

**PREPARED TESTIMONY
OF
MARK W. EVERSON
COMMISSIONER, INTERNAL REVENUE
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
ON
COLLECTING TAXES FROM DEFENSE DEPARTMENT CONTRACTORS
FEBRUARY 12, 2004**

INTRODUCTION AND SUMMARY

Mr. Chairman, Senator Levin and distinguished members of the subcommittee, I welcome the opportunity to testify on the General Accounting Office's study on the need for strengthening government procedures and assure that Department of Defense contractors meet their federal tax obligations.

I want to say at the outset that we at the IRS agree with the major conclusions of the GAO study we are discussing today, and believe that many improvements can be made to our own efforts in this area. We are not taking full advantage of the Federal Payment Levy Program (FPLP) to collect delinquent taxes.

Before providing detailed comments on the need to improve contractor accountability, let me make general comments on the IRS agenda and the collection challenges we face.

At the IRS, our working equation is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes.

To support this philosophy of service plus enforcement equals compliance, we are guided by three themes.

First, we are improving service, making it easier for the taxpayer to understand and comply with the tax laws. We have divided the IRS into "customer segments" – including wages and income, small, medium and large businesses, non-profits and governmental entities. In the last four years, our toll-free telephone service has risen sharply. Downloads of IRS forms from our website have soared. Electronic filing of taxes has jumped from 29 million in 1999 to 52 million last year and nearly half of all taxpayers are expected to efile this coming year.

Second, we are modernizing our information technology at the IRS. The progress that I just mentioned in electronic filing and telephone service represent significant progress in our technological capabilities. But updating our antiquated computer system is also a formidable challenge. We have failed to deliver on large projects on master files and

infrastructure. We are now calibrating our efforts and focusing on improved delivery of critical projects involving our taxpayer master files and file systems.

Third, we are boosting enforcement, a key emphasis of the President's 2005 budget request just sent to Congress.

Our best estimates find that we lose a quarter trillion dollars each year because taxpayers do not pay their tax voluntarily or in a timely fashion. (This is a rough estimate based largely upon 1988 data from our old Taxpayer Compliance Measurement Program).

In the last four years, the number of Americans saying it is OK to cheat on taxes rose from 11 to 17 percent. Sixty percent of Americans believe that people are more likely to cheat on taxes and take a chance on being audited.

This drop in compliance coincides with the drop in enforcement of the tax law. Since 1996, the number of IRS revenue agents, officers, and criminal investigators has dropped by over 25 percent. This reduction has taken the meat out of enforcement. In addition, the IRS is now in a tougher budget neighborhood, having to compete with transportation for scarce resources.

Let me just say that I appreciate the support from the members of this subcommittee and the Finance Committee for increased enforcement. Mr. Chairman, I appreciate that you and Senator Levin held a hearing last fall on corporate tax shelters and accounting firms promoting those shelters. We want to work with you on statutory reform and stepping up budget resources for the IRS.

As the GAO has observed in the past, a lack of resources has hampered the IRS' ability to collect taxes even when we know who is cheating. Billions of dollars are left on the table each year because we do not have enough front-line revenue officers to collect these known debts.

Our whole tax system is one of voluntary self-assessment. This subcommittee well knows that the government's revenue stream is at risk. So is basic respect for the rule of law.

At the IRS we have begun to address the tax gap crisis. We have shifted badly needed resources so we can hire more front-line enforcement personnel – who will primarily focus on non-compliance among high income individuals and businesses.

In addition, I am most pleased and grateful that the President's FY 2005 budget submission requests an additional \$300 million for enforcement activities over the FY 2004 consolidated appropriations level.

What will this extra \$300 million do?

It will carry out four objectives in the enforcement area. They are:

- Discourage cheating and non-compliance, particularly by corporations, high income individuals and tax exempt groups.
- Help attorneys, accountants and other tax professionals adhere to professional standards and obey the law.
- Detect and deter domestic and off-shore tax and financial criminal activity.
- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance and other purposes.

This funding in the FY2005 budget will enable us to hire 1,014 collection personnel in our field and campus offices. When fully trained, they will collect roughly \$97 million additional revenue in fiscal year 2005 and more than one billion dollars in fiscal year 2006.

The Administration also has proposed to allow us to use private collection agencies to locate and contact taxpayers with outstanding tax liabilities. This proposal would greatly assist our collection efforts.

COLLECTING TAXES FROM DELINQUENT CONTRACTORS

Let me now turn to the GAO report and collecting taxes from delinquent contractors at the Department of Defense.

This is a shared problem that DOD and the IRS must address in a unified fashion if we are to achieve the common goal of ensuring that all contractors pay their taxes owed and that we take appropriate enforcement actions, including levies, against those who do not comply with the law. From the IRS' perspective, I believe we can achieve this goal through a multi-pronged approach.

GAO identified a number of specific concerns in our collection processes that we must squarely address. In the body of my testimony, I will outline the steps the IRS has begun to take to eliminate the barriers and impediments that have hampered our ability to pursue collection actions against these contractors. I have also directed our Criminal Investigation Division to review the 47 cases identified by the GAO to determine whether there is evidence of potential criminal tax evasion or failure to pay that would warrant opening a formal criminal investigation.

However, I want to stress in no uncertain terms that we will continue to respect all taxpayer rights in dealing with this situation and the individual contractors in question. The IRS Restructuring and Reform Act of 1998 (RRA 98) created new taxpayer rights for Collection Due Process, Installment Agreements and Offers in Compromise to which we must and will adhere. To the extent that DOD contractors, or other taxpayers, are abusing these important taxpayer protections in order to improperly delay or impede

enforcement action, the Administration's FY 2005 Budget proposal to address frivolous tax submissions will address those situations.

I would welcome the opportunity to work with the subcommittee, the Treasury Department, DOD, and the Office of Management and Budget to seek ways to prevent these kinds of problems from occurring in the first place. It is far easier and less expensive to prevent a problem up-front than it is to fix it down the road, or in this case, go through the time consuming and costly process of collecting delinquent taxes.

In this regard, let me make one last point. I believe all federal contractors, including those receiving money from DOD, should be held to high standards. Compared to contractors in the private sector, for instance, federal contractors face stiffer penalties and more stringent regulations involving equal opportunity and other laws. Contractors receiving taxpayer dollars should not cheat these very same taxpayers by passing their tax bills onto them. While we recognize that taxpayers may have legitimate differences with the IRS regarding their tax obligations, there are specific mechanisms for addressing those differences. Simply ignoring, or actively evading, one's tax obligations should not be acceptable.

FEDERAL PAYMENT LEVY PROGRAM

Mr. Chairman, as part of the overall collection process, we agree that the Federal Payment Levy Program can become a more effective tool to collect delinquent federal taxes owed by businesses and individuals who receive federal payments, including the cited DOD contractors.

The FPLP program provides an automated process for serving tax levies and collecting unpaid taxes through Treasury's Financial Management Service (FMS). The FMS uses its Treasury Offset Program (TOP) to match certain types of federal payments against federal tax debt records. As a result the program applies a portion of these federal payments to the outstanding tax liabilities. The administration has proposed improving the FPLP program by allowing FMS to retain directly a portion of the levied funds as payment for FMS's fees.

To ensure that we take full advantage of FPLP and other enforcement tools, we have taken a number of promising short-term steps to speed the collection of delinquent taxes. One of these addresses so-called system "blocks."

As GAO observes, IRS can restrict or block both the number of cases that enter the FPLP and the point in the collection process they enter it. For example, in the past, IRS excluded most accounts in the Automatic Collection System (ACS) process due to resource constraints related to the issuance of required levy notices and the potential increase in telephone calls from taxpayers responding to those notices. Cases in the levy notification process are also excluded to guarantee that proper notification has been executed.

After the required notice process, these cases then go to Automated Collection Operation or to our collection queue to await assignment to a field revenue officer. When that assignment is made depends on workload. At present time, workload far exceeds our limited number of field collection revenue officers.

In addition, cases assigned to revenue officers have been excluded to allow an assessment of the taxpayer's financial situation on a case by case basis prior to IRS levy action. We have taken steps to unblock these cases. Revenue officers will continue to assess each case individually subsequent to the 15% FPLP levy and may either remove the case from FPLP or send a manual levy to attach 100% of the contract proceeds.

Since implementation of the FPLP, IRS has also blocked the majority of the cases in the collection queue from the levy program for one year. The decision to exclude these cases from the FPLP was intended to ensure that we did not proceed with a levy if the taxpayer was in the process of proposing to pay via an installment agreement or offering to compromise the liability. Statutory protections prohibit levy action in these situations, and we wanted to be certain that we did not violate these protections.

That's too long. We have reviewed this system to find ways to speed up collections while not violating taxpayer rights. We changed the procedure in January 2004, and now all cases residing in the collection queue (unless they meet an operational or statutory exclusion criteria) will be part of FPLP. We previously updated our Inventory Delivery System to identify many of the in-business trust fund taxpayers as high priority work for field collection. These cases now bypass the Automated Collection System (ACS) and are placed directly in the queue for assignment to a revenue officer. By removing the block on queue cases, over a million more delinquent tax modules will be included in the FPLP match with FMS. By sending these cases to the field earlier in the collection process, while still respecting taxpayer rights, the likelihood of collection is improved because businesses are not as deeply in debt to the IRS (or other creditors) as they would be if the case had been deferred or delayed.

Mr. Chairman, we thoroughly reviewed the other systemic "blocks" in our FPLP procedures and information systems and agree with GAO that we can eliminate many blocks that delay referral of a significant number of cases into the levy program. We have identified a number of blocks that can be safely removed including many cases in our revenue officer inventory as well as our automated collection operation. We also plan to include certain cases that had been excluded as a result of criminal investigation activities. As a result of this effort, more than two million additional delinquent accounts and over \$25 billion will be included in the FPLP earlier in the collection process.

There are other steps we are taking. The GAO's report also mentions problems with data quality in the Central Contractor Registration (CCR) database, particularly as it relates to inaccurate or bogus Taxpayer Identification Numbers (TINs) provided by registered taxpayers. As we stated in our response to another GAO audit, "More Can Be Done to Ensure Federal Agencies File Accurate Information Returns," we are working with the

DOD to ensure that the vendor TINs on the CCR are accurate to the extent allowed by Section 6103 of the Internal Revenue Code.

We will continue our rollout of an interactive web-based *e*-Services application that enables certain payors to validate tax identification numbers in real time. If these payors, including other federal agencies, use this system to validate their contractors' TINs, the validity of TINs in the CCR database will be significantly improved. Prior to the implementation of this web-based system, federal agencies have had the ability and opportunity to enter into a Memo of Understanding with the IRS that would allow us to do a computer run to match their TINs and identify invalid payee TINs.

We will work with Defense Financial Accounting Service (DFAS) and FMS to obtain active contractor information. If we are able to identify contractors in the CCR who actually have federal contracts, we can explore ways to accelerate the issuance of the Collection Due Process notice (a notice required by statute prior to levy). By sending this notice earlier in the collection process, we would be able to levy more contractor payments at the time of disbursement.

GAO matched IRS delinquent tax accounts with DFAS listing of active contracts and found that there were approximately 8,600 taxpayers with both delinquent accounts and active DOD contracts. Working with DFAS and FMS, IRS will further attempt to recreate the match process used by GAO. We propose to identify cases in which there is currently an active contract and an outstanding tax liability. We will examine them to determine the case status, the appropriateness of levy as the next action, and whether referral to the FPLP is appropriate.

FILING AND PAYMENT COMPLIANCE (F&PC) MODERNIZATION

Mr. Chairman we are also making some fundamental changes to the entire collection process. The Filing and Payment Compliance (F&PC) modernization project is an end-to-end strategy to resolve collection issues quickly and fairly. Using industry best practices, it augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights is an important component of this strategy. The ultimate goals are to resolve all balance due cases above a minimum threshold, shorten the filing compliance lifecycle to ensure resolution before the next filing due date and shorten the payment compliance lifecycle to six months for non-enforcement cases.

New technologies will provide an integrated suite of tools across the full filing and payment compliance process life cycle. Two examples include Decision Analytics, which will provide risk based scoring, case prioritization, and select the most suitable treatment stream to be applied to each case, and Collection System, which will provide inventory management, case workload management and case resolution tools. These tools will provide the IRS with the ability to manage its accounts receivable more effectively and efficiently.

The goals of F&PC will be achieved in an environment that protects taxpayer rights, reduces taxpayer burden, and increases customer as well as employee satisfaction. All F&PC systems and processes will meet privacy and security standards, and afford full protection of taxpayer rights. F&PC will ensure that similar taxpayers are treated fairly and consistently across geographic and economic lines. Improved workload management tools will guarantee that procedures are fairly and consistently applied in addressing compliance issues.

Taxpayers will have improved access to IRS assistance, including on-line (self-correct), phone, and field. F&PC will result in improved timeliness and accuracy of data and quicker case resolution. Employees will work cases that are current and matched to their skill level, while utilizing improved tools to manage and work their inventories.

COLLECTION CHALLENGES AND EARLY PREVENTION

Mr. Chairman, we will work with the GAO to carry out many of its key recommendations. As I previously stated, we are implementing a number of short-term steps that will go a long way to remove the barriers and impediments that GAO identified. We will revise the way we work cases to make better use of the Federal Payment Levy Program.

However, we must also realize inherent limitations. Some of the DOD cases, such as the ones in which a taxpayer transferred assets to another company, or in which an individual diverted corporate assets to personal use by taking a sizeable loan from the corporation, were more sophisticated and would not have been resolved by the FPLP. They require solid collection work by our revenue officers.

In addition, the notion of “levy first” is also a bit misleading. As discussed in more detail below, we are obligated to follow specific and often detailed procedures throughout the collection process, and particularly with respect to proposed levies. By their very nature, these taxpayer rights provision add time and steps to the collection process. In many cases, the IRS and FMS cannot take levy action while a taxpayer is attempting to address a tax liability. The Administration’s Budget contains an important proposal that will help ensure that these taxpayers protections are not abused to unnecessarily delay the collection of tax, including through levies.

Another helpful budget proposal would make up to 100 percent of a vendor’s payments subject to offset under the Federal Payment Levy Program, up from the current 15 percent maximum offset level.

However, the larger issue is one of prevention. In this regard, I would welcome the opportunity to work with the subcommittee and federal agencies to seek ways to prevent these kinds of problems from occurring in the first place. We intend to create a cross-functional group drawn from the Internal Revenue Service, the Financial Management Service, Office of Management and Budget, and the Department of Defense.

We will ask this group to examine short-term operational changes and long-term solutions – and report back by June 1 of this year. It is far easier and less expensive to put a stop to a problem up-front than it is to fix it down the road, or in this case, go through the time consuming and costly process of collecting delinquent taxes.

TAXPAYER PROTECTION AFFECTING ACCOUNTS ELIGIBLE FOR FPLP

Although we are examining all ways in which the FPLP can be made more effective, particularly with respect to DOD contractors with outstanding tax obligations, important, statutory taxpayer protections limit the number of outstanding accounts that may be eligible for referral to the FPLP at any given time. In general, these provisions prohibit levy action when a taxpayer takes one of a number of actions either to attempt to resolve an outstanding tax liability or to challenge a collection action such as a proposed levy.

When enacted in 1997, the use of the new continuous levy authority, as with all levies, was generally limited under the Internal Revenue Code only by certain notice provisions, such as the notice and demand for payment under section 6303 and the notice of intent to levy under section 6331(d)(1). These automated notices gave taxpayers the opportunity to pay prior to levy and the opportunity to propose alternative payment arrangements but did not erect significant barriers to collection should a taxpayer neglect to do so.

In RRA 98, Congress added additional taxpayer protections that can significantly postpone use of the federal payment levy:

- Section 6330 generally prohibits the use of any levy (including continuous levies by FMS as part of the FPLP) unless the IRS has notified the taxpayer of his or her right to a Collection Due Process (CDP) hearing. If the taxpayer requests a CDP hearing, then the proposed levy cannot proceed until the resolution of that hearing, which may involve judicial review. The IRS must give taxpayers an opportunity to respond to the CDP notice, and suspends levy action during this period, even if the taxpayer ultimately does not request a CDP hearing.
- Section 6331(k) generally prohibits levy action when a taxpayer has proposed to compromise a tax liability or seeks to enter into an installment agreement. A taxpayer may appeal the rejection of an offer in compromise or proposed installment agreement to the IRS Office of Appeals, and the prohibition on levy continues while this appeal is pending.
- Section 6331(i) prohibits the making of levies during the period that a taxpayer's refund suit for a divisible tax (such as employment taxes) is pending in federal district court. Thus, if such a suit were pending with respect to employment taxes relating to a particular employee and a particular tax period, the IRS generally could not commence a levy to collect from that employer. In some cases, the IRS will be prohibited from collecting unpaid

taxes not directly involved in the refund action, such as taxes relating to other tax periods or different employees.

Some of the other statutory provisions that affect the eligibility of an account for the FPLP include those relating to Innocent and Injured Spouse claims and Taxpayer Assistance Orders by the National Taxpayer Advocate. Military personnel serving in a designated combat zone are further excluded.

Mr. Chairman, the IRS has and must continue to honor these statutory taxpayer rights. Although these provisions may limit the accounts that may be eligible for the FPLP, Congress enacted these provisions to provide important protections to taxpayers. Although we are continually examining how we can make all of our operations, including the collection process, more efficient and effective, that changes we make cannot be at the expense of taxpayer protections.

At the same time, we are aware that some taxpayers are abusing the safeguards enacted by Congress and are using these provisions to improperly delay and impede tax administration. Some taxpayers, for example, are basing offers to compromise a liability or CDP hearing requests on frivolous arguments that are utterly lacking in merit. Although we deal with these frivolous submissions, doing so takes time and provides these taxpayers with protection from levy in the interim. This not only is a waste of IRS resources but also is unfair to the vast majority of taxpayers who do their best to pay their fair share and to those taxpayers are using these procedures as a legitimate attempt to address their tax obligations.

The Administration's Budget for FY 2005 contains an important proposal that will allow the IRS to deal quickly with frivolous submissions that delay or impede tax administration. This proposal will cover frivolous offers in compromise, offers to enter into installment agreements, and requests for CDP hearings. The IRS under this proposal will be able to move forward quickly with collection action (including levy) when a taxpayer is raising frivolous arguments, and the proposal has been carefully crafted to ensure that it targets only those taxpayers who are abusing the system. To the extent that DoD contractors are abusing existing taxpayer protections to avoid levy under the FPLP, this proposal will allow the IRS to put a stop to these practices.

CONCLUSION

Mr. Chairman, the IRS welcomes the findings and recommendations made by the General Accounting Office. We will work with the subcommittee, the Department of Defense, the Financial Management Service, the GAO and all other affected parties to deal with these specific contractor cases and to improve and revise the way we work future cases to make better use of the Federal Payment Levy Program.

We are making specific changes to address the concerns raised by GAO. We took steps to make an additional \$20 billion subject to taxes. We are examining the 47 cases that

GAO identified as potentially involving criminal acts. And we are creating a cross-functional group to come up more solutions. I hope that we can all come together and look for constructive ways to prevent this type of abuse from occurring.

Lastly, I once again urge the Congress to support the Administration's FY 05 budget request for the IRS. It is critical to ensuring that we have an effective enforcement program and to maintaining the public's confidence in the fairness of our system. Thank you, and I welcome your questions.