability of \$1 million or more to verify that information on the returns matches data entered into the master file. However, IRS does not have comparable procedures for reviewing excise tax

¹⁸U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

¹⁹U.S. General Accounting Office, *Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds*, GAO/AIMD-99-17 (Washington D.C.: Nov. 9, 1998).

data entered using another excise tax–related form, Form 8849, Claim for Refund of Excise Taxes.²⁰

On January 1, 2002, IRS implemented new procedures for recording excise tax refunds and credits claimed by taxpayers. As part of this change, IRS established a new set of credit reference numbers to identify the type of excise tax refund or credit within a taxpayer’s master file account. For example, a claim for a \$200,000 refund on gasoline tax would be recorded as \$200,000 to credit reference number 362. Under IRS’s prior procedures, it would have recorded this refund as a negative \$200,000 under the abstract number 62. This new procedure affected how IRS recorded and summarized credit information necessary for excise tax certifications, but did not change how the credits should affect the taxpayer’s ultimate excise tax liability.

However, in testing a statistical sample of excise tax collections from the first 6 months of fiscal year 2002, we identified 17 instances in which IRS personnel entered the credit information into the taxpayer’s master file account using both the old and new method, which resulted in IRS counting these credits twice in the certification process. We estimate that the net most likely error associated with counting credits twice is an understatement of \$14.1 million, but the understatement could be as high as \$198.2 million. Although we projected the effect of these errors on the population of items tested, we are not able to project the effect on the certification results because of the additional procedures IRS performs on the data to derive certified amounts. However, the effect of double-counting credits resulted in distributing smaller amounts to the Highway Trust Fund than should have been distributed for the quarters ended December 31, 2001, and March 31, 2002.

Although IRS ultimately detected and corrected these errors, they were detected months later by personnel at IRS headquarters and not by reviewers at IRS’s Cincinnati Compliance Campus. According to IRS, the errors were attributable to one individual in the Cincinnati Compliance Campus’s Excise Tax Unit who did not fully comprehend the new procedures. We found that IRS did not have effective controls in its Cincinnati Excise Tax Unit to timely detect and correct such data entry errors. Some of these errors went uncorrected for 5 months or longer, and the corrections were not fully reflected until IRS completed its certification to the Highway Trust Fund for the quarter ending June 30, 2002. Thus, for the quarters ended December 31, 2001, and March 31, 2002, these errors resulted in amounts IRS certified to the Highway Trust Fund being understated. Because IRS made these corrections in time for their inclusion on the final certification reflected in the trust fund’s fiscal year-end financial statements, there was no net effect on distributions to the Highway Trust Fund for fiscal year 2002. Had these errors occurred later in the year, IRS would not have had the time to make corrections, and the amount of excise taxes distributed to the Highway Trust Fund would have been less than they should have been for fiscal year 2002.

²⁰Taxpayers use the Form 8849 to claim certain fuel-related refunds, such as nontaxable uses or tax paid on the resale of fuel previously taxed.

Having effective procedures to timely detect and correct data entry errors is essential to maintaining accurate excise tax information in IRS's master file. Since the excise tax data from IRS's master file serve as the basis for its certification of receipts to trust funds, the lack of these procedures could lead to erroneous excise tax data in IRS's master file, resulting in inaccurate certifications and distributions to trust funds.

Recommendation

We recommend that you direct IRS management to develop and implement post-input review procedures to verify the accuracy of excise tax credit information in the master file. In establishing these procedures, IRS could consider establishing a dollar threshold, similar to the threshold it established for its reviews of excise tax assessment information on the Form 720 excise tax returns, that would trigger post-input verification of excise tax credit information.

IRS's Comments and Our Evaluation

IRS agreed with our recommendation. In its response, IRS stated that it was working with the Cincinnati Compliance Campus to develop and implement post-input review procedures to verify the accuracy of excise tax credit information posted to the master file. We will evaluate the effectiveness of IRS's efforts in conjunction with our fiscal year 2003 agreed-upon procedures review.

Excise Tax Certification Errors Continue to Go Undetected

In conducting the agreed-upon procedures review for fiscal year 2002, we identified errors on IRS's excise tax certifications that were not detected by supervisory review. The lack of effective supervisory review increases the risk that errors will be made in the preparation of excise tax certifications and that such errors will not be detected on a timely basis, resulting in incorrect excise tax distributions to the trust funds.

GAO's *Standards for Internal Control in the Federal Government* requires agencies to implement internal control procedures to ensure the accurate and timely recording of transactions and events. In addition, *Standards for Internal Control in the Federal Government* requires that qualified and continual supervision be provided to ensure that internal control objectives are achieved.

As discussed previously, IRS relies on a combination of manual and automated procedures to prepare its excise tax certifications. This process is very complex, cumbersome, and prone to error. In prior reviews,²¹ we reported weaknesses in IRS's controls over its certification process. At that time, we recommended that IRS (1) develop, document, and implement detailed written procedures for summarizing data used to prepare trust fund certifications, (2) establish procedures requiring IRS personnel to review distribution rates provided by OTA before those rates are used in the certification, and (3) implement review procedures over its process for

²¹GAO/AIMD-99-17 and U.S. General Accounting Office, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GA0-01-42 (Washington D.C.: Nov. 17, 2000).

summarizing data used in its certifications. In response to our prior recommendations, IRS created a checklist to guide reviewers and document the review of the certification results. In addition, IRS finalized written procedures for its certification process in November 2002.

Although the checklist assists IRS reviewers in identifying simple mathematical errors, we continued to find logical and analytical errors in fiscal year 2002 that were not detected by supervisory review. For example, a report used by an IRS analyst to prepare the refund certification for the quarter ended December 31, 2001, contained erroneous amounts for gasohol and bus diesel fuel tax refunds. As a result, IRS overstated its refund certification for the Highway Trust Fund for the quarter by approximately \$81 million. We readily identified the error because the reported amounts for one of these taxes varied significantly from previous quarters. Nevertheless, IRS did not detect the error even though the certification results passed through multiple levels of review. Had IRS not made a correction after we brought the matter to its attention, distributions to the Highway Trust Fund would have been approximately \$81 million less than they should have been in fiscal year 2002.

In another instance, we discovered that IRS reported refund amounts as credits and credit amounts as refunds on its refund/credit certification letters for both the Highway Trust Fund and the Airport and Airway Trust Fund for the quarter ended September 30, 2002. Generally, IRS-certified refunds for the Highway Trust Fund are one and a half times as large as the certified credits for the fund. To have a situation where the opposite occurred should have alerted the reviewer to a potential error. Although we readily identified the errors during our review of the schedule accompanying the certification letter, IRS did not detect the errors through its review process. These errors did not affect the accuracy of the distributions to the Highway Trust Fund or the Airport and Airway Trust Fund in fiscal year 2002 because BPD adjusts trust fund distributions using the combined amount of refunds and credits. However, this is an example of a logical error that was not detected by IRS reviews.

We had identified similar problems in our fiscal year 2001 review. Specifically, IRS also reported refunds as credits and credits as refunds on its refund/credit certification for the quarter ended March 31, 2001. Also, in our fiscal year 2001 review, we found that IRS used the wrong excise tax and distribution rates for 10 percent gasohol on its Highway Trust Fund receipt certification for the quarter ended March 31, 2001. The IRS analyst used the excise tax and distribution rate table that was in effect on December 22, 2000, rather than the rate table that became effective on January 1, 2001. Consequently, IRS misstated certified collections to both the Highway Account and the Mass Transit Account of the Highway Trust Fund, resulting in about \$1 million less being distributed to the Highway Trust Fund.

In response to our finding that it had reversed reported refund and credit amounts in 2002, IRS added another step to the review checklist to prevent this error. However, while the checklist can assist reviewers in verifying certification results, it cannot substitute for an in-depth understanding of the certification process. For example, although the checklist contains a specific procedure to verify that the analyst used the correct tax and distribution rate for each type of taxable good or service (e.g., for

gasohol), it does not assist a reviewer in determining whether the analyst used the correct rate table (e.g., for the correct time period). Adding another step to the checklist each time a new problem surfaces will not ensure that proper reviews of the certification results are conducted.

While we do not specifically know why IRS's supervisory review procedures failed to detect these errors, we did note a lack of consistency in the supervisory review responsibility. Specifically, during fiscal year 2002, four different officials were responsible for reviewing the certifications. A comprehensive understanding of IRS's certification process is essential to detecting logical and analytical errors made by analysts. Absent this understanding, officials responsible for reviewing excise tax certifications may continue to lack the ability to perform an effective review of the certifications. Given the errors we continue to find in our review of IRS's certification process and their potential to significantly affect the accuracy of the associated distributions to trust funds, more needs to be done to ensure that supervisory reviews over the certifications are effective.

Recommendations

We recommend that you direct IRS management to

- investigate why certification errors continue to go undetected through IRS's review procedures and
- develop and implement an action plan to improve the certification review process.

IRS's Comments and Our Evaluation

IRS agreed with our recommendations. In its response, IRS stated that it has a new management team in place to review the current excise tax certification process and to develop an action plan for improving the certification reviews. We will evaluate the effectiveness of IRS's efforts in conjunction with our fiscal year 2003 agreed-upon procedures review.

Changes to Certification Process Were Not Effectively Coordinated

As discussed earlier, the collection, distribution, and certification of excise tax revenues to trust funds are performed by four component entities within Treasury—OTA, FMS, BPD, and IRS. Coordination among these entities is essential to ensure the proper distribution of excise tax revenue to trust funds. In a prior review, we reported a deficiency in IRS's procedures for using OTA information in its certification process. Specifically, we reported that IRS used tax and distribution rates from OTA without first verifying their accuracy.²² In response, IRS established an informal working group within Treasury specifically to discuss and coordinate issues related to trust fund tax revenue distributions. However, in conducting our

²²GAO/AIMD-99-17.

agreed-upon procedures review for fiscal year 2002, we noted that effective coordination was not always achieved.

As we previously discussed, IRS, as part of its receipt certification process in prior years, deducted credits claimed by taxpayers from their excise tax liability before applying their payments to the liability amount. Thus, IRS-certified excise tax receipts were reduced by credit claims. However, IRS believed that the information would be more useful, both internally and to the Department of Transportation, if it summarized and reported these credits separately rather than applying them against the tax liability amount. Therefore, in fiscal year 2002, IRS developed changes to the way it records credit information in its computer systems, as well as to the way it accounts for and reports this information in its certifications.

On January 1, 2002, IRS implemented these procedural and system changes to its method for recording and summarizing excise tax credits, including changes to its procedures for recording taxpayer refund claims submitted on Form 8849. Although IRS officials told us that they had notified the Treasury working group of the planned changes, this notification was not documented in the form of a letter, memorandum, or minutes to the Treasury working group meeting. Further, IRS did not obtain written affirmation from FMS or BPD that these entities understood the effect these changes would have on the information reported to them. In fact, FMS and BPD were unable to use the revised form of certification information to make necessary adjustments to the trust fund distributions. Consequently, IRS had to add steps to its certification process to revert to its previous reporting format in order to make its certification data usable to these entities. As a result, IRS further complicated its already complex certification process. Although we did not identify any certification errors directly attributable to the changes in procedure, the added complexity increases the likelihood that errors could be made and go undetected by IRS's current review procedures.

Recommendation

We recommend that you direct IRS management to communicate in writing any potential changes in IRS's certification process to other Treasury entities that use the certification information, and to obtain concurrence from these entities prior to implementing such changes.

IRS's Comments and Our Evaluation

IRS agreed with our recommendation. In its response, IRS stated that it plans to provide documented recommendations to the excise tax working group for potential changes to the certification process. We will evaluate the effectiveness of IRS's actions in conjunction with our fiscal year 2003 agreed-upon procedures review.

Certification Time Frame Will Not Accommodate Accelerated Reporting

As discussed previously, under IRS's current certification process, IRS certifies collections for each quarter about 5 and one-half months after the quarter ends. As a result of this delay, excise tax receipts for the fourth quarter of fiscal year 2002, which ended September 30, 2002, were not certified until March 2003. Consequently, adjustments to initial distributions of excise tax receipts for the fourth quarter that were based on IRS's certification were not recorded in time to be reflected in the trust funds' financial statements for fiscal year 2002, which OMB required to be issued by February 1, 2003.

Beginning with agencies' fiscal year 2004 performance and accountability reports, OMB will require the issuance of these reports, including the agencies' audited financial statements, by November 15. To prepare for this, the Department of Transportation is planning to accelerate its fiscal year 2003 reporting date to December 2003. This accelerated reporting date will exacerbate the effects of the lag between the collection of excise tax receipts and their subsequent certification by IRS. As a result, under the current certification time frame, IRS's certification for the third quarter, historically completed in December, would not be completed in time for any adjustments to the initial distribution to the trust funds to be made and reflected on the trust funds' financial statements for fiscal year 2003. Because the certification of fourth quarter excise tax receipts also would not be completed prior to the issuance of the financial statements, this means that 6 months of excise tax distributions reported in the trust funds' financial statements would not have been certified by IRS, increasing the potential for significantly inaccurate distributions.

We believe the opportunity exists for IRS to accelerate the timing of its excise tax receipt certifications. IRS has indicated that it needs the 5 and one-half month period between the end of a quarter and completion of the certification to allow for submission and processing of returns and for recording, reviewing, and analyzing payment and tax return data. However, our review of IRS's certification data for 4 quarters²³ shows IRS has historically received and recorded at least 90 percent of the Form 720 excise tax returns related to the Highway Trust Fund and the Airport and Airway Trust Fund 2 months prior to its cutoff for initiating the certification. Our analysis further shows that fewer than 100 of the largest payers of excise taxes—those with liabilities of \$10 million or more per quarter—account for over 91 percent of certified receipts to the Highway Trust Fund and over 85 percent of certified receipts to the Airport and Airway Trust Fund.

The combination of (1) excise taxes reported in tax returns with liability amounts below \$10 million that are received and recorded by IRS 2 months prior to its certification cutoff and (2) excise taxes reported in tax returns with liability amounts

²³We reviewed data from IRS's Collection Certification System and master file from the quarters ended June 30, 2001, September 30, 2001, December 31, 2001, and March 31, 2002. IRS had made these data available to us for our fiscal years 2002 and 2001 agreed-upon procedures reviews and IRS financial statement audits.

of \$10 million or more accounts for more than 96 percent of the taxes IRS certified to both the Highway Trust Fund and the Airport and Airway Trust Fund for those quarters. Therefore, IRS could accelerate the timing of its certifications of excise tax receipts to the Highway Trust Fund and the Airport and Airway Trust Fund by at least 2 months by implementing procedures to ensure that it has timely received and recorded tax returns from the largest payers of excise taxes.

In each of the 4 quarters we reviewed, IRS data indicate that it has generally received over 70 percent of the large returns 2 weeks after the return due date. By taking a more proactive approach—tracking the status of these taxpayers’ returns, following up with those who have not filed timely to encourage filing, and ensuring prompt processing of large returns—we believe IRS should be able to accelerate completion of its certification of excise tax receipts without significantly increasing the potential for large amounts of quarterly receipts to go uncertified.

Unless IRS establishes procedures to allow it to significantly accelerate its certification of excise tax revenues to trust funds, the amount of annual excise tax revenues reported by the Department of Transportation for the Highway Trust Fund and the Airport and Airway Trust Fund for fiscal year 2003 and beyond will include 6 months of excise tax revenue distributions based on estimates. To the extent these estimates differ significantly from the actual amounts that should have been distributed to the trust funds, the result could be both significantly inaccurate distributions and, in the case of the Highway Trust Fund, incorrect allocations of revenues to states.²⁴

Recommendations

To enable IRS to accelerate its excise tax receipt certification process, we recommend that you direct IRS management to implement procedures to proactively ensure the timely receipt and recording of the largest excise tax returns. Specifically, IRS management should develop and implement procedures at the Cincinnati Campus to

- annually identify excise taxpayers with the largest excise tax liabilities affecting the Highway Trust Fund and the Airport and Airway Trust Fund. In identifying these taxpayers, IRS should consider the potential effect on trust fund distributions if one or more of these taxpayers’ returns were omitted from its certification;
- track the status of tax return filings for the largest payers of excise taxes and contact these taxpayers if the submission processing campus has not received their tax returns by 2 weeks after the due date; and

²⁴The Transportation Equity Act for the 21st Century, Pub. L. No. 105-178, 112 Stat. 107 (1998) enhanced the link between the amount of funds received by states and the amount of tax receipts credited to the Highway Trust Fund by requiring that highway program funds be distributed to states on the basis of annual highway account receipts.

- monitor the receipt and processing status of these large returns to ensure that they are promptly recorded in IRS's master file prior to certifying excise tax distributions.

IRS's Comments and Our Evaluation

IRS agreed with this issue and indicated that it is taking action to address our findings. In its response, IRS stated that it would identify and provide a list of the top 100 excise taxpayers to the Cincinnati Submission Processing and Compliance Campuses for the identification and expedited processing of these taxpayers' returns. Additionally, IRS stated it was working with the Cincinnati Compliance Campus to implement additional monitoring of the top 100 excise taxpayers to ensure timely receipt of excise tax returns and will conduct an analysis of these taxpayers' receipt pattern to support modifying IRS's current timeline for contacting the taxpayers for submission of their returns.

While IRS does not plan to accelerate its certification of excise tax receipts to trust funds for the third quarter of fiscal year 2003, it stated that it would conduct "mock" nonpublished certifications to determine the impact of an accelerated 4-month certification on all trust funds. In our discussions with IRS officials, they have stated that IRS plans to share this information with the Department of Transportation's auditors so that they can determine the extent to which adjustments may be required to reported excise tax revenues on the trust funds' fiscal year 2003 financial statements. We will evaluate IRS's actions in conjunction with our fiscal year 2003 agreed-upon procedures review.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should send your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform within 60 days after the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this report.

This report is intended for use by the management of IRS. We are sending copies to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Transportation, Treasury and General Government, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; and the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Senate Committee on Government Affairs. We are also sending copies to the Chairmen and Ranking Minority Members of the House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Transportation, Treasury, and Independent Agencies, House Committee on

Appropriations; Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform; and the Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Director of the Office of Management and Budget, the Secretary of the Treasury, the Secretary of Transportation, and the Inspector General of the Department of Transportation. Copies will be made available to others upon request. The report is also available at no charge on GAO's Internet site, at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by IRS officials and staff during our fiscal year 2002 review. If you have any questions or need assistance in addressing these matters, please contact Charles Payton, Assistant Director, at (213) 830-1084.

Sincerely yours,

A handwritten signature in cursive script that reads "Steven J. Sebastian".

Steven J. Sebastian
Director
Financial Management and Assurance

Enclosure I

Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

JUL 16 2003

Mr. Steven J. Sebastian
Director
Financial Management and Assurance
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Sebastian:

I reviewed the General Accounting Office (GAO) draft report titled, *Improvements Needed In Controls Over IRS's Excise Tax Certification Process (GAO-03-687R, June 2003)*. Over the last several years, we have adopted numerous improvements to ensure the adequacy of our excise tax certification process and internal controls. We have an excellent program in place to monitor our performance in these areas. For example, we

- Developed and published Internal Revenue Manual (IRM) 1.8.3, Procedures for the Certifications, Refunds and Credits, documenting excise tax certification reporting activities
- Coordinated with the Cincinnati field personnel to develop and implement post-processing procedures for claims related to excise tax returns
- Trained supervisors to look for relevant items when reviewing and approving excise tax trust fund certifications
- Coordinated the result of a new refund and credit certification process with the other Treasury bureaus and Trust Fund entities

We agree with the issues presented in the draft report. We have already taken actions to address the recommendations. I would like to comment on the four recommendations of your report.

Recommendation: We recommend that you direct IRS management to develop and implement post-input review procedures to verify the accuracy of excise tax credit information in the master file. In establishing these procedures, IRS could consider establishing a dollar threshold, similar to the threshold it established for its review of excise tax assessment information on the Form 720 excise tax returns that would trigger post-input verification of excise tax credit information.

Corrective Action: We are working with the Cincinnati Compliance campus senior management to develop and implement post-input review procedures to verify the accuracy of excise tax credit information posted to the master file. We anticipate implementation by September 30, 2003.

Recommendation: We recommend that you direct IRS management to investigate why certification errors continue to go undetected through IRS's review procedures and develop and implement an action plan to improve the certification review process.

Corrective Action: We have a new management team in place to review the current excise tax certification process and to develop an action plan for improving the certification reviews.

Recommendation: We recommend that you direct IRS management to communicate in writing any potential changes in IRS's certification process with other Treasury entities that use the certification information, and to obtain concurrence from these entities prior to implementing such changes.

Corrective Action: The IRS is a standing member of the Treasury Excise Tax Working Group comprised of subject matter experts from Department of the Treasury's Bureau of Public Debt (BPD), Financial Management Service (FMS), Office of Cash & Debt Management (OCDM), and Office of Tax Analysis (OTA). The working group, which meets at least quarterly, was formed to address internal and external issues related to excise tax revenue receipts, certification, and allocation of funds to Trust Fund recipients.

We implemented in January 2002 the transcription of Form 720, Quarterly Federal Excise Tax Return, Schedule C information. We discussed this with the Excise Tax Trust Fund Working Group prior to implementation. This change was to reduce the labor intensive and error prone manual copying of data from Schedule C claims to pages one and two of the Form 720. This change provides IRS with total liability by type of tax and not a netted total from the Form 720.

Based on the first year results and analysis of this transcription change, we will provide documented recommendations to the Excise Tax Trust Fund Working Group for potential changes to the certification process.

Recommendation: To enable IRS to accelerate its excise tax receipt certification process, we recommend that you direct IRS management to implement procedures to proactively ensure the timely receipt and recording of the largest excise tax returns. Specifically, IRS management should develop and implement procedures at the Cincinnati Service Center Campus to

- Annually identify excise taxpayers with the largest excise tax liabilities affecting the Highway Trust Fund and the Airport and Airway Trust Fund. In

identifying these taxpayers, IRS should consider the potential effect on trust fund distributions if one or more of these taxpayers' returns were omitted from its certification;

- track the status of tax return filings for the largest payers of excise taxes and contact these taxpayers if the service center has not received their tax return by 2 weeks after the due date; and
- monitor the receipt and processing status of these large returns to ensure that they are promptly recorded in IRS's master file prior to certifying excise tax distributions.


Comments: We agree to conduct a pilot consisting of mock, non-published, certifications for four quarters (June 2003 through March 2004) to determine the impact of an accelerated four-month certification on all Trust Fund recipients while maintaining the current six-month certification. We will provide documentation of our analysis of the mock certification compared to the actual certification to the Excise Tax Trust Fund Working Group and your staff to ascertain the impact on smaller trust fund recipient investment activities.

We will identify and provide a list of the top 100 excise taxpayers to the Cincinnati Submission Processing and Compliance Campuses for the identification and expedited processing of these taxpayer's returns.

We are working with the Cincinnati Compliance Campus to implement additional monitoring of the top 100 excise taxpayers to ensure timely receipt of excise tax returns. We have procedures in place to verify receipt of Form 720 "million-dollar" returns and correct posting of the data on these returns to the master file. We will also conduct an analysis of the top 100 excise taxpayers' receipt pattern to support modifying the current timeline for contacting taxpayers for the submission of their returns. This analysis will run concurrent with the mock certification pilot.

I appreciate your input and will continue to take the necessary steps to improve our excise tax certification process. With the continued dedication and cooperation of both our staffs, we will further enhance our excise tax certification procedures and internal controls. If you have any questions, or would like to discuss this response in more detail, please contact Greg Kane at (202) 435-5346.

Sincerely,


John M. Dalrymple
Deputy Commissioner for Operations Support

Enclosure II

Objectives, Scope, and Methodology

The objective of the agreed-upon procedures work was to assist the Inspector General of the Department of Transportation in ascertaining whether the net excise tax collections and excise tax certifications reported by IRS for the fiscal year ended September 30, 2002, were supported by the underlying records. We did not perform work on excise taxes collected by other Treasury bureaus, such as the Customs Service and the Bureau of Alcohol, Tobacco, and Firearms.

In performing the agreed-upon procedures, we gained an understanding of the internal controls over the excise tax collection and certification process. The objectives of this report were to (1) discuss the underlying internal control issues that allowed errors identified in the agreed-upon procedures work to occur, (2) discuss timing issues that have the potential to affect the accuracy of excise tax distributions, and (3) provide recommendations for effectively addressing these issues.

To accomplish our objectives, we examined, on a test basis, evidence supporting the net excise tax collection amounts related to the Highway Trust Fund and the Airport and Airway Trust Fund reported in the Collection Certification System. We used dollar unit sampling to select a sample of 94 prorated Highway Trust Fund–related excise tax collections from the audit files²⁵ for the first 6 months of fiscal year 2002, using a confidence level of 80 percent, a test materiality of \$315 million, and an expected error amount of \$94.5 million.

We selected a sample of 62 prorated Airport and Airway Trust Fund–related excise tax collections from the audit files for the first 6 months of fiscal year 2002, using a confidence level of 80 percent, a test materiality of \$91 million, and an expected error amount of \$27.3 million.

For each prorated excise tax collection sampled, we

- checked to see that the assessment amount on the tax return for the sampled abstract agreed with the amount recorded in IRS’s master file,
- checked the mathematical accuracy of the taxpayers’ calculations on the tax returns for the related abstract, and
- recomputed the prorated collection amount based on information from the master file and compared this amount to the sample items selected from the Collection Certification System audit file.

We also performed detailed testing on the population of collections not designated as related to the Highway Trust Fund or the Airport and Airway Trust Fund to determine

²⁵The Collection Certification System produces what IRS refers to as “audit files.” These audit files contain the individual prorated collections, by abstract and taxpayer identification number, that make up the certified total amounts for each abstract.

if they contained any Highway Trust Fund or Airport and Airway Trust Fund excise tax collections.

Further, we performed the following procedures on IRS's certifications:

- We verified the mathematical accuracy of the totals on the certification letters for the Highway Trust Fund and Airport and Airway Trust Fund.
- We traced certified amounts for selected excise taxes from the certification letters through summary schedules to the supporting reports.

To determine the percentages of amounts certified to the Highway Trust Fund and Airport and Airway Trust Fund that are accounted for by excise tax returns with liabilities of \$10 million or more and the amounts from other excise tax returns received and recorded in IRS's master file 2 months earlier than the certification cutoff, we analyzed IRS's Collection Certification System and master file data. IRS made these sources available to us for our fiscal years 2002 and 2001 agreed-upon procedures reviews and fiscal years 2002 and 2001 IRS financial statements audits. These included the audit support files from the quarters ended June 30, 2001, September 30, 2001, December 31, 2001, and March 31, 2002. Using these data, we

- identified excise tax returns by tax period and categorized excise taxes for the tax returns identified that related to the Highway Trust Fund and the Airport and Airway Trust Fund using data from IRS's audit support file, and
- summed the amounts related to the Highway Trust Fund and the Airport and Airway Trust Fund for all tax returns with tax liabilities of \$10 million or more and amounts related to tax returns with liabilities below \$10 million that had been recorded in IRS's master file 2 months earlier than the certification date.

We conducted our work primarily from March 2002 through January 2003, with some follow-up work through April 2003, in accordance with U.S. generally accepted government auditing standards.

We requested comments on a draft of this report from the Commissioner of IRS. We received written comments from the Deputy Commissioner for Operations Support.

Enclosure III

GAO Contacts and Staff Acknowledgments

GAO Contacts

Charles E. Payton, (213) 830-1084
Ted Hu, (213) 830-1108

Acknowledgments

Staff making key contributions to this report were David Elder, Gail Luna, Esther Tepper, Julia Matta, and Sharon Byrd.

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