Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution

January 2005

Reference Number: 2005-30-022

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

January 21, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit
(Small Business and Corporate Programs)

SUBJECT: Final Audit Report - Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution (Audit # 200430004)

This report presents the results of our review of the Internal Revenue Service's (IRS) Excess Collections File (XSF).[1] The overall objective of this review was to determine the financial effect and taxpayer burden on credit balance accounts that are not resolved before the IRS transfers large-dollar payments into its XSF.

In summary, the IRS' internal controls for resolving cases before transferring large-dollar payments to its XSF are not adequate. We concluded that large-dollar payments are being transferred without sufficient research or contact with taxpayers. When payments are transferred to the XSF without effective case resolution, the IRS may be subjecting taxpayers to unwarranted notices. Also, by transferring payments without obtaining the associated tax returns, the IRS is not assisting taxpayers in meeting their obligations to file their tax returns and pay their taxes due. We concluded that if controls were adequate, 25 percent of the dollars in the XSF could have been credited to taxpayers' accounts.

[1] The XSF contains payments/credits that cannot be applied to a taxpayer's account. These payments/credits are generally caused by one of a limited number of conditions, such as when a taxpayer submits a tax payment but does not file a tax return, when a taxpayer files a tax return past the time period to receive a refund, or when the IRS is unable determine to which taxpayer account to apply a payment. The IRS sends correspondence to the taxpayer regarding these payments/credits before transferring them.

Our analysis of the XSF showed the overall file had grown 65 percent during a 4-year period. In March 1999, the XSF contained approximately $2.3 billion,[2] but it had risen to approximately $3.8 billion through October 2003.

A review of 88 taxpayer accounts[3] with at least 1 tax module[4] totaling $1 million or more in at least 1 tax period[5] identified 57 taxpayers with tax modules involving approximately $931 million that could have been resolved and prevented from being transferred to the XSF. We identified two major types of cases. In 1 type of case, 29 of the 57 taxpayer accounts had payments transferred because the taxpayers did not file tax returns for which they were liable. In the other type of case, 28 of the 57 taxpayer accounts had payments transferred due to insufficient IRS employee research or IRS employee contact with the taxpayers, or improper adjustments to the taxpayers' accounts.

We recommended the Director, Customer Account Services, Wage and Investment Division, change case resolution procedures to allow for additional research and contact with taxpayers and to ensure better coordination with each business division before tax modules with a credit balance are closed. We also recommended the IRS implement procedures for large-dollar cases to require field contact to obtain delinquent returns or follow procedures required by the Internal Revenue Code[6] for nonfilers. Finally, we recommended additional managerial oversight to assist in case resolution to prevent erroneous payment transfers.

Management's Response: The IRS generally agreed with the intent of the recommendations. The Director, Customer Account Services, Wage and Investment Division, will form a task group with representatives from each operating division to review their current procedures, the cases we reviewed, and our recommendations. They expect to convene the task group by January 31, 2005, and anticipate the group's findings and recommendations by October 2005.

The IRS did not fully agree with the Outcome Measures contained in Appendix IV. They did not agree with the benefit of $855 million associated with the 29 taxpayers who failed to file a return. They believe taxpayers who failed to file a proper tax return did not comply with their legal obligation and, therefore, put themselves at risk. The IRS response stated that the IRS is not obligated to file returns on the taxpayer's behalf under the provisions of Internal Revenue Code (I.R.C.) 6020(b).

IRS management did agree with the benefit associated with the 28 taxpayers with payments of $76 million that were attributed to insufficient research or contact or an

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[2] *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* (Reference Number 2000-30-088, dated June 2000).
[3] We analyzed 88 taxpayer accounts during our review. However, one taxpayer had two tax modules that appeared in two different categories.
[4] A record of tax data for a taxpayer covering only one type of tax for one tax period. A taxpayer may have more than one tax module.
[5] Identifies the time covered by a return or an account (e.g., tax period ending December 2003).
[6] 26 U.S.C. § 6020(b) (2004).

improper adjustment. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We recognize the numerous systemic and procedural improvements the IRS has made to the management of the XSF during the past 3 years. While these improvements have made it possible for the IRS to perfect many payments and apply them to the proper taxpayer accounts, we believe the IRS could do more to assist those taxpayers, especially government entities, in complying with filing requirements. Our results show that the majority of the outcome measures are associated with government agencies that did not file a tax return.

There are a variety of reasons why we believe it is appropriate for the IRS to file returns for taxpayers in these cases.

- The I.R.C. states, "If any person fails to make any return required by any Internal Revenue Law or regulation . . . the Secretary [of the Treasury] shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise." Although the IRS may not be obligated to file returns for taxpayers, they do have the legal authority to do so.
- Our results show that 51 percent of the cases we reviewed had taxpayer accounts totaling almost $855 million and had at least 1 tax module that required a tax return to be filed. These taxpayers submitted substantial payments for tax compliance purposes and have a filing requirement; therefore, it would be appropriate for the IRS to follow its existing procedures for preparing a tax return when attempts to obtain a voluntary tax return fail.
- The Large and Mid-Size Business Division performed an independent study because of concern that there may be a large amount of unpaid taxes due for non-filed tax returns. From its sample of large-dollar tax modules, the IRS was able to secure tax returns from most of the taxpayers.
- The IRS response of not using the provisions of the I.R.C. appears inconsistent with its Non-Filer Strategy, the purpose of which is to identify cases for which the IRS can obtain a tax return and assess a tax liability. The objective is to ensure taxpayers who are legally required to file do so and to address those individuals who are not required to file but may be due refunds or credits.
- In our opinion, which is supported by IRS studies, taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability.

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

Table of Contents

Background

The Internal Revenue Service (IRS) has established a system of internal controls to ensure taxpayer payments and the associated documents are properly applied to a taxpayer's Master File[1] account. When payments and the associated documents are not received and/or processed as expected, the Accounts Maintenance (AM) function at each IRS campus[2] is responsible for ensuring general account resolution. After AM function research has been performed and Internal Revenue Manual (IRM) procedures have been followed, if a payment cannot be applied to an account, the payment is over 1 year old, and the case is still not resolved, the payment is transferred to the Excess Collections file (XSF).

Our analysis of the overall XSF showed it had grown 65 percent during the 4-year period from March 1999 (approximately $2.3 billion[3]) through October 2003 (approximately $3.8 billion[4] involving more than 1.9 million tax modules).[5]

The XSF generally contains payments that cannot be applied to the proper tax account. In our opinion, taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability. The payments that eventually go to the XSF are generally caused by one of a limited number of conditions, such as when a taxpayer submits a tax payment but does not file a tax return, when a taxpayer files a tax return past the time period to receive a refund,[6] or when the IRS is unable to determine to which taxpayer's account to apply a payment.

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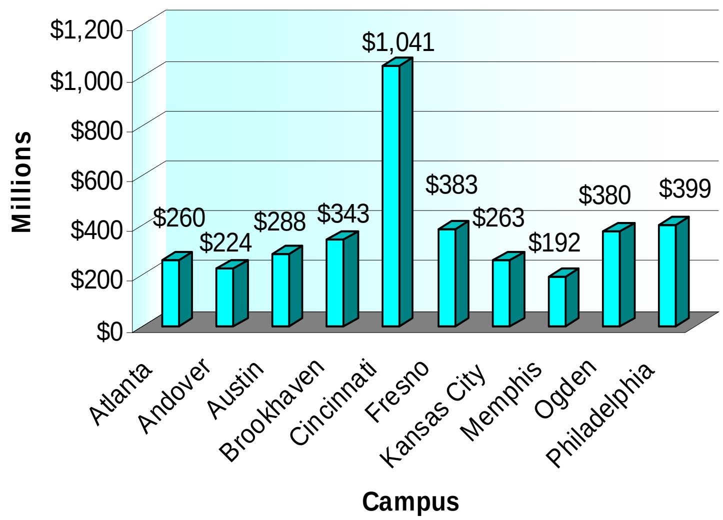
[1] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward the data to the Computing Centers for analysis and posting to taxpayer accounts.
[3] *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* (Reference Number 2000-30-088, dated June 2000).
[4] We obtained a data extract as of October 2003.
[5] A record of tax data for a taxpayer covering only one type of tax for one tax period. A taxpayer may have more than one tax module.
[6] 26 U.S.C. § 6511 (2004).

The IRM instructs employees to perform research on each payment before adding it to the XSF, regardless of the dollar amount of the item. Both large- and small-dollar cases are to receive equal attention, but large-dollar cases will be worked first. Figure 1 shows the total dollars for the XSF maintained at each campus.

Figure 1: Total Dollars in the XSF for Each Campus



Source: Data extract obtained by the Treasury Inspector General for Tax Administration (TIGTA) as of October 2003.

This audit was performed at the IRS Philadelphia Campus and included analyses of the 10 campuses' XSFs during the period October 2003 through August 2004. We interviewed IRS management from the Wage and Investment (W&I) Division in Atlanta, Georgia, and Cincinnati, Ohio; the Small Business/Self-Employed (SB/SE) Division in Cincinnati, Ohio, and New Carrollton, Maryland; and the Large and Mid-Size Business (LMSB) Division in Washington, D.C. We coordinated and validated our analyses of the individual cases with the SB/SE Division Accounts Management unit staff at the Philadelphia Campus.

The audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Procedures for Transferring Large-Dollar Payments to the Excess Collections File Are Not Adequate for Case Resolution

The IRS' internal control procedures for transferring large-dollar payments to its XSF are not adequate. We concluded that large-dollar payments are being transferred to the XSF without sufficient research or contact with taxpayers. If controls were adequate, 25 percent of the dollars in the XSF could have been credited to taxpayers' accounts.

When payments are transferred to the XSF without effective case resolution, the IRS may be subjecting taxpayers to unwarranted notices. Also, by transferring payments without obtaining the associated tax returns, the IRS is not assisting taxpayers in meeting their obligations to file their tax returns and pay their taxes due.

Our analysis of 88 taxpayer accounts[7] with at least 1 tax module totaling $1 million or more in at least 1 tax period[8] identified 57 taxpayers with tax modules involving approximately $931 million that could have been resolved and prevented from being transferred to the XSF. The inadequate internal controls allowed filing noncompliance or improper adjustments to taxpayer accounts.

- Twenty-nine (51 percent) of 57 taxpayer accounts, totaling almost $855 million, had at least 1 tax module that required a tax return to be filed. Because these taxpayers submitted payments and have a filing requirement, the IRS should have followed procedures for preparing a tax return as prescribed by the Internal Revenue Code (I.R.C.)[9] when attempts to obtain a voluntary tax return failed. In some cases, taxpayers had filed the same type of return(s) for the tax periods before and after the subject periods.
- Twenty-eight (49 percent) of 57 taxpayer accounts had payments totaling almost $76 million transferred due to insufficient IRS employee research or contact with the taxpayers, or an improper adjustment to the account.

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[7] We analyzed 88 taxpayer accounts during our review. However, one taxpayer had two tax modules that appeared in two different categories.
[8] Identifies the time covered by a return or an account (e.g., tax period ending December 2003).
[9] 26 U.S.C. § 6020(b) (2004).

Because necessary documentation was not available, we could not determine why payments totaling approximately $45 million were transferred for 16 of the 88 taxpayer accounts.

The remaining 16 taxpayer accounts had payments totaling almost $49 million correctly transferred to the XSF. Most of these payments were transferred because of an action taken by the taxpayers, such as filing a tax return past the time period to receive a refund.[10]

The Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government*[11] state internal controls should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations. When taxpayer accounts are not properly credited, taxpayers may receive unwarranted balance due notices and the IRS' case workload may increase.
- Reliability of financial reporting. By not properly crediting the appropriate accounts, the IRS cannot determine if it has collected the correct amount of taxes due or if a taxpayer is due a refund of overpaid taxes.
- Compliance with applicable laws and regulations. The IRS must proactively identify and investigate potentially nonfiled returns to maintain public confidence in the voluntary tax system and ensure the tax laws are applied fairly to all taxpayers.

We concluded the IRS' internal control procedures for transferring payments to the XSF are not meeting these standards because approximately $931 million in payments was transferred without sufficient research or contact with taxpayers.

[10] 26 U.S.C. § 6511 (2004). The IRS will assess tax, refund a credit, and collect taxes within a specific time period. This limit is known as the statute of limitations.

[11] GAO/AIMD-00-21.3.1, dated November 1999.

Assisting nonfilers in meeting their tax filing obligations will reduce the number of payments transferred to the XSF

Part of the IRS National Non-Filer Strategy is to identify cases for which it can obtain a tax return and assess a tax liability. The IRS' objective is to ensure taxpayers who are legally required to file do so and to address those individuals who are not required to file but may be due refunds or credits.

From our analysis, 29 taxpayers submitted payments, totaling almost $855 million, that were transferred to the XSF because the taxpayers did not file tax returns. We concluded that these cases would have been productive because the taxpayers had already attempted to comply by submitting payments.

When a taxpayer has a filing requirement and a tax return has not been received, the IRS can initiate a Taxpayer Delinquency Investigation (TDI).[12] Of the 29 taxpayers who did not file a tax return, 14 accounts showed no evidence that a TDI was initiated. These taxpayers submitted payments totaling over $56 million.

The remaining 15 taxpayers had TDIs initiated for their accounts. However, seven TDIs were closed because the IRS determined the taxpayers were not required to file the subject returns. These returns included the Employer's Quarterly Federal Tax Return (Form 941), the Annual Return of Withheld Federal Income Tax (Form 945), and U.S. Corporation Income Tax Return (Form 1120). Our analysis showed these TDIs were incorrectly closed and the taxpayers were, in fact, required to file the tax returns. Two of the 7 taxpayers were government entities that had submitted payments totaling approximately $744 million.

The IRM states, "Federal Agencies are not exempt from the employment tax filing, paying, and reporting requirements. [The] Congress did not provide any exceptions for Federal Agencies." The IRM further states it is important for all government agencies to set a good example because private

[12] The goal of these investigations is to bring the taxpayer into full compliance, including securing the full payment of the tax liability with the delinquent return.

employers are expected to meet all requirements for filing and paying their taxes timely. One of the goals of the IRS Strategic Business Plan is to discourage and deter abuse within tax-exempt and government entities. From our analysis, we found another government entity had not filed tax returns for 7 years and had credits remaining in its tax modules of approximately $38 million.[13]

Further, our opinion that taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability is supported by an independent study performed by the LMSB Division. The IRS initiated this analysis because of concern that there may be a large amount of unpaid taxes due for nonfiled tax returns. From its sample of large-dollar tax modules, the IRS was able to secure tax returns from most of the taxpayers. Another study performed by the LMSB Division on income tax nonfilers concluded, "The presence of a credit balance is indicative that the taxpayer expects to file a return which shows tax due."

The I.R.C.[14] states, "If any person fails to make any return required by any Internal Revenue Law or regulation . . . the Secretary [of the Treasury] shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise." From this legal authority, the IRS developed the Delinquent Return and Substitute for Return procedures to address taxpayers who do not file required tax returns. The purpose of the procedures is to assess the correct tax liability by either securing a valid voluntary tax return from the taxpayer (Delinquent Return) or, if securing a return is not possible, computing tax, interest, and penalties based on information submitted by payers or based on other internally available information (Substitute for Return). There is no indication the IRS followed these procedures for taxpayers with these large-dollar credit[15] balances before transferring the payments to the XSF.

Although these taxpayers have made an attempt to comply with their tax obligations by submitting these payments,

[13] We did not secure any evidence that a TDI had been issued.
[14] 26 U.S.C. § 6020(b) (2004).
[15] An amount paid or transferred as payment to an account.

without the proper documentation (i.e., tax returns) the IRS is unable to determine if the taxpayers have fully paid their tax liabilities.

Increasing managerial oversight could assist in case resolution and prevent payments from being transferred to the XSF

Our analysis of the XSF showed the account grew 65 percent during a 4-year period. We recognize there are situations in which payments are required to be transferred to the XSF, including tax refunds from taxpayers who have filed their tax returns past the time to receive a refund, photocopy fees, and conscience money.[16] However, increasing managerial oversight of tax modules with large-dollar payments could prevent costly errors and protect taxpayer rights. Our analysis showed 29 taxpayer accounts required a tax return to be secured and 28 taxpayer accounts had incorrect or insufficient actions taken.

We also identified instances in which IRS employees transferred payments to the XSF without performing sufficient research. For example, there were cases in which taxpayers fabricated the amount of withholding to claim refunds. The IRS processed these claims; however, since the returns were filed past the statute of limitations, the fabricated refund amounts were transferred to the XSF. In these cases, the taxpayers actually owed a balance due, but will not receive a notice for the proper amount of tax due, and the XSF is artificially overstated.

Contributing to this situation are several related sections of the IRM that may be preventing employees from expending additional time to research or contact taxpayers before deciding to transfer payments to the XSF. For example, the procedures for cases sent to the Statute of Limitations function state that, due to the adverse impact on the

[16] This is a remittance received to ease the taxpayer's conscience and is usually accompanied by an anonymous note so indicating.

Accounts Receivable Dollar Inventory,[17] all large dollar debit[18] and credit[19] tax modules involving a balance of $25,000 and over must be expeditiously resolved. When these balances are not resolved expeditiously, the time period in which the IRS may refund a credit to a taxpayer or assess a tax liability may be limited.

However, by transferring these payments expeditiously, employees may not be taking sufficient action to ensure the proper resolution. Figure 2 shows a listing of dollars in the XSF for tax modules with $25,000 or more as of October 2003.

Figure 2: Dollars by Tax Module in the XSF as of October 2003

Tax Module Ranges	Modules	Dollars[20]
$25,000 - $49,999	**5,109**	$ 173,517,277
$50,000 - $99,999	**2,080**	$ 140,909,261
$100,000 - $249,999	**1,006**	$ 148,385,202
$250,000 - $499,999	**302**	$ 104,902,076
$500,000 - $999,999	**118**	$ 79,353,674
$1,000,000 and over	**96**[21]	$ 1,019,593,411
Total	**8,711**	**$ 1,666,660,901**

Source: Data extract obtained by the TIGTA as of October 2003.

Also, XSF procedures advise employees to research payments and give equal attention to both large and small cases but state that large-dollar cases will be worked first. However, the procedures also state that research does not

[17] Consists of delinquent taxes owed by taxpayers. If a taxpayer does not pay an outstanding tax liability in full within 10 days of notification, the account is placed into the accounts receivable inventory. Delinquent taxes remain in the inventory until they are either paid or abated, or until the collection statute of limitations expires (10 years).

[18] A condition in which the balance due on a tax account exceeds the total amount of credits.

[19] A condition in which the amount of credits on a tax account exceeds the balance due.

[20] All figures are rounded.

[21] These 96 tax modules were included in the review of the 88 taxpayer accounts.

have to be conducted for statute-expired cases.[22] These procedures are advising employees not to conduct research that could aid in case resolution.

We recognize that the IRS improved internal controls after a previous TIGTA audit involving the XSF. However, the type of cases identified in this review can still occur. By expending additional time on research or contact with taxpayers and increasing the managerial review of large-dollar cases, the IRS can leverage its resources and minimize the number of large-dollar payments transferred to the XSF.

Recommendations

To assist in case resolution and prevent payments from being prematurely transferred to the XSF, the Director, Customer Account Services, W&I Division, should:

1. Change IRM procedures to allow for additional employee research or taxpayer contact to obtain needed information for large-dollar cases.

Management's Response: A task force will be formed and will review current guidance in each operating division's IRM and develop appropriate procedures to ensure that large dollar cases receive proper attention.

2. Increase managerial review for all tax modules, at an amount established by each business operating division, before payments are transferred to the XSF or remain unresolved.

Management's Response: The task force will review current guidance for each operating division and determine if changes are needed to established practices.

3. Require IRS employee field contact, when needed, for tax modules over an amount established by each business operating division when a tax return is needed.

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[22] These cases would involve payments more than 2 years from the payment date or 3 years from the return filed date, whichever date is later.

Management's Response: The task force will review current guidance for each operating division and determine if changes are needed to established practices.

4. Ensure the I.R.C.[23] procedures are used during case resolution when the taxpayer is unable or unwilling to submit a tax return for large-dollar cases.

Management's Response: IRS management stated the IRS is not obligated to file returns under the provisions of I.R.C. 6020(b) on the taxpayer's behalf. Therefore, the IRS does not fully agree with the benefit of $855 million associated with the 29 taxpayers who failed to file a return. IRS management stated that taxpayers who failed to file a proper tax return did not comply with their legal obligation and, therefore, put themselves at risk. However, the task force will review current practices and guidance for use of I.R.C. 6020(b) procedures in resolving situations where large-dollar credits are present, but the returns are not filed.

Office of Audit Comment: We recognize the numerous systemic and procedural improvements the IRS has made to the management of the XSF during the past 3 years. While these improvements have made it possible for the IRS to perfect many payments and apply them to the proper taxpayer accounts, we believe the IRS could do more to assist those taxpayers, especially government entities, in complying with filing requirements. Our results show the majority of the outcome measures are associated with government agencies that did not file a tax return.

There are a variety of reasons why we believe it is appropriate for the IRS to file returns for taxpayers in these cases.

- The I.R.C. states, "If any person fails to make any return required by any Internal Revenue Law or regulation . . . the Secretary [of the Treasury] shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise." Although the IRS may not be obligated to file returns for taxpayers, they do have the legal authority to do so.

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[23] 26 U.S.C. § 6020(b) (2004).

- Our results show that 51 percent of the cases we reviewed had taxpayer accounts totaling almost $855 million and had at least 1 tax module that required a tax return to be filed. These taxpayers submitted substantial payments for tax compliance purposes and have a filing requirement; therefore, it would be appropriate for the IRS to follow its existing procedures for preparing a tax return when attempts to obtain a voluntary tax return fail.
- The LMSB Division performed an independent study because of concern that there may be a large amount of unpaid taxes due for non-filed tax returns. From its sample of large-dollar tax modules, the IRS was able to secure tax returns from most of the taxpayers.
- The IRS response of not using the provisions of the I.R.C. appears inconsistent with its Non-Filer Strategy, the purpose of which is to identify cases for which the IRS can obtain a tax return and assess a tax liability. The objective is to ensure taxpayers who are legally required to file do so and to address those individuals who are not required to file but may be due refunds or credits.
- In our opinion, which is supported by IRS studies, taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability.

5. Ensure better coordination with each business operating division before tax modules with a credit balance are closed. This coordination would include advising the respective business operating division of the large-dollar payments being transferred to the XSF.

<u>Management's Response</u>: The task group will review the need for and feasibility of this recommendation in light of their overall findings and any proposed changes to procedures.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to determine the financial effect and taxpayer burden on credit balance accounts that are not resolved before the Internal Revenue Service (IRS) transfers large-dollar payments into its Excess Collections file (XSF).[1]

To accomplish our objective, we:

I. Obtained a computer extract of the IRS' XSF as of October 2003 from all 10 campuses.[2]

II. Identified all 88[3] taxpayers that had 96 tax modules[4] in the XSF with payments totaling $1 million or more in at least 1 tax period.[5]

III. Researched the actions taken for these payments using the Integrated Data Retrieval System[6] and requested original documentation (i.e., tax returns). We determined if sufficient actions were taken before the payments were transferred into the XSF.

IV. Coordinated with IRS analysts from the Small Business/Self-Employed Division Accounts Management unit staff at the Philadelphia Campus to validate our analyses.

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[1] The XSF contains payments/credits that cannot be applied to a taxpayer's account. These payments/credits are generally caused by one of a limited number of conditions, such as when a taxpayer submits a tax payment but does not file a tax return, when a taxpayer files a tax return past the time period to receive a refund, or when the IRS is unable determine to which taxpayer account to apply a payment. The IRS sends correspondence to the taxpayer regarding these payments/credits before transferring them.

[2] The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

[3] We analyzed 88 taxpayer accounts during our review. However, one taxpayer had two tax modules that appeared in two different categories.

[4] A record of tax data for a taxpayer covering only one type of tax for one tax period. A taxpayer may have more than one tax module.

[5] Identifies the time covered by a return or an account (e.g., tax period ending December 2003).

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

Appendix II

Major Contributors to This Report

Parker F. Pearson, Director
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Carole Connolly, Lead Auditor
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Appendix III

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- Commissioner, Tax Exempt and Government Entities Division SE:T
- Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 57 taxpayers affected; approximately $931 million in payments transferred to the Excess Collections file (XSF)[1] (see page 3).

Methodology Used to Measure the Reported Benefit:

As of October 2003, the XSF contained approximately $3.8 billion. Our analysis of the XSF showed 88[2] taxpayers had tax modules[3] (totaling over $1 billion) with payments totaling $1 million or more in at least 1 tax period.[4] Of the 88 taxpayers, 57 had tax modules with payments totaling approximately $931 million that could have been prevented from being transferred to the XSF. Ineffective internal controls allowed for improper adjustments to taxpayers' accounts.

- Twenty-nine (51 percent) of 57 taxpayer accounts, totaling almost $855 million, had at least 1 tax module that required a tax return to be filed. Because these taxpayers submitted payments and have a filing requirement, the IRS should have followed procedures for preparing a tax return as prescribed by the Internal Revenue Code[5] when attempts to obtain a voluntary tax return failed.
- Twenty-eight (49 percent) of 57 taxpayer accounts had payments totaling almost $76 million transferred due to insufficient research or contact with the taxpayers, or an improper adjustment to the accounts.

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[1] The XSF contains payments/credits that cannot be applied to a taxpayer's account. These payments/credits are generally caused by one of a limited number of conditions, such as when a taxpayer submits a tax payment but does not file a tax return, when a taxpayer files a tax return past the time period to receive a refund, or when the IRS is unable determine to which taxpayer account to apply a payment. The IRS sends correspondence to the taxpayer regarding these payments/credits before transferring them.
[2] We analyzed 88 taxpayer accounts during our review. However, one taxpayer had two tax modules that appeared in two different categories.
[3] A record of tax data for a taxpayer covering only one type of tax for one tax period. A taxpayer may have more than one tax module.
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[5] 26 U.S.C. § 6020(b) (2004).

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
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DEC 2 2 2004

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

FROM: Henry O. Lamar, Jr. Henry O. Lamar, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution (Audit # 200430004)

I am responding to your draft report titled, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* (Audit # 200430004). Daily, we accurately and promptly process huge volumes of payments and credits. During Fiscal Year (FY) 2004, we processed over 206 million payment transactions totaling almost $2 trillion. Payments we cannot readily identify go through special processing involving extensive research. We identify most through these research efforts or through subsequent contact with the taxpayer. We take additional steps to properly apply the unidentified remittances that remain. As a result, we successfully resolved over 18,117 payments and properly applied more than $105 million in payments from the Unidentified Remittance File in FY 2004.

We move the funds to the Excess Collection Files (XSF) when we are unable to resolve the proper application of a credit to a specific tax liability. Funds in this account remain available to be applied to a tax liability for seven years. Moving credits to the XSF is a necessary accounting action that ensures the accuracy of our accounting for tax receipts, payments, and liabilities to the Department of the Treasury. Credits which cannot be clearly associated with liabilities must be moved from the IRS' primary tax accounts to ensure proper revenue accounting to the Treasury. These funds cannot be classified as "tax receipts".

During the past three years, we made numerous systemic and procedural improvements to the management of the XSF. It appears many of the credits reviewed were transferred to the XSF file prior to the implementation of these changes. As a result of your prior audit, "*Millions of Dollars in Internal Revenue Service Excess*

Collections Accounts Could Be Credited to Taxpayers," June 2000[1], we formed a multi-functional task group and addressed a number of systemic and procedural issues to improve the management of the XSF. The following actions were taken:

- Improved computer programming to identify and match balance due tax periods with credits that are available for the period in XSF.
- Developed computer programming and procedures to produce a monthly XSF "open" status listing. Technical employees review the listing for possible association with taxpayers' accounts.
- Developed a computer application that notifies taxpayers every six months that there is a credit available. The notification explains that a return must be filed to receive the credit. The notice also explains the statute of limitations for refunds.
- Developed a computer application that provides a "final notice" to taxpayers six months prior to the expiration of the statute of limitations for refunds. The notice advises the taxpayer that the statute expiration is imminent.
- Extended the period of time that credits remained available on the Master File and readily available for application to a liability.
- Provided additional training to technical staff responsible for administering the XSF and statute cases.

We believe these systemic and procedural improvements have had a positive impact, allowing us to perfect many payments and apply them to the proper taxpayer account. While I agree there are further opportunities to improve our controls prior to moving funds to XSF, it is important to recognize that your report focuses on exception cases that have, despite our efforts, remained unresolved. I generally agree with the intent of your recommendations; however I have asked the Director, Customer Account Services, Wage and Investment Division, to form a task group with representatives from each Operating Division to review our current procedures, the cases you reviewed, and your recommendations. We expect to convene the task group by January 31, 2005, and anticipate the group's findings and recommendations by October 2005.

I do not fully agree with your Outcome Measure contained in Appendix IV. The action to move funds to the XSF file does not necessarily negatively impact a taxpayer's rights or entitlements. I do not agree with the benefit of $855 million associated with the 29 taxpayers who failed to file a return. Those taxpayers who failed to file a proper tax return did not comply with their legal obligation and, therefore, put themselves at risk. The movement of funds to XSF is a result of this failure, not the cause. Taxpayers are required by law to file returns when they are due. The IRS is not obligated to file returns under the provisions of Internal Revenue Code (I.R.C.) 26 U.S.C. § 6020(b) on the taxpayer's behalf. I agree with the benefit associated with the 28 taxpayers with

[1] Treasury Inspector General for Tax Administration: *Millions of Dollars on Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers*, Reference Number :2003-30-088 (June 2000)

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payments of $76 million that you attribute to insufficient research or contact or an improper adjustment.

Our comments to your recommendation are attached.

If you have any questions, please call me at (404) 338-7060, or members of your staff may contact David L. Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

To assist in case resolution and prevent payments from being prematurely transferred to the XSF, the Director, W&I Customer Account Services, should:

RECOMMENDATION 1
Change the IRM procedures to allow for additional employee research or taxpayer contact to obtain needed information for the large-dollar cases.

CORRECTIVE ACTION
The task group will review current guidance in each Operating Division's IRM and develop appropriate procedures to ensure that large dollar cases receive proper attention.

IMPLEMENTATION DATE
January 15, 2006

RESPONSIBLE OFFICIAL
Director, W&I CAS - Lead
Director, W&I Compliance
Director, SB/SE, Collection Policy
Director, SB/SE, Campus Collection Compliance
Director, LMSB, Performance Management, Quality Assurance and Audit Assistance
Director, TE/GE, Government Entities

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2
Increase managerial review for all tax modules, at an amount established by each Operating Division, before payments are transferred to the XSF or remain unresolved.

CORRECTIVE ACTION
The task group will review current guidance for each Operating Division and determine if changes are needed to established practices.

IMPLEMENTATION DATE
January 15, 2006

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Director, LMSB, Performance Management, Quality Assurance and Audit Assistance
Director, TE/GE, Government Entities

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3
Require IRS employee field contact, when needed, for tax modules over an amount established by each Operating Division when a tax return is needed.

CORRECTIVE ACTION
The task group will review current guidance for each Operating Division and determine if changes are needed to established practices.

IMPLEMENTATION DATE
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CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4
Ensure that I.R.C. procedures are used during case resolution when the taxpayer is unable or unwilling to submit a tax return for large-dollar cases.

CORRECTIVE ACTION
As noted above, I.R.C. § 6020(b) does not require IRS to file tax returns on a taxpayer's behalf. The purpose of this provision is to provide IRS the ability to compute and

assess the correct tax, interest and penalty where taxpayers fail to file required tax returns. Current operating procedures, selection criteria, and resources allocated for such cases are risk-based and balanced against other enforcement priorities. However, the task group will review current practices and guidance for use of IRC 6020(b) procedures in resolving situations where large-dollar credits are present, but the returns are not filed.

IMPLEMENTATION DATE
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CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5
Ensure better coordination with each Operating Division before tax modules are closed with a credit balance. This coordination would include advising the respective Operating Division of the large dollar payments being transferred to the XSF.

CORRECTIVE ACTION
The task group will review the need for and feasibility of this recommendation in light of their overall findings and any proposed changes to procedures.

IMPLEMENTATION DATE
January 15, 2006

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CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.