

**The Collection Field Function Needs to
Improve Case Actions to Prevent Employers
From Incurring Additional Trust Fund Tax
Liabilities**

September 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 21, 2005

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Collection Field Function Needs to
Improve Case Actions to Prevent Employers From Incurring
Additional Trust Fund Tax Liabilities (Audit # 200430019)

This report presents the results of our review of the Internal Revenue Service's (IRS) Trust Fund Tax Liabilities. The overall objective of this review was to determine whether the Small Business/Self-Employed (SB/SE) Division Collection Field function (CFf) was effectively using the collection tools available when working cases in which trust fund¹ taxpayers pyramided² their tax liabilities.

In summary, employers use the Employer's Quarterly Federal Tax Return (Form 941) to file and establish the tax liability for trust fund taxes. Advance payments made for these taxes are called Federal Tax Deposits (FTD).³ The large number of in-business taxpayers who repeatedly pyramid trust fund taxes is a major compliance problem for the IRS. As of March 31, 2005, employers owed the IRS approximately \$10.6⁴ billion on delinquent trust fund accounts. Addressing employment tax noncompliance by expanding trust fund programs and implementing related strategies was a priority for the SB/SE Division in Fiscal Year (FY) 2004 and continues to be emphasized in FY 2005. Per IRS procedures, successful resolution of delinquent trust fund taxpayer cases

¹ A trust fund tax is money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the United States Department of the Treasury.

² Pyramiding involves the incurring of future additional tax liabilities.

³ FTDs are advance payments made for the trust fund taxes. Generally, these payments are made once a month, twice a month, four times a month, or eight times a month, depending upon the amount of the quarterly liability and frequency of the payroll.

⁴ National Collection 5000-2 Reports – Taxpayer Delinquent Account Cumulative Report as of March 31, 2005.

requires early intervention by the CFf and effective and timely actions to prevent taxpayers from pyramiding.

To meet our objective, we selected and reviewed a sample of 223 cases to determine whether appropriate collection actions were timely taken. When we selected our sample (as of April 15, 2004) from SB/SE Division cases, there were 101,698 trust fund cases open in the CFf, with a total outstanding balance of approximately \$5 billion. The population from which we selected our sample included 11,375 cases that met the following criteria: had been open for 1.5 to 2.5 years, had liabilities greater than \$10,000, had 2 or more open delinquent accounts, and involved in-business taxpayers. The total outstanding balance on these 11,375 cases was approximately \$972 million. This was approximately 11 percent of the entire CFf open trust fund case inventory as of April 15, 2004.

While our sample included only older cases, the majority of the cases (79 percent) in the CFf open inventory at that time were fewer than 15 months old. As a result, our sample of 223 cases was not representative of the entire trust fund case work of the CFf. Our sample was representative of the most delinquent taxpayer cases.

We determined revenue officers (RO) took some actions that were effective. For example, they conducted effective initial contacts, performed compliance checks, and requested immediate filing and full payment of all delinquent accounts. However, improvements are needed for ROs to take timely actions and use appropriate enforcement tools to help prevent taxpayers from pyramiding additional tax liabilities. Our review of a statistically valid sample of 223 in-business trust fund (IBTF) taxpayers showed that, once ROs were assigned cases, they did not make timely initial contact in 92 (41 percent) cases. In addition, the ROs did not timely follow up in 50 percent of the cases in which taxpayers missed specific deadlines, thus allowing the taxpayers to procrastinate more. Further, we identified lapses in actions of 75 days or more throughout the investigation in 121 (54 percent) cases, thus delaying case resolution.

Our review also showed that FTDs were required in 206 of the 223 cases. ROs did not request current FTDs on initial contact with the taxpayers in 77 (37 percent) of the 206 cases. In 63 (31 percent) of the 206 cases, the ROs did not monitor FTDs throughout the investigation. Finally, some type of enforcement action was required in 211 of the 223 cases (12 cases did not require enforcement actions.). In 5 of the 211 cases, enforcement actions were not used, and in the remaining 206⁵ cases, additional enforcement actions could have been taken and were not in 91 (44 percent)

⁵ These 206 cases are not necessarily the same as the 206 cases mentioned previously related to FTDs, although there are some of the same cases in both.

cases. For example, ROs could have used a levy, summons, Letter 903 (DO),⁶ and/or Trust Fund Recovery Penalty interview in those cases.⁷

FY 2004 CFf Operational reviews by the SB/SE Division Headquarters Office and the Collection Quality Measurement System⁸ reviews identified issues similar to those we identified during this audit. For example, they identified problems related to initial and follow-up actions, enforcement actions, activity lapses, and/or monitoring of FTDs (pyramiding). To identify ways to improve procedures for dealing with IBTF cases, the SB/SE Division has implemented several strategies including the collection reengineering process.⁹ As a result, revisions are being made in the compliance process and appear to be contributing to positive business results, such as an increase in case productivity and dollars collected and a reduction of delinquent accounts cycle time.

We recommended the Director, Collection, emphasize and monitor the use of Letter 903 (DO), closely monitor new management accountability requirements and efforts to ensure there is more managerial involvement in cases at all management levels, emphasize that ROs need to do a better job of following through on their plans of action, and ensure both ROs and managers better use the Integrated Collection System (ICS)¹⁰ features for timely follow-ups and monitoring of older cases for which enforcement actions are necessary.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendations. SB/SE Division management prepared the following training courses to be delivered as part of the FY 2005 Collection Continuing Professional Education: in-business trust fund pyramiding prevention techniques for ROs with an emphasis on the appropriate issuance of the Letter 903 (DO) and use of the trust fund compliance procedures, workload management for ROs with an emphasis on following through on their plans of action, and workload management for ROs with an emphasis on using the systemic notification follow-up feature within ICS to more effectively monitor their cases for follow-up. They also will coordinate with the Modernization and Information Technology Services organization to develop a process to systemically monitor the use of Letter 903 (DO). Finally, FY 2006 Operational Reviews conducted by the Director, Collection, will include a component that specifically evaluates adherence to the review requirements for in-business trust fund and pyramiding cases

⁶ Letter 903 (DO) alerts a taxpayer of the seriousness of noncompliance and explains more fully the alternatives that can be taken if the taxpayer is still not in compliance with the trust fund tax requirements.

⁷ The Trust Fund Recovery Penalty is a penalty that may be assessed against any person who is responsible for collecting or paying withheld income and employment taxes, or for paying collected excise taxes, and willfully fails to collect or pay them.

⁸ The Collection Quality Measurement System is designed to monitor, through a sample of closed cases, crucial aspects of an RO's job performance. Closed case files are reviewed to measure the organizational performance.

⁹ This process was designed to improve workload selection and case work quality and to reduce cycle time.

¹⁰ The ICS is an automated system used to control and monitor delinquent cases assigned to ROs in the IRS field offices.

that have been established in the Internal Revenue Manual. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: SB/SE Division management agreed with the recommendations and plans to take appropriate corrective actions; however, they commented they could not measure the future value of the potential benefit. We and SB/SE Division management agree that additional liabilities may not all accrue and the resulting balance due amounts may not be collected because it is likely that some of the taxpayers will be unable to fully pay. However, ineffective actions on cases were allowing taxes to pyramid throughout the population at the time of our review and the amount projected is reasonable. Therefore, we did not adjust the potential outcome measures in this report.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities

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Background

Collection principles state that public trust requires the Internal Revenue Service (IRS) to ensure all taxpayers promptly file their returns and pay the proper amount of tax, regardless of the amount owed. IRS employees should work with taxpayers to meet all their filing and paying requirements. This involves identifying and addressing noncompliance to prevent future delinquencies.

Per IRS procedures, the collection process begins with a series of delinquency notices or bills mailed to a taxpayer when the taxpayer does not file or pay taxes due. When the taxpayer fails to respond within a specified period of time, a delinquent return or a balance due account is generated. Generally, the IRS attempts to contact the taxpayer by telephone at this point. However, there are some priority cases that are assigned directly to the Collection Field function (CFf), where a revenue officer (RO) attempts face-to-face contact with the taxpayer. Once a delinquent account is assigned, the RO conducts an investigation to determine what collection procedures and enforcement actions should be used to bring the taxpayer into full compliance. From a broad range of collection tools, ROs select the one(s) most appropriate for each case. ROs attempt to obtain full payment and can use enforcement tools such as liens, levies, and seizure of assets when taxpayers do not attempt to comply.¹ The IRS recognizes that these collection tools are important elements of an effective compliance program; therefore, when appropriate, these actions should be taken promptly.

Employers use the Employer's Quarterly Federal Tax Return (Form 941) to file and establish the tax liability for trust fund taxes.² Employers with tax liabilities over a certain amount are required to make Federal Tax Deposits (FTD).³

¹ For definitions of collection tools and actions, see Appendix V.

² A trust fund tax is money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the Department of the Treasury.

³ FTDs are advance payments made for the trust fund taxes. Generally, these payments are made once a month, twice a month, four times a month, or eight times a month, depending upon the amount of the quarterly liability and frequency of the payroll.

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Employees who have taxes withheld from their wages expect the funds to be properly deposited and credited to their accounts, and employers expect compliance by their competitors. IRS procedures state that successful resolution of delinquent trust fund taxpayer cases requires early intervention by the CFf and effective and timely actions to prevent taxpayers from incurring future additional tax liabilities (pyramiding).

The large number of in-business taxpayers who repeatedly pyramid trust fund taxes (known as repeaters) continues to be a major compliance problem for the IRS. As of March 31, 2005, employers owed the IRS approximately \$10.6 billion⁴ on delinquent trust fund accounts.

Addressing employment tax noncompliance by expanding trust fund programs and implementing related strategies was an operational priority for the Small Business/Self-Employed (SB/SE) Division in Fiscal Year (FY) 2004. The FY 2004 Program Letter placed emphasis on the importance of monitoring trust fund deposits, monitoring filing and payment requirements on delinquent accounts, and taking appropriate steps to address taxpayers who incur additional tax liabilities. In FY 2005, the SB/SE Division continued to place emphasis on trust fund cases. The FY 2005 Program Letter also emphasized case work productivity by focusing on effective and appropriate case and enforcement actions, addressing enforcement boundaries, and assessing the effectiveness and need for various requirements.

In FY 2000, the Treasury Inspector General for Tax Administration (TIGTA) issued an audit report⁵ about in-business trust fund (IBTF) taxpayer cases worked in the CFf. We determined that, although some actions were effective, improvement was needed in taking more timely actions on cases, taking more enforcement actions, and assigning cases more timely. Our current FY 2005 audit's main emphasis was to follow up on the prior audit and

⁴ National Collection 5000-2 Reports – Taxpayer Delinquent Account Cumulative Report as of March 31, 2005.

⁵ *Improvements Are Needed in Resolving In-Business Trust Fund Delinquencies to Prevent Tax Liabilities from Pyramiding* (Reference Number 2000-30-111, dated August 2000).

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determine if available collection tools are being effectively used when appropriate. We concentrated our audit work on the most egregious taxpayer cases: taxpayers with delinquent tax liabilities who continue to pyramid their liabilities while the cases are open. Therefore, the results of this review are not representative of the overall case work performed by the CFf.

This review was performed at the SB/SE Division Collection function in New Carrollton, Maryland, during the period June 2004 through April 2005. The audit was conducted 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.

The Collection Field Function Effectively Used Certain Collection Tools While Working Cases

We reviewed 223 open IBTF cases. These cases were a statistical nationwide sample of Integrated Collection System (ICS)⁶ cases that had been open since sometime in Calendar Year (CY) 2002 and had pyramided during CY 2003 through April 2004.

When we selected our sample (as of April 15, 2004) from SB/SE Division cases, there were 101,698 trust fund cases open in the CFf, with a total outstanding balance of approximately \$5 billion. The population from which we selected our sample included 11,375 cases that had been open for 1.5 to 2.5 years, had liabilities greater than \$10,000, had 2 or more open delinquent accounts, and involved in-business taxpayers. The total outstanding balance on these 11,375 cases was approximately \$972 million. This was approximately 11 percent of the entire CFf open trust fund case inventory as of April 15, 2004. While our review focused on older cases, the majority of the cases (79 percent) in the CFf open inventory at that time were fewer than 15 months old.

As a result, our sample of 223 cases was not representative of the entire trust fund case work of the CFf. Our sample was representative of the most delinquent taxpayer cases. Our audit scope was designed to identify cases that had been open after December 2001 and before January 2003 and had

⁶ The ICS is an automated system used to control and monitor delinquent cases assigned to ROs in the IRS field offices.

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pyramided additional liabilities. Our goal was to determine if all applicable collection tools were used to resolve these types of cases.

Our review of the 223 cases showed that, overall, ROs effectively used certain collection tools/actions. The cases were timely assigned to the ROs who conducted effective initial contacts. For example, ROs took proper actions such as performing a compliance check, determining the current status of the delinquent account, and requesting immediate filing and full payment of all delinquent accounts. In most cases, the ROs attempted to secure sufficient information, when appropriate, to make an ability-to-pay determination. When taxpayers were required to take actions, the ROs ensured the taxpayers fully understood what was expected and when and warned of specific consequences for not complying with the requests.

In addition, some taxpayers complied on certain cases when ROs took effective actions. For example, some taxpayers became current with FTDs when ROs monitored the FTDs regularly. Also, when Letter 903 (DO)⁷ was issued to taxpayers, some taxpayers changed their filing and paying behavior by becoming current or going out of business and therefore no longer pyramiding.

The Collection Field Function Needs to Take More Timely Actions and Improve Its Use of Certain Collection Tools

Although our review showed that ROs took certain effective actions, improvements are needed in taking timely actions on cases and using enforcement tools to potentially prevent taxpayers from pyramiding.

The CFF needs to improve the timeliness of actions and follow-ups

Although ROs took effective actions at initial interviews, they did not always make timely initial contacts. IRS procedures require that, once a new IBTF case is assigned, the RO must make an initial contact within 30 calendar days for taxpayers with prior delinquencies (repeaters) and

⁷ Letter 903 (DO) alerts a taxpayer of the seriousness of noncompliance and explains more fully the alternatives that can be taken if the taxpayer is still not in compliance with the trust fund tax deposit and filing requirements.

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45 days for all others. ROs did not make timely initial contact in 92 (41 percent) of the 223 cases we reviewed. The range of days for the initial contact in these cases was 46 to 686, with a median of 80 days.⁸

Not only did delays occur in initial contact, they also occurred in actions throughout the investigation. When a taxpayer needs to take actions such as filing a return, providing information, or paying the balance due, IRS procedures require the assigned RO to set a deadline for when the action is expected and to warn the taxpayer of the consequence if he or she fails to comply timely. In addition, when the taxpayer misses a specific deadline, the RO should follow up within 10 days. Generally, the ROs set timely deadlines for taxpayer actions and informed them of the consequences for not complying. However, they did not timely follow up. In 174 (80 percent) of the 218 cases in which ROs had set deadlines, taxpayers did not perform required actions by the deadline date. In 87 (50 percent) of these 174 cases, ROs did not perform timely follow-ups, thus allowing the taxpayers to procrastinate more. The following examples are based on two cases with untimely follow-up actions.

- The RO sent an appointment letter to conduct the initial contact. Over the next 10 months, the taxpayer did not comply with the initial request and missed 5 other deadlines such as appointment dates, partial payments, and filing of delinquent returns. The RO talked with the taxpayer over the telephone each time, set new deadlines, and warned the taxpayer of consequences including the issuance of a levy. However, on four occasions, the RO did not make timely follow-ups, such as taking applicable enforcement actions. During this time, the taxpayer made some partial payments; however, the taxpayer did not make FTDs and was not in compliance. As a result, the taxpayer pyramided 7 additional liabilities during the 2 years the case had been open.

⁸ We took a conservative approach to this analysis and used a 45-day criterion on all cases, although there were repeater cases in our sample that had untimely contact between 30 and 45 days after assignment to the RO.

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- At the initial contact, the RO established a plan of action with the taxpayer to pay the account and get into compliance. In addition, the RO set deadlines and warned the taxpayer of consequences. Over the next 18 months, the RO did not take any follow-up actions. Finally, after the taxpayer missed many other deadlines, the RO took enforcement actions including filing liens and issuing levies. As a result, the taxpayer finally complied with prior requests for financial information and delinquent returns. The taxpayer pyramided 8 additional liabilities during the 2 years the case had been open.

In the above examples, the ROs should have taken immediate enforcement actions after the taxpayers missed the deadlines. The ROs needed to timely follow the established plans of action, instead of setting new deadlines that allowed the taxpayers to procrastinate and pyramid additional liabilities.

In addition to untimely follow-up actions, there were overall lapses in actions throughout the investigations, which resulted in a longer time to resolve the cases. The Collection Quality Measurement System (CQMS)⁹ standards define activity lapses as 75 days or more. Of the 223 cases in our review, 121 (54 percent) had 186 delays of 75 days or more. Table 1 provides a detailed breakdown of the range of delay days for the 121 cases. (A taxpayer case could have more than one delay).

⁹ The CQMS is designed to monitor, through a sample of closed cases, crucial aspects of an RO's job performance. Closed case files are reviewed to measure the organizational performance.

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Table 1: Time Lapses Throughout the Investigation

Range of Delay Days	Number of Occurrences
75 – 100	77
101 – 125	32
126 – 150	16
151 –175	21
176 – 200	15
201 or more	25
<u>Total</u>	<u>186</u>

Source: TIGTA review of 223 cases.

Some reasons given in the case histories for the delays were case reassignments to other ROs, ROs working other priority cases, and ROs on leave or in training. However, most of the time (69 percent of the delays), the reasons for delay were not documented.

The CFf needs to improve the monitoring of FTDs and its use of enforcement actions

ROs did not always request and monitor FTD payments

Generally, taxpayers are required to make FTD payments once a month, twice a month, four times a month, or eight times a month, depending upon the amount of the quarterly liability and the frequency of payroll. When a taxpayer is identified as a potential repeater, pyramiding must be stopped immediately according to IRS procedures. To reduce the number of repeaters, the RO should request the current FTDs from the date of the first contact and should continue monitoring FTDs throughout the investigation.

Our review showed that FTDs were required in 206 of the 223 cases. ROs did not request current FTDs on initial contact with the taxpayers in 77 (37 percent) of the 206 cases. In 63 (31 percent) of the 206 cases, the ROs did not monitor FTDs throughout the investigation. This was a primary reason why the taxpayers continued to pyramid trust fund taxes in 95 percent of these 63 cases.

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In addition, we determined whether taxpayers were still liable for FTDs and whether they were current as of the dates¹⁰ of our case review. We determined that, of the 163 taxpayers still liable for FTDs, approximately 50 percent were not current.

ROs can improve their use of enforcement tools

IRS procedures state an RO should demand immediate filing of delinquent returns and full payment of all delinquent accounts when he or she meets with a taxpayer. If the taxpayer is unable to comply, the RO should secure a collection information statement or basic asset information, such as bank accounts and real or personal property owned, to make a lien determination. This enables the RO to take enforcement actions, when appropriate.

Enforcement actions should be taken early in the investigation when applicable and may prompt a repeater taxpayer to comply or respond to the RO's requests. ROs can take several types of enforcement actions to help protect the Federal Government's interests: liens, levies on a delinquent taxpayer's assets including bank accounts and accounts receivables, summonses to legally obtain a taxpayer's records, and seizures of a taxpayer's properties.

Of the 223 cases, 211 cases required enforcement actions (12 cases did not require enforcement actions). In 5 cases, no enforcement actions were taken. In the remaining 206¹¹ cases, some type of enforcement action was used, such as liens were filed when appropriate. However, in 91 (44 percent) of the 206 cases, additional enforcement actions could have been taken and were not. The following are some examples:

- **Levy** – A levy is generally used to obtain funds due to a taxpayer that are being held by a third party. Some examples of property are a taxpayer's bank accounts, wages, or accounts receivables. Although a levy was used in 113 (51 percent) cases, it could have been used

¹⁰ The dates of the case review were from August 2004 through February 2005.

¹¹ These 206 cases are not necessarily the same as the 206 cases mentioned on page 7, although there are some of the same cases in both.

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as a collection tool in an additional 35 (16 percent) cases.¹² For example, a levy is appropriate when a taxpayer has a history of delinquency, is not showing an effort to pay the delinquent taxes, and is not paying current taxes.

- **Summons** – The RO should issue a summons only when a taxpayer will not produce the desired records or other information voluntarily. It allows the RO to request legal enforcement through a court of law if the taxpayer fails to fully comply. Although a summons was used in 54 (24 percent) cases, it could have been used as a tool in an additional 27 (12 percent) cases. For example, use of a summons is appropriate to get a financial statement from a taxpayer who is not complying with the RO's request.
- **Letter 903 (DO)** – Letter 903 (DO) is used for the most egregious cases in which taxpayers are not complying, other collection procedures have already been unproductive, and the taxpayer continues to pyramid liabilities. Letter 903 (DO) begins the process of requiring monthly filing and special bank deposits. If those deposits are not made, the taxpayer is subject to criminal prosecution.

Historically, the CFf has made little use of this enforcement tool. In FY 2000, our prior audit results showed that ROs generally did not use the Letter 903 (DO). As part of their corrective actions to recommendations in our report, IRS management conducted a project to increase the use of Letter 903 (DO). Our current review of 223 cases showed that ROs used the Letter 903 (DO) in 9 cases (4 percent). In some of these cases, the Letter had a positive effect on the taxpayer because the taxpayer became current or went out of business and no longer incurred new tax liabilities. While use of the Letter 903 (DO) had improved since our prior review, we determined the Letter could have been used in an

¹² For these 35 cases, taxpayers had been provided their Collection Due Process rights and the RO stated levy action was an appropriate next action.

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additional 19 (9 percent) cases in our current review. In other words, a Letter 903 (DO) was appropriate in 28 cases, but it was used in only 9 (32 percent) of the cases.

Use of a Letter 903 (DO) is appropriate when a taxpayer is not current with FTDs; the taxpayer continues to pyramid liabilities although the RO has used a lien, levy, and summons; and use of a seizure is not applicable. In this type of situation, use of a Letter 903 (DO) would have been appropriate to get the taxpayer to deposit currently due trust fund taxes or to require the taxpayer to make future monthly deposit arrangements in an attempt to stop the pyramiding.

- **Trust Fund Recovery Penalty (TFRP)** – The TFRP is equal to the unpaid balance of the trust fund tax and is assessed against any responsible person required to collect, account for, and pay over the trust fund taxes such as an officer of a corporation. IRS procedures require a TFRP interview with all potential responsible persons to be initiated when the taxpayer cannot fully pay the liability. It is intended to secure detailed information to determine the responsibility and willfulness of the responsible person. Out of the 166 taxpayers in our sample for whom a TFRP interview was applicable, ROs did not initiate or conduct the TFRP interview on 47 (28 percent) cases.

Various factors contributed to the ineffective case actions

First, SB/SE Division management informed us that some residual issues exist relating to implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98).¹³ In their opinion, ROs encounter or perceive that process and procedural barriers exist when they attempt to take necessary actions, which in turn lead to delays in case activity. The RRA 98 provides for removal of employees under certain conditions. In our prior review, we also determined that this contributed to actions not being

¹³ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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effectively taken. The IRS recently initiated an independent survey to attempt to identify the extent of this concern.

Second, based on information from SB/SE Division management, collection basics need to be reinforced. They believe some ROs may be confused over the appropriate next steps in case activity, including enforcement actions, and do not understand enforcement action boundaries. We identified similar issues in our case reviews that showed ROs are hesitant to follow through with warnings given to taxpayers and, therefore, allow taxpayers to procrastinate. In addition, there are many times when enforcement actions were appropriate but not used. (See results in the prior Timely Follow-Up and Enforcement sections.) ROs may not be frequently using the benefit of the follow-up feature within the ICS to help ensure timely actions. Although cases assigned to the ROs are based on their experience level and the difficulty of the case and inventory levels are managed by group managers, the ROs are not using all the collection procedures to help ensure quality work on cases.

Finally, prior to FY 2005, the SB/SE Division was not organizationally set up to have the Collection function operate as a separate function. Territory managers and Area Office directors were responsible for both the Examination and Collection functions and may have had no Collection function experience.¹⁴ Therefore, a direct chain of command for Collection function management from the group manager level through the executive level did not always exist, and many managers did not have the background to manage a Collection function. SB/SE Division Headquarters executives believed this potentially caused a lack of managerial accountability for Collection function activities. In early FY 2005, RO group managers began reporting to Collection function Territory managers, who report to Collection function Area Office directors.

¹⁴ The field offices for the SB/SE Division are called Area Offices and Area directors are the heads of those offices. Territory managers are the second-line managers that report to the Area directors and generally oversee a few Collection function groups.

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Ineffective case actions resulted in the pyramiding of millions of dollars of new tax liabilities

Untimely initial contacts delay an RO from requesting the immediate filing and full payment of all delinquent accounts. These also delay the demand of current FTDs, which allows a taxpayer to continue to pyramid trust fund taxes.

Untimely follow-ups and delays in action cause the cases to remain open longer than necessary, which could also affect customer satisfaction. These untimely actions, together with not using available collection tools such as monitoring FTDs and enforcement actions, prevent ROs from stopping pyramiding and ensuring taxpayers are in compliance with the filing and payment of trust funds taxes.

Although ROs collected \$5.1 million while working the 223 cases, a larger amount in additional tax liabilities (\$8.7 million) pyramided from the time these cases were assigned to the CFf. The taxpayers pyramided approximately \$1.7 million in trust fund taxes between assignment to CFf and the initial contact and the remainder after the initial contact. In fact, there was an aggregate outstanding liability of \$17.7 million still remaining on these cases at the time of our review. When the cases first came into the CFf, their balance of taxes owed was \$14.4 million.¹⁵

We estimate it is possible that approximately \$430 million¹⁶ could have pyramided if ROs did not take effective actions to keep taxpayers from pyramiding on similar cases in our population. While we recognize effective actions could not have prevented all of the \$430 million from pyramiding, a substantial portion could have been prevented if the ROs had used timely and effective case actions. See Appendix IV for additional information.

¹⁵ The \$14.4 million minus \$5.1 million collected plus \$8.7 million accrued does not exactly equal to the \$17.7 outstanding balance because we did not include in the \$5.1 million payments made to the IRS that were not made through the ROs or credit transfers into the taxpayers' accounts.

¹⁶ This projection is potential accruals, all of which may not be accrued. In addition, not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the RO.

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Recommendations

The Director, Collection, SB/SE Division, should:

1. Emphasize and monitor use of the Letter 903 (DO) to determine how to increase its use when applicable.

Management's Response: SB/SE Division management prepared a training course on in-business trust fund pyramiding prevention techniques for ROs with an emphasis on the appropriate issuance of Letter 903 (DO) and use of the trust fund compliance procedures. They are delivering this training during August and September 2005 as part of FY 2005 Collection Continuing Professional Education (CPE) for ROs. They also will coordinate with the Modernization and Information Technology Services organization to develop a process to systemically monitor the use of Letter 903 (DO).

2. Closely monitor new requirements for management accountability and activity in case actions to ensure managerial involvement at all levels is occurring as planned. (See the following section regarding new procedures for management accountability and involvement.)

Management's Response: FY 2006 Operational Reviews conducted by the Director, Collection, will include a component that specifically evaluates adherence to the review requirements for in-business trust fund and pyramiding cases that have been established in Internal Revenue Manual exhibits 1.4.50-8 and 1.4.50-9.

3. Emphasize that ROs need to do a better job of following through on their plans of action.

Management's Response: SB/SE Division management prepared training on workload management for ROs with an emphasis on following through on their plans of action. They are delivering this training during August and September 2005 as part of FY 2005 Collection CPE for ROs.

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4. Ensure ROs and managers better use ICS features for timely follow-ups and monitoring of older cases for which enforcement actions are needed.

Management's Response: SB/SE Division management prepared training on workload management for ROs with an emphasis on using the systemic notification follow-up feature within ICS to more effectively monitor their cases for follow-up. They are delivering this training during August and September 2005 as part of FY 2005 Collection CPE for ROs.

Office of Audit Comment: SB/SE Division management agreed with the recommendations and plans to take appropriate corrective actions; however, they commented that they could not measure the future value of the potential benefit. We and SB/SE Division management agree that additional liabilities may not all accrue and the resulting balance due amounts may not be collected because it is likely that some of the taxpayers will be unable to fully pay. However, ineffective actions on cases were allowing taxes to pyramid throughout the population at the time of our review and the amount projected is reasonable. Therefore, we did not adjust the potential outcome measures in this report.

Management Monitoring and Implementation of Changes Appear to Have Had a Positive Effect on Business Results

FY 2004 CFf Operational reviews by the SB/SE Division Headquarters Office and CQMS reviews have identified issues similar to those we identified during this audit. During CFf Operational reviews, Collection function management reviewed several types of cases with the major focus on general collection cases. Their reviews identified problems on cases related to initial and follow-up actions, financial analysis, enforcement actions, and monitoring of FTDs. Focus reviews were also conducted as part of the review to identify concerns and need for changes.

Nationwide CQMS reviews also identified problems with setting specific dates, identifying actions to be performed by the taxpayer, warning the taxpayer of possible consequences, making timely follow-ups, having activity lapses greater than 75 days, and monitoring of FTDs (pyramiding).

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To identify ways to improve procedures for dealing with IBTF cases, the SB/SE Division has implemented several strategies. For example:

- The collection reengineering process was designed to improve workload selection and case work quality and to reduce cycle time.
- The Collection Consultation Initiative process was designed to promote casework communication between the RO and group manager, resulting in more timely resolution of cases.
- The Collection Group Manager Handbook was published to provide procedures for case management and review, to strengthen new managerial accountability, and to promote more effective case action.

We have performed audits of the Collection Consultation Initiative¹⁷ and workload selection¹⁸ process. We determined that overall effectiveness of the Collection Consultation Initiative could be improved by ensuring milestones and completion dates for required collection activities are clearly identified and case plans of action are consistently prepared. On the workload selection process, we determined that productivity results showed varying degrees of improvement after the criteria were revised. In theory, the workload selection process would allow trust fund cases to be assigned sooner, and fewer tax periods would pyramid before CFf intervention.

SB/SE Division executives informed us the collection reengineering process is continuing and they are making strides in revising the compliance processes. They believe this should have a positive impact on the quality of the case work in the field. Some changes or requests for changes in the process include:

¹⁷ *Implementation of the Collection Field Function Consultation Initiative Was Carefully Coordinated, but Some Aspects Could Be Enhanced* (Reference Number 2005-30-011, dated November 2004).

¹⁸ *The Revised Collection Case Selection Criteria That Expedites Trust Fund Workload to the Field Appears Effective* (Reference Number 2004-30-173, dated September 2004).

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- Emphasis on explaining to ROs the purpose of the notice of Federal tax lien and improving its use when appropriate.
- Issuance of Letter 1058¹⁹ on initial contact with the taxpayer only when levy or seizure is the next action. In the future, there is a potential plan for issuance of Letter 1058 on trust fund cases prior to assignment to ROs.
- Mandatory review by the group manager for the IBTF cases where taxpayers pyramided after a case was assigned.
- Requirement for ROs to not only request copies of FTD receipts but also consider verifying whether the correct amount is being deposited.

Some of the changes appear to already be contributing to positive business results, such as an increase in case productivity and dollars collected and a reduction of delinquent accounts cycle time. For example, Table 2 shows a 4.2 percent increase of dollars collected. Collection function management expects these positive results to continue as the SB/SE Division follows the course outlined in the FY 2005 Collection Program Letter.

Table 2: Some Improvements in Dollars Collected

Fiscal Year	Dollars in Inventory	Dollars Collected
1 st 6 months FY 2004	5,800,843,541	886,056,502
1 st 6 months FY 2005	5,275,037,630	923,459,936
% Decrease/ Increase	-9.1%	4.2%

Source: National Collection 5000-2 Reports – Field Function Taxpayer Delinquent Accounts.

¹⁹ Letter 1058 is a final notice of intent to levy and notice of taxpayer’s right to a hearing.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Small Business/Self-Employed (SB/SE) Division Collection Field function was effectively using the collection tools available when working cases in which trust fund¹ taxpayers pyramided² their tax liabilities. To accomplish this objective, we:

- I. Reviewed Internal Revenue Service (IRS) guidelines related to in-business trust fund (IBTF) taxpayer cases and discussed procedures with SB/SE Division management to determine if trend analyses were performed to identify characteristics of the delinquent IBTF taxpayers and how quality review results were being used and to evaluate results from operational reviews.
- II. Selected a sample of 223 of the most delinquent IBTF taxpayer accounts from the Integrated Collection System (ICS)³ to determine if collection tools were used effectively.
 - A. Using ICS, as of April 14, 2004, identified 101,698 open trust fund cases in the SB/SE Division. We applied the following criteria to further define the population of cases we planned to review: in-business taxpayer accounts where the dollar amount of the aggregate taxpayer liability exceeded \$10,000, taxpayers had cases established after December 2001 and before January 2003, and taxpayers had pyramided new liabilities after December 2002. This resulted in 11,375 IBTF taxpayers having an aggregate outstanding liability greater than \$10,000 on 2 or more open delinquent accounts.
 - B. Using the population of 11,375 open cases, selected a statistical sample of 223 cases to review. We used the following sampling criteria: a 90 percent confidence level, a 30 percent estimated error rate, and a ± 5 percent precision rate.
- III. Reviewed 223 cases and evaluated actions taken to determine if revenue officers and group managers effectively used the collection tools.
 - A. Created a case review check sheet to record actions taken by revenue officers and group managers.
 - B. Determined if appropriate actions were taken on first contact and throughout the investigation, such as performing compliance checks, setting deadlines, following

¹ A trust fund tax is money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the Department of the Treasury.

² Pyramiding involves the incurring of future additional tax liabilities.

³The ICS is an automated system used to control and monitor delinquent cases assigned to revenue officers in the IRS field offices

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- up timely, ensuring taxpayers fully understood the actions required, and performing adequate asset research.
- C. Determined if actions were timely taken, such as assigning cases to revenue officers, following up, taking enforcement actions, and monitoring Federal Tax Deposits.⁴
 - D. Determined if enforcement actions were effectively used, such as liens, levies, seizures, and Letter 903 (DO).⁵
 - E. Determined if the IRS effectively implemented corrective actions to our previous audit report⁶ findings.
 - F. Calculated the potential effect of our results across the population.
 - G. Discussed exception cases with SB/SE Division management to identify the cause for ineffective actions.

⁴ Federal Tax Deposits are advance payments made for the trust fund taxes. Generally, these payments are made once a month, twice a month, four times a month, or eight times a month, depending upon the amount of the quarterly liability and frequency of the payroll.

⁵ Letter 903 (DO) alerts a taxpayer of the seriousness of noncompliance and explains more fully the alternatives that can be taken if the taxpayer is still not in compliance with the trust fund tax requirements.

⁶ *Improvements Are Needed in Resolving In-Business Trust Fund Delinquencies to Prevent Tax Liabilities from Pyramiding* (Reference Number 2000-30-111, dated August 2000).

The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities

Appendix II

Major Contributors to This Report

Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Collection, Small Business/Self-Employed Division SE:S:C
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

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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:

- Increased Revenue – Potential; \$430 million additional accruals¹ (see page 4).

Methodology Used to Measure the Reported Benefit:

For our population, we identified 11,375 in-business trust fund² cases from an extract of the Integrated Collection System³ cases as of April 15, 2004. These cases had been open since sometime in Calendar Year (CY) 2002, had pyramided⁴ during CY 2003 through April 2004, had liabilities greater than \$10,000, and had 2 or more delinquent accounts. From this population, we selected a nationwide statistical sample of 223 cases using a confidence level of 90 percent, a precision level of ± 5 percent, and an estimated error rate of 30 percent.

Each of the 223 taxpayers in our sample accrued additional tax liabilities while the cases were open through April 30, 2004, for a total of \$8,693,905 of additional pyramided liabilities. However, in 12 of these cases, revenue officers took all effective actions. Therefore, there were 211 (95 percent) of 223 cases that contained at least 1 of the ineffective actions described in this report.

For these 211 cases, a total of \$8,392,131 additional liabilities pyramided, resulting in an average of \$39,773 per case (\$8,392,131/211). Projecting this average potential accrual per case over 10,806 taxpayers (which is 95 percent of our overall population of 11,375 taxpayers), we estimate that approximately \$430 million (10,806 x \$39,773) could pyramid if revenue officers do not take effective actions, such as enforcement actions, monitoring of Federal Tax Deposits,⁵ and/or timely follow-ups, on these cases. The methodology used to calculate this benefit was discussed with an analyst in the Small Business/Self-Employed Division, Strategy, Research, and Performance Management, Field Research function.

¹ These are projections of potential accruals, all of which may not be accrued. In addition, not all of this projected amount would be collected due to taxpayer behavior that is out of the control of the revenue officer.

² A trust fund tax is money withheld from an employee's wages (income, Social Security, and Medicare taxes) by an employer and held in trust until paid to the Department of the Treasury.

³ The Integrated Collection System is an automated system used to control and monitor delinquent cases assigned to revenue officers in the Internal Revenue Service field offices.

⁴ Pyramiding involves the incurring of future additional tax liabilities.

⁵ Federal Tax Deposits are advance payments made for the trust fund taxes. Generally, these payments are made once a month, twice a month, four times a month, or eight times a month, depending upon the amount of the quarterly liability and frequency of the payroll.

Additional Definitions of Collection Tools and Actions

Installment Agreement – Installment agreements are arrangements whereby the Internal Revenue Service (IRS) allows taxpayers to pay liabilities over time. During the course of an installment agreement, penalties and interest continue to accrue.

Levy – Internal Revenue Code Section 6331 authorizes the IRS to collect taxes by levy upon a taxpayer’s property or rights to property if the taxpayer neglects or refuses to pay the tax within 10 days after receiving a notice and demand to pay the tax. Taxpayers have appeal rights and there is a waiting period after that 10-day period. The IRS can levy a taxpayer’s salary and wages, bank accounts, or other money owed to the taxpayer.

Lien – A Federal tax lien is created by statute and attaches to a taxpayer’s property and rights to property for the amount of the liability when an assessment has been made, a demand for payment has been made, and the taxpayer has neglected or refused to pay within 10 days of notification. The IRS files a Notice of Federal Tax Lien, which notifies people that the lien exists.

Seizure – Seizure refers to taking a taxpayer’s property for unpaid tax. If other actions such as liens, levies, and installment agreements have been taken to collect the delinquent taxes and the taxpayer has not fully paid the tax due, the revenue officer has the authority to take the taxpayer’s funds or property for the payment of tax.

Summons – A summons is an enforcement tool used by the IRS to obtain information from either the taxpayer or third parties when the taxpayer will not produce the desired records or other information voluntarily. A summons should be issued when the IRS is prepared to seek judicial enforcement if the summoned party fails to fully comply.

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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
AUG 29 2005

August 25, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown *KMB*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Collection Field Function Needs to Improve Case Actions to Prevent Employers from Incurring Additional Trust Fund Liabilities (Audit #200430019)

We have reviewed your report and agree with the recommendations. While the sample of cases selected for review was not representative of the Collection Field function's (CFF's) inventory as a whole, we share your concerns about ineffective case actions on some of our most egregious taxpayer cases.

The Small Business/Self Employed (SB/SE) Division Collection management identified many of the same concerns noted in your report during SB/SE Collection Policy's Fiscal Year (FY) 2004 reviews of revenue officer cases, and through our Collection Quality Measurement System (CQMS) reviews. As a result, we initiated actions that have already contributed to positive trends in the Collection program for FY 2005.

For example, SB/SE reorganized along functional lines at the beginning of FY 2005. Prior to this reorganization, group managers and territory managers reported to managers responsible for both Collection and Examination programs, often with a functional background in only one area. Since the reorganization, Collection group managers and territory managers report to Collection area directors. This provides for greater managerial accountability. We also implemented procedural changes that are having a positive impact upon the quality of casework in the field and we have more improvements in process. We have seen positive business results in FY 2005, such as an increase in dollars collected, increased productivity, and a reduction in delinquent account cycle time.

You recommended four actions in your report that should positively impact the quality of casework in CFF. You also indicated that these recommendations would provide a potential increase in revenue of \$430 million, based on the additional tax liabilities that could possibly have pyramided on the population of cases selected if revenue officers did not take effective actions. We agree that ineffective actions on other cases in the

The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities

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population may have resulted in additional liabilities accruing similar to those that accrued in the cases you reviewed. We also concur with your observation that not all of this projected amount would be collected. However, we cannot measure the future value of this potential benefit, as it was based on a specific population of cases within the CFf inventory as of April 14, 2004. The organizational and procedural changes we have implemented since these cases were worked in CFf also would impact this outcome measure.

Our comments on your recommendations follow:

RECOMMENDATION 1:

The Director, Collection, SB/SE Division should emphasize and monitor use of Letter 903 (L-903) to determine how to increase its usage when applicable.

CORRECTIVE ACTION:

We prepared a training course on in-business trust fund pyramiding prevention techniques for revenue officers, with an emphasis on the appropriate issuance of L-903 and use of the trust fund compliance procedures. We are delivering this training during August and September 2005 as part of FY 2005 Collection Continuing Professional Education (CPE) for revenue officers.

We also will coordinate with Modernization and Information Technology Services (MITS) to develop a process to systemically monitor the use of L-903.

IMPLEMENTATION DATE:

October 15, 2005

RESPONSIBLE OFFICIAL:

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

Program Manager, Field Payment Compliance, will advise the Director, Collection Policy, of any delays.

RECOMMENDATION 2:

The Director, Collection, SB/SE Division should closely monitor new requirements for management accountability and activity in case actions to ensure that managerial involvement at all levels is occurring as planned.

CORRECTIVE ACTION:

FY 2006 Operational Reviews conducted by the Director, Collection, will include a component that specifically evaluates adherence to the review requirements for in-business trust fund and pyramiding cases that have been established in IRM Exhibits 1.4.50-8 and 1.4.50-9.

The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities

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IMPLEMENTATION DATE:

October 15, 2005

RESPONSIBLE OFFICIAL:

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

Program Manager, Field Payment Compliance, will advise the Director, Collection Policy, of any delays.

RECOMMENDATION 3:

The Director, Collection, SB/SE Division should emphasize that revenue officers need to do a better job of following through on their plans of action.

CORRECTIVE ACTION:

We prepared training on workload management for revenue officers, with an emphasis on following through on their plans of action. We are delivering this training during August and September 2005 as part of FY 2005 Collection CPE for revenue officers.

IMPLEMENTATION DATE:

October 15, 2005

RESPONSIBLE OFFICIAL:

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

Program Manager, Field Payment Compliance, will advise the Director, Collection Policy, of any delays.

RECOMMENDATION 4:

The Director, Collection, SB/SE Division should ensure revenue officers and managers better use the Integrated Collection System (ICS) features for timely follow-ups and monitoring of older cases for which enforcement actions are needed.

CORRECTIVE ACTION:

We prepared training on workload management for revenue officers, with an emphasis on using the systemic notification follow-up feature within ICS to more effectively monitor their cases for follow-up. We are delivering this training during August and September 2005 as part of FY 2005 Collection CPE for revenue officers.

IMPLEMENTATION DATE:

October 15, 2005

The Collection Field Function Needs to Improve Case Actions to Prevent Employers From Incurring Additional Trust Fund Tax Liabilities

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RESPONSIBLE OFFICIAL:

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

Program Manager, Field Payment Compliance, will advise the Director, Collection Policy, of any delays.

If you have any questions, please contact me at (202) 622-0600 or Brady R. Bennett, Director, Collection, SB/SE Division, at (202) 283-7660.