

June 2005

FINANCIAL  
MANAGEMENT

Thousands of Civilian  
Agency Contractors  
Abuse the Federal Tax  
System with Little  
Consequence



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-637](#), a report to congressional requesters

## Why GAO Did This Study

Tax abuses by contractors working for the Department of Defense, on which GAO previously reported, have led to concerns about similar abuses by those hired by civilian agencies. GAO was asked to determine if similar problems exist at civilian agencies and, if so, to (1) quantify the amount of unpaid federal taxes owed by civilian agency contractors paid through the Financial Management Service (FMS), (2) identify any statutory or policy impediments and control weaknesses that impede tax collections under the Federal Payment Levy Program (FPLP), and (3) determine whether there are indications of abusive or potential criminal activity by contractors with unpaid tax debts.

## What GAO Recommends

GAO makes 18 recommendations to FMS to improve the FPLP and increase by tens of millions of dollars annually the amounts levied from payments to contractors with unpaid federal taxes. GAO also recommends that the Internal Revenue Service (IRS) review and, if warranted, pursue collection or criminal investigation of the 50 case study contractors identified in this report. IRS agreed and FMS partially agreed. FMS did not agree that it should withhold payments to contractors without names or work with IRS to address challenges related to levying purchase card payments. GAO disagrees with FMS's assessment and reiterates support for all of its recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-05-637](http://www.gao.gov/cgi-bin/getrpt?GAO-05-637).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Greg Kutz at (202) 512-9095 or Steven Sebastian at (202) 512-3406.

## FINANCIAL MANAGEMENT

# Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence

## What GAO Found

FMS and IRS records showed that about 33,000 civilian agency contractors owed over \$3 billion in unpaid federal taxes as of September 30, 2004. All 50 civilian agency contractors we investigated had abusive and potentially criminal activity. For example, businesses with employees did not forward payroll taxes withheld from their employees to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Further, several individuals own multiple businesses with unpaid federal taxes—one individual owns about 20 businesses that did not fully pay taxes related to over 300 returns. Some contractors purchased or owned millions of dollars of property while they did not remit payroll taxes. These activities were identified for contractors at the Departments of Justice, Homeland Security, and Veterans Affairs; the National Aeronautics and Space Administration; and others agencies.

### Examples of Abusive and Potentially Criminal Activity

| Business       | Unpaid tax amount | Fiscal year 2004 FMS payments | Contractor activity   |
|----------------|-------------------|-------------------------------|---|
| Health care    | \$18 million      | \$300,000                     | Purchased multimillion-dollar properties while not paying millions in payroll taxes                               |
| Consulting     | \$1 million       | \$200,000                     | Doubled salary of one officer/owner to over \$750,000 while not remitting payroll taxes                           |
| Temporary help | \$900,000         | \$1 million                   | A pattern of nearly 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts |
| Security       | \$400,000         | \$200,000                     | Diverted payroll taxes to a foreign bank account to build a house overseas  |

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

GAO's analysis indicates that if all tax debts owed by, and all payments made to, the 33,000 contractors were included in the FPLP, FMS could have collected hundreds of millions of dollars in fiscal year 2004. However, because only a fraction of all unpaid taxes and a portion of FMS payments are subjected to the levy program, FMS actually collected only \$16 million from civilian contractors. For example, about \$171 billion of unpaid federal taxes were not sent to the levy program to be offset against payments because of specific statutory requirements or IRS policy exclusions, such as debtors' claims of financial hardship or bankruptcy.

Tens of billions of dollars in federal payments were not compared against tax debts for potential levy because FMS did not proactively manage and oversee the levy program. Until we brought it to FMS's attention, FMS did not know that it did not submit \$40 billion of contractor payments from some civilian agencies for potential levy. FMS also did not identify payment files that did not contain contractor tax identification numbers, names, or both, resulting in \$21 billion in payments to contractors that could not be levied. FMS also excluded billions of dollars from levy because of what it considered programming limitations without taking proactive steps to overcome those limitations. Further, civilian agency purchase card payments to contractors totaling \$10 billion could not be levied. Improvements at FMS could result in tens of millions of dollars of additional levies annually.

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# Contents

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## Letter

|   |    |
|---|----|
| Results in Brief  | 1  |
| Background  | 4  |
| Civilian Contractors Have Billions of Dollars in Unpaid Federal Taxes   | 9  |
| Legal Requirements and IRS Policy Decisions Contribute to the Levy Collection Gap                                   | 14 |
| Lack of FMS Oversight and Proactive Management Further Contribute to the Levy Collection Gap                        | 22 |
| Civilian Agency Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System | 30 |
| Conclusions   | 44 |
| Recommendations for Executive Action  | 54 |
| Agency Comments and Our Evaluation  | 57 |

---

## Appendixes

|  |    |
|--|----|
| <b>Appendix I: Scope and Methodology</b>                           | 64 |
| <b>Appendix II: Contractors with Unpaid Federal Taxes</b>          | 69 |
| <b>Appendix III: Comments from the Internal Revenue Service</b>    | 78 |
| <b>Appendix IV: Comments from the Financial Management Service</b> | 81 |
| <b>Appendix V: Staff Acknowledgments</b>                           | 85 |

---

## Tables

|  |    |
|--|----|
| Table 1: Payments Not Matched against Tax Debts for Potential Levy                           | 31 |
| Table 2: Types of Goods and Services Provided by Civilian Agency Contractors in Case Studies | 45 |
| Table 3: Civilian Agency Contractors with Unpaid Federal Taxes                               | 48 |
| Table 4: Civilian Agency Contractors with Unpaid Federal Taxes                               | 69 |

---

## Figures

|   |    |
|---|----|
| Figure 1: Levy Process  | 12 |
| Figure 2: Type of Debt Owed by Civilian Contractors as of September 30, 2004                      | 17 |
| Figure 3: Civilian Contractors' Unpaid Federal Taxes by Tax Periods through 2003 by Calendar Year | 18 |
| Figure 4: Levy Status of Unpaid Federal Taxes as of April 2005                                    | 23 |
| Figure 5: IRS Statutory Exclusions as of April 2005   | 24 |

---

|  |    |
|--|----|
| Figure 6: IRS's Policy Exclusions from the Levy Program as of April 2005         | 26 |
| Figure 7: Purchase Card Expenditures by Civilian Agencies—Fiscal Years 1997-2004 | 42 |

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**Abbreviations**

|         |   |
|---------|---|
| ACH     | Automated Clearing House                          |
| ACH-CTX | Automated Clearing House-Corporate Trade Exchange |
| ACS     | Automated Collection System                       |
| DCIA    | Debt Collection Improvement Act of 1996           |
| DOD     | Department of Defense                             |
| EFT     | electronic funds transfer                         |
| FICA    | Federal Insurance Contribution Act                |
| FMS     | Financial Management Service                      |
| FPLP    | Federal Payment Levy Program                      |
| IRS     | Internal Revenue Service                          |
| NASA    | National Aeronautics and Space Administration     |
| PACER   | Payments, Claims, and Enhanced Reconciliation     |
| TFRP    | trust fund recovery penalty                       |
| TIN     | taxpayer identification number                    |
| TOP     | Treasury Offset Program                           |

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United States Government Accountability Office  
Washington, D.C. 20548

June 16, 2005

### Congressional Requesters

The success of our tax system hinges on the public's perception of its fairness, including the extent to which taxpayers believe their friends, neighbors, and business competitors are complying with the tax laws and are actually paying their taxes. The Internal Revenue Service's (IRS) own data in this regard are not encouraging. IRS reported that the federal government does not receive hundreds of billions of dollars in taxes owed annually. Recent IRS data, released in March 2005, showed that the estimated net annual tax gap—the difference between what taxpayers should pay on a timely basis and what IRS collected through voluntary compliance and enforcement activities—ranged from \$250 billion to nearly \$300 billion.<sup>1</sup>

A portion of the tax gap is owed by contractors receiving payments from the federal government. For example, in February 2004, we reported that some Department of Defense (DOD) contractors abuse the federal tax system with little consequence.<sup>2</sup> In our report and during a related congressional hearing,<sup>3</sup> we pointed out that based on our analysis of a limited number of DOD disbursement systems, more than 27,000 DOD contractors owed nearly \$3 billion in unpaid federal taxes. We also reported that some of these contractors were engaged in abusive<sup>4</sup> and

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<sup>1</sup> These data were released to the public as part of a National Research Program sample of 46,000 individual tax returns for calendar year 2001. The tax gap amount also includes an estimate for corporate tax debt based on IRS's 1988 compliance research.

<sup>2</sup> GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-95](#) (Washington, D.C.: Feb. 12, 2004).

<sup>3</sup> GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-414T](#) (Washington, D.C.: Feb. 12, 2004).

<sup>4</sup> We considered activity to be abusive when a contractor's actions or inactions, though not illegal, took advantage of the existing tax enforcement and administration system to avoid fulfilling federal tax obligations and were deficient or improper when compared with behavior that a prudent person would consider reasonable.

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potentially criminal<sup>5</sup> activities. Due to the significance of the issues raised at that hearing, you asked us to provide additional information about whether contractors for other federal agencies were engaged in similar tax abuses and to provide recommendations to increase the effectiveness and efficiency of tax revenue collections from federal contractors under the Federal Payment Levy Program (FPLP).

This is the first in a series of reports to respond to your request. The specific objectives of this first audit and investigation were, to the extent possible, to (1) quantify the magnitude of unpaid taxes of contractors at federal civilian agencies that are paid through the Department of the Treasury's (Treasury) Financial Management Service (FMS); (2) identify some statutory or policy impediments and control weaknesses that impede tax collections under the FPLP; and (3) determine, using case studies, whether indications exist that federal contractors with unpaid taxes are engaged in abusive or potentially criminal activities. To identify the extent of such activities, we analyzed the tax debt and activity of entities with either the same owners or officers, common taxpayer identification numbers (TIN) or addresses, or other relationships as a group to identify patterns of abusive or potentially criminal activities. We will address issues surrounding the amount of tax debt IRS sends to the FPLP in subsequent reports.

To meet our first two objectives, we (1) identified civilian agency contractors receiving federal payments that owe taxes by comparing the database of FMS contractor payments with the IRS database of unpaid taxes, (2) estimated the potential dollar amount that could be collected if all unpaid taxes owed by civilian contractors and all FMS payments to civilian contractors were subject to the FPLP, (3) reviewed major federal laws and regulations and FMS policies on the FPLP, and (4) interviewed FMS and IRS officials on processes and procedures related to the FPLP. To avoid overstating the tax debt and potential levy amount, we limited the population of tax debts from which we performed our analysis to tax debts that have been agreed to by the taxpayers or confirmed by the courts, tax debts for periods prior to calendar year 2004, tax debts of more than \$100, and fiscal year 2004 civilian contractor payments paid through FMS of

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<sup>5</sup> We characterized as potentially criminal any activity related to federal tax liability that may be a crime under a specific provision of the Internal Revenue Code. Depending on the potential penalty provided by statute, the activity could be a felony (punishable by imprisonment of more than 1 year) or a misdemeanor (punishable by imprisonment of 1 year or less).

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more than \$100. We used data mining techniques to meet our third objective—identifying civilian agency contractors engaged in abusive or potentially criminal activity.

Although we were able to validate that the payment data provided by FMS reflected disbursements to contractors, we were unable to confirm that the disbursement data we received reflect all payments made to contractors. Specifically, FMS was unable to provide us with electronic disbursement data related to payments made to contractors through Fedwire, a large system used for payments requiring same-day settlement. Further, IRS's databases do not identify all unpaid federal taxes caused by a contractors' underreporting of income or failure to file taxes. Because of these problems, the FMS and IRS data we used will likely understate the magnitude of contractors with unpaid federal taxes and the potential levy collection. Further details on our scope and methodology are included in appendix I.

Our work was performed from May 2004 through May 2005 in accordance with generally accepted government auditing standards. The investigative portion of our work was completed in accordance with investigative standards established by the President's Council on Integrity and Efficiency. The results of 10 case studies we investigated are shown in table 3. The results of another 40 case studies are included in appendix II. We requested comments on a draft of comments on a draft of this report from the Commissioner for Internal Revenue or his designee and from the Commissioner, Financial Management Service or his designee. We received written comments from the Internal Revenue Service and the Financial Management Service, which are reprinted in appendixes III and IV of this report.

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## Results in Brief

As was the case at DOD, many contractors of civilian agencies throughout the federal government abuse the federal tax system with little consequence. Our analysis of FMS and IRS records showed that about 33,000 contractors that received substantial federal payments from civilian agencies during fiscal year 2004 owed a total of more than \$3 billion in unpaid taxes. The unpaid taxes included corporate income, excise, unemployment, individual income, and payroll taxes.<sup>6</sup> We estimate that if there were no legal or procedural impediments to levying contractor payments to satisfy unpaid federal taxes, IRS and FMS could collect hundreds of millions of dollars annually. Since FMS collected \$16 million in levies<sup>7</sup> from civilian contractors through the FPLP during fiscal year 2004, there is a significant tax levy collection gap. We also found evidence of abusive and potentially criminal activity on the part of contractors with unpaid tax debts.

A substantial portion of the levy collection gap is attributable to legal requirements and policy decisions at IRS. Of IRS's approximately \$269 billion in unpaid federal taxes as of April 2005, about \$171 billion is excluded from the levy program. Of this amount, about \$71 billion was excluded because of statutory provisions while another \$100 billion was excluded due to IRS policy decisions. This leaves approximately \$98 billion in tax debt potentially subject to collection through the levy program. However, for 70 percent of the amount that IRS forwards to FMS for potential levy, IRS had not yet completed all of the legal notifications necessary for FMS to begin levying payments. As a result, only a small fraction of all unpaid federal taxes are eligible to be collected through the levy program. While the exclusion of unpaid federal taxes from the levy program is justified depending on the circumstances, it nevertheless results in the potential loss of hundreds of millions of dollars in tax collections. We will examine in detail in a later report the accuracy and reasonableness of the IRS exclusions.

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<sup>6</sup> Payroll taxes are amounts that businesses withheld from employees' wages for federal income taxes, Social Security, and Medicare but failed to remit to IRS, as well as the related employer matching contributions for Social Security and Medicare taxes.

<sup>7</sup> Levy generically refers to seizure of property to collect a debt. For tax debt, it is the legal process by which IRS orders a third party (e.g., FMS) to turn over property in its possession (e.g., the federal payment) that belongs to the tax debtor named in a notice of levy. Overall, the reduction of federal payments to satisfy debt is referred to as an offset.

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Weaknesses in internal controls and lack of proactive management at FMS further restricted the levy potential and contributed to the levy collection gap. We estimate that if the FMS deficiencies we identified were corrected, FMS could have collected at least \$50 million more than it did in fiscal year 2004. Specifically, lack of oversight led to FMS's failure to update its levy database to include all agency paying stations, resulting in \$40 billion in contractor payments—16 percent of all fiscal year 2004 contractor payments recorded in FMS's payment database—being inappropriately excluded from the levy program. Lack of oversight also resulted in payments being sent to the levy program without the necessary data required for levy. Payments with missing data included \$17 billion in payments made to contractors without TINs and with obviously erroneous TINs,<sup>8</sup> nearly \$4 billion without valid contractor names, and \$5 billion without proper payment type coding. A cursory review could have identified these deficiencies in agency-submitted payment files. With the exception of payments without TINs, FMS was not aware of these omissions until we brought them to its attention. Further, although FMS was aware that payments were made to contractors without TINs, FMS had not taken action to address this deficiency. FMS's failure to identify and enforce information requirements for disbursements reduced the amount of unpaid federal taxes that was collected through the FPLP.

FMS has not been proactive in making changes necessary to maximize levy collections by adding tens of billions of dollars in payments that are currently excluded from the FPLP. These exclusions include about \$26 billion (11 percent of FMS's 2004 contractor disbursements) of certain categories of payments that FMS recorded in its payment database during fiscal year 2004, and an unknown but potentially material amount of Fedwire payments—payments requiring same-day settlement. FMS has not taken actions to include these payments in the levy program because of what it considers programming limitations. Similarly, FMS does not levy any contractor payments to collect taxes owed by individuals, including self-employed individuals and those with sole proprietorships. IRS and FMS decided not to levy contractors' payments to collect the unpaid federal taxes of contractors that file individual tax returns to avoid the possibility of mistakenly levying an individual's payment to satisfy an

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<sup>8</sup> A TIN is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number assigned by IRS serves as the TIN. For individuals, the Social Security number assigned by the Social Security Administration serves as the TIN.

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unrelated business's tax debt. Such an error could occur because a business and an individual could have identical TINs and similar names, and FMS's disbursement files do not distinguish between payments to businesses and payments to individuals. While FMS and IRS officials recognized that the potential risk of an improper levy resulting from an erroneous match of an individual's payment with a business's tax debt is probably small, they have only recently begun to take steps to allow the unpaid federal taxes of individuals to be collected under the levy program.

Finally, FMS has not addressed other challenges in the levy program that further limit its effectiveness at collecting unpaid taxes. These challenges include (1) matching the contractor name on the payment record to the name in IRS's tax records, (2) levying contractors paid with government purchase cards, and (3) implementing the increased 100 percent levy provision authorized in 2004. We found that nearly \$2 billion of payments to contractors with unpaid taxes could not be levied because of the requirement to match both the name and TIN in the payment records to the unpaid federal taxes in the Treasury Offset Program (TOP) database. FMS does not subject to levy the nearly \$10 billion of fiscal year 2004 federal payments to contractors made with purchase cards because the government payment is made to the bank that issued the purchase card, not the contractor doing business with the government. FMS officials stated that although they had met with certain bank officials and another federal agency regarding this issue, they had not yet determined how to collect federal debts from contractors paid with the purchase cards. Finally, FMS faces a significant challenge in implementing a provision of the American Jobs Creation Act of 2004, which allows the federal government to levy up to 100 percent—up from a maximum of 15 percent—of specified payments for goods and services provided by contractors with unpaid federal taxes. FMS faces difficulty because civilian payment systems presently do not distinguish goods and services, which are subject to the increased 100 percent levy provision, from real estate payments, which IRS has determined are not. Overall, until FMS improves its oversight and management of the FPLP and addresses these challenges, it will not be able to realize the full potential of the program.

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Our audit and investigation of 50 case study contractors<sup>9</sup> paid through FMS identified numerous instances of abusive or potentially criminal activity. The subjects of the 50 case studies are mostly small companies—many of them closely held by the owners and officers—operating in wage-based industries. These companies provided building maintenance, computer, consulting, health care, personnel, security, and other services at numerous federal agencies, including agencies tasked with national security and law enforcement, such as the Departments of Homeland Security, Justice, and State. The 50 case studies included businesses that had unpaid payroll taxes (as well as corporate income, personal income, and other types of unpaid taxes). One group of related businesses had unpaid taxes in over 300 tax returns. Rather than fulfilling their role as “trustees” and forwarding these amounts as required by law to IRS, these contractors diverted the money for personal gain or to fund their businesses. Willful failure to remit payroll taxes is a felony.

Some owners or officers of businesses with unpaid taxes also have individual tax debts and are associated with other businesses that have unpaid federal taxes. One case study contractor has a 20-year history of opening a business, failing to remit taxes withheld from employees to IRS, and then closing the business, only to start the cycle all over again and incur more tax debts almost immediately. We also found that a number of owners or officers in our case studies have significant personal assets, including a sports team, commercial properties, houses worth over \$1 million, and luxury vehicles. Despite owning significant assets, the owners or officers did not ensure the payment of the delinquent taxes of their businesses, and sometimes did not pay their own individual income taxes.

Through our case studies, we also found that some owners or officers of civilian agency contractors with unpaid federal taxes had been convicted or indicted of criminal conduct, such as embezzlement and money laundering. For example, an officer of one case study contractor was convicted for stealing hundreds of thousands of dollars from the company, and the company’s owner was indicted for embezzlement. Some

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<sup>9</sup> In instances where our work indicates that the owners or officers of the business are involved in other related entities that have unpaid federal taxes, we performed detailed audit and investigation on the related entities, the owners or officers, and not just the original business we identified. In instances where related entities exist, we defined a case study to include all the related entities, and reported on the combined unpaid taxes and combined fiscal year 2004 payments for all the related entities.

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contractors included in our investigation stated that they diverted the payroll taxes that they did not remit to IRS for personal gain or to fund their businesses. One of the owners was using the payroll taxes not remitted to IRS to build a house overseas.

Finally, to improve collections under the FPLP, we are making 18 recommendations to the Commissioner of the Financial Management Service, including recommendations to include all payment categories in the levy program; ensure payments from all agency paying stations are subjected to potential levy; and verify that all payment files contain information needed to levy contractor payments, such as payment type, name, and TIN (where required). We are also recommending that FMS work with IRS to determine how to collect unpaid taxes from sole proprietors and contractors paid with government purchase cards and to determine the steps needed to implement the 100 percent levy authorized by the American Jobs Creation Act of 2004. In addition, we are making a recommendation to the Commissioner of Internal Revenue to review the 50 case study companies and determine whether additional collection action or criminal investigation is warranted.

IRS agreed and FMS partially agreed with our recommendations. FMS did not agree with our recommendations that it should withhold payments to contractors without names or work with IRS to explore options to levy or otherwise collect from purchase card payments. FMS also disagreed with our characterization of its management of the levy program but did not dispute the factual basis on which we based our findings and recommendations. We disagree with FMS's assessment and reiterate support for our recommendations. See the "Agency Comments and Our Evaluation" section of this report for a more detailed discussion of the agency comments. We have reprinted the IRS and FMS written comments in appendixes III and IV.

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## Background

In its role as the nation's tax collector, IRS is responsible for collecting taxes, processing tax returns, and enforcing the nation's tax laws. Treasury's FMS is the central disbursing authority for civilian agencies. With limited exceptions,<sup>10</sup> FMS processes most disbursements for civilian agencies in the executive branch. FMS is also the federal government's central debt collection agency. Since fiscal year 2000, FMS has operated the FPLP in conjunction with IRS to collect unpaid federal taxes, including tax debt owed by federal contractors.

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## IRS's Collection of Unpaid Taxes

Since 1990, we have designated IRS's enforcement of tax laws as a governmentwide high-risk area.<sup>11</sup> In attempting to ensure that taxpayers fulfill their obligations, IRS is challenged on virtually every front. While IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased, until fiscal year 2005, the resources IRS has been able to dedicate to enforcing the tax laws have declined. Enforcement efforts are designed to increase compliance and reduce the tax gap. However, IRS recently reported that the gross tax gap, that is, the difference between what the taxpayers should pay on a timely basis and what they actually pay, exceed \$300 billion annually. IRS estimated the gross tax gap to be between \$312 billion and \$353. IRS further reported that its enforcement activities, coupled with late payments, recover just \$55 billion of that amount, leaving a net tax gap of from \$257 billion to \$298 billion. Preliminary IRS estimates indicate that noncompliance is from 15 percent to 16.6 percent of taxpayers' true tax liability, which further fuels congressional and public concern that declines in IRS compliance and collections programs are eroding taxpayer confidence in the fairness of our federal tax system.

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<sup>10</sup> A few civilian agencies, such as the U.S. Postal Service, have their own disbursing authority and do their own disbursements. Although DOD has its own disbursement authority, some DOD payments are made through FMS.

<sup>11</sup> Additionally, we designated IRS's financial management and systems modernization as high-risk areas in 1995. See GAO, *High-Risk Series: An Overview*, [GAO/HR-95-1](#) (Washington, D.C.: February 1995). In 2005, two of IRS's high-risk areas—collection of unpaid taxes and earned income credit noncompliance—were consolidated to make a single high-risk area called enforcement of tax laws. Also in 2005, IRS's high-risk areas of business systems modernization and financial management were merged into a single high-risk area called business systems modernization. See GAO, *High-Risk Series, An Update*, [GAO-05-207](#) (Washington, D.C.: January 2005).

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## FMS Disbursements

In fiscal year 2004, FMS made over 940 million disbursements totaling over \$1.5 trillion. FMS's major disbursing activities include paying Social Security benefits, veterans' compensation, federal tax refunds, federal salaries and pensions, and contractor and miscellaneous payments. For statutory and logistical reasons, a limited number of other governmental agencies, such as DOD and the U.S. Postal Service, have their own authority to disburse funds. Those agencies that have the authority to disburse federal funds are referred to as Non-Treasury Disbursing Offices.

Although FMS is the disbursing agent for most of the federal government, that is, it physically writes the checks or sends the electronic payments, it does so on the behalf of, and at the direction of, the various federal agencies. Federal agencies may have multiple offices or locations that perform accounting for and preparation of payment information, referred to by FMS as agency locations or paying stations.<sup>12</sup> To generate a payment, an agency payment location sends FMS a payment file, along with an accompanying payment certification requesting that FMS disburse funds. Agencies typically send the certification and detailed payment information in an automated form, and FMS loads the payment data into its payment system. Once loaded, FMS verifies that all payment requests were properly authorized and certified and that the amount on the payment file agrees with the certification amount before processing the payments for disbursement.

FMS disburses federal funds via three main mechanisms: electronic funds transfer (EFT) via Automated Clearing House (ACH), Fedwire, and checks. Fedwire is also an EFT that provides for immediate transfers of funds from the government's account in the Federal Reserve to the contractors' bank accounts. According to FMS records, of the approximately \$1.5 trillion disbursed by FMS in fiscal year 2004, about 66 percent was disbursed using ACH, 17 percent via Fedwire, and the remaining 17 percent as checks.

Once payments are disbursed, payment information related to ACH and checks are sent to FMS's Payments, Claims, and Enhanced Reconciliation (PACER) system, which maintains payment data and provides federal

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<sup>12</sup> The Treasury agency location code (ALC) is used to identify transactions, documents, and reports processed through Treasury by a specific accounting point or station, within an agency or bureau of a federal department or independent agency. The use of the ALC, also referred to as the accounting station symbol, enables Treasury to reconcile deposits and disbursements.

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payment agencies online access to these data. Among other payments, PACER contained about 12.9 million contractor payments valued at \$247 billion for fiscal year 2004. Unlike checks and ACH payments, detailed information regarding Fedwire payments is not sent to the PACER payment database.

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## Treasury Offset and Federal Payment Levy Programs

In 1996, Congress passed the Debt Collection Improvement Act 1996 (DCIA) to maximize the collection of delinquent nontax debts owed to federal agencies. As part of implementing its responsibilities under DCIA, Treasury established the TOP, to be administered by FMS, to centralize the process by which certain federal payments are withheld or reduced (offset) to collect delinquent nontax debts owed to federal agencies.<sup>13</sup> Under the regulations implementing DCIA, FMS and other disbursing agencies are required to compare their payment records with debt recorded in the TOP database. If a match occurs, the disbursing agency must offset the payment, thereby reducing or eliminating the nontax debt.

To improve collection of unpaid taxes, the Taxpayer Relief Act of 1997 authorized IRS to continuously levy up to 15 percent of specified federal payments made to businesses and individuals with unpaid federal taxes.<sup>14</sup> The continuous levy program, now referred to as FPLP, was implemented in July 2000. The FPLP provides for the levy of various federal payments, including federal employee retirement payments, certain Social Security payments, selected federal salaries, and contractor payments. For payments disbursed by FMS on behalf of most federal agencies, the amount to be levied and credited to IRS is deducted before FMS disburses the payment. In fiscal year 2004, IRS received \$114 million through the FPLP for delinquent taxes, \$16 million of which was from payments to civilian contractors.

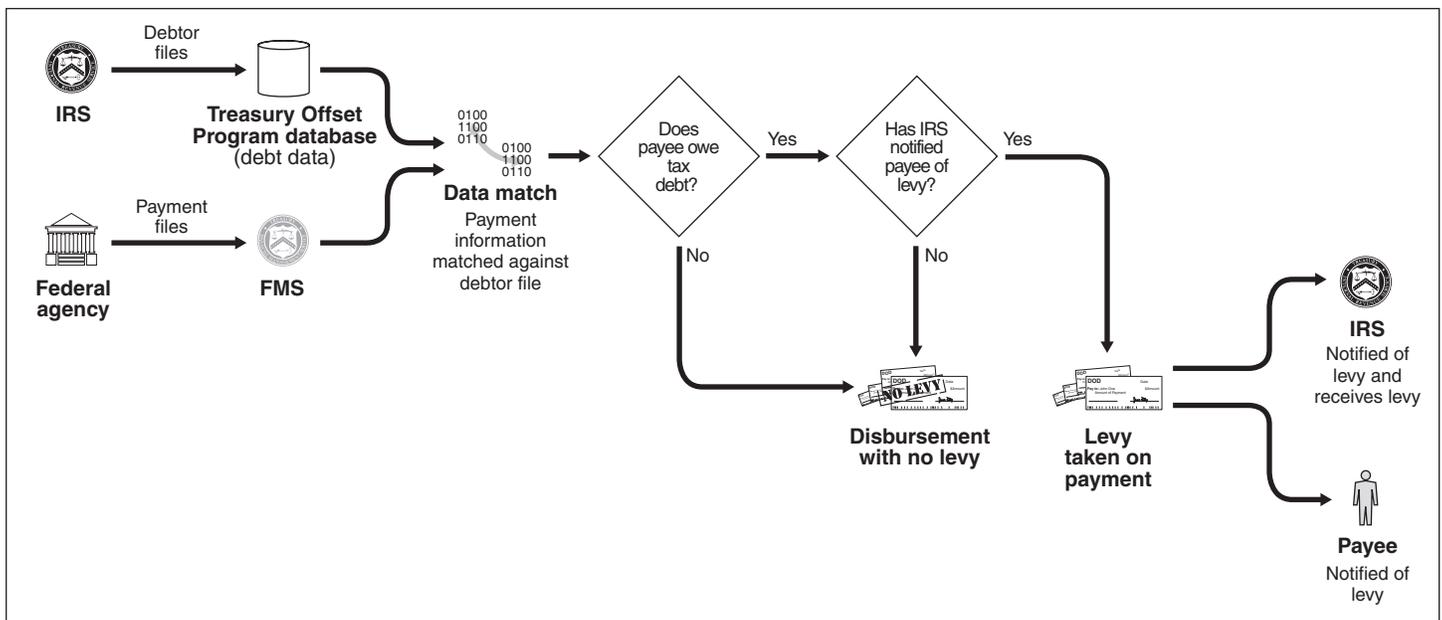
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<sup>13</sup> In addition, for certain federal payments, TOP collects child support debts and state income tax debts on behalf of the states.

<sup>14</sup> Taxpayer Relief Act of 1997 § 1024, 26 U.S.C. § 6331(h) (2000).

IRS coordinated with FMS to utilize the TOP database as the means of collecting taxes under the FPLP. Each week IRS sends FMS an extract of its tax debt files containing updated account balances of tax debts that are already in TOP, the new tax debts that need to be added to TOP, and all taxes in TOP that need to be rescinded.<sup>15</sup> These data are uploaded into TOP. For a payment to be levied through the FPLP, a debt has to exist in TOP and a payment has to be available. Figure 1 provides an overview of this process.

**Figure 1: Levy Process**



Source: GAO.

<sup>15</sup> Debts are rescinded for a variety of reasons. For example, IRS will rescind a debt if the debtor is subject to a bankruptcy stay or if other reasons justify the rescission (such as when debt is paid in full, compromised, or otherwise satisfied).

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FMS sends payment data to TOP to be matched against unpaid federal taxes. TOP electronically compares the names and TINs on the payment files to the control names (first four characters of the names) and TINs of the debtors listed in TOP. If there is a match and IRS has updated TOP to reflect that it has completed all legal notifications, the federal payment is reduced (levied) to help satisfy the unpaid federal taxes.

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## Federal Contractor Tax Compliance Task Force

To address issues raised by our February 12, 2004, report and testimony, a multi-agency task force was established to help improve the FPLP. The task force includes representatives from the Department of Defense, Defense Finance and Accounting Service, IRS, FMS, General Services Administration (GSA), Office of Management and Budget, and Department of Justice.

The objectives of the task force were to (1) identify and implement short-term and long-term operational changes to improve federal tax compliance of DOD contractors, including increasing the number of tax debts and the number of DOD contractor payments available for matching through TOP, and (2) identify potential changes that would enhance efforts to address federal contractor tax delinquencies and prevent future occurrences of tax abuse by federal contractors.

The task force issued its report in October 2004. In its report, the task force identified actions and made recommendations to improve tax compliance of federal contractors, including maximizing the number of delinquent tax debts that IRS makes available for matching, maximizing DOD payment information available for matching, increasing the effectiveness of the matching and levy processes, and preventing federal contract awards to those who abuse the tax system. A number of the improvements identified by the task force have already been implemented.

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## Civilian Contractors Have Billions of Dollars in Unpaid Federal Taxes

Our analysis indicates that the failure to pay taxes among DOD contractors also exists among civilian agency contractors and totaled billions of dollars. Our analysis of FMS and IRS records indicates that during fiscal year 2004, FMS made payments on behalf of civilian agencies to about 33,000 federal contractors with over \$3.3 billion in unpaid federal taxes as of September 30, 2004.<sup>16</sup> We estimate that if there were no legal or administrative impediments to the levy program—if all unpaid federal taxes were considered and all payments to these 33,000 contractors with unpaid federal taxes were subjected to the 15 percent levy—FMS could have collected as much as \$350 million in unpaid federal taxes from civilian contractors during fiscal 2004.<sup>17</sup> Because some unpaid federal taxes are excluded due to statutory requirements, IRS and FMS would never be able to collect the entire amount. Over half of the \$3.3 billion in tax debt was coded by IRS as being excluded from the levy program for statutory reasons, including contractors being in bankruptcy, having installment payment agreements, or awaiting the completion of the required legal notifications regarding the tax debt. However, many improvements can be made to lessen the tax levy collection gap. As will be discussed later in the report, the American Jobs Creation Act of 2004<sup>18</sup> increased the maximum levy to 100 percent of any specified payments to contractors for goods and services provided the federal government. When implemented, the maximum levy amount that could be collected is even greater.

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<sup>16</sup> Our initial matches of civilian contractor payments made during fiscal year 2004 with IRS tax debt as of September 30, 2004, identified about 63,000 contractors that had tax debt totaling \$5.4 billion. We excluded from our preliminary estimates tax debts that have not been agreed to by the tax debtor or affirmed by the court, tax debts from calendar year 2004, tax debts of \$100 or less, and fiscal year 2004 FMS payments of \$100 or less.

<sup>17</sup> This figure represents the potential levy that could be collected if there were no legal or administrative impediments, that is, if all payments, for which we have information, could be levied against all IRS tax debt. This potential amount is likely understated because of data limitations in the payment files and other issues, some of which are discussed in this report.

<sup>18</sup> Pub. L. No. 108-357, § 887(a), 118 Stat. 1418, October 22, 2004, to be codified at 26 U.S.C. § 6331 (h)(3).

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## Characteristics of Contractors' Unpaid Federal Taxes

The amount of unpaid taxes for these contractors paid through Treasury FMS ranged from a small amount owed by an individual for a single tax period<sup>19</sup> to a group of related businesses owing about \$13 million for over 300 tax periods.<sup>20</sup> Unpaid taxes owed by these contractors included payroll, corporate income, excise, unemployment, individual income, and other types of taxes.

In the case of unpaid payroll taxes, employers withheld federal taxes from employees' wages, but did not send the withheld payroll taxes or the employers' matching amounts to IRS as required by law, instead diverting the money for personal gain or to fund their businesses. One IRS official acknowledged that frequently small businesses are undercapitalized and use the tax money as operating capital. However, employers are subject to civil and criminal penalties if they do not remit payroll taxes to the federal government. When an employer withholds taxes from an employee's wages, the employer is deemed to have a responsibility to deposit in a separate bank account these amounts held "in trust" for the federal government until making a federal tax deposit in that amount.<sup>21</sup> To the extent these withheld amounts are not forwarded to the federal government, the employer is liable for these amounts, as well as the employer's matching Social Security contributions. Individuals within the business (e.g., corporate officers) may be held personally liable for the withheld amounts not forwarded, and they can be assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).<sup>22</sup>

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<sup>19</sup> A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is generally one quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, although payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year. As described later in this report, a case study consists in some cases of multiple related entities, some or all of which owe tax debts. The number of tax periods and the accumulated tax debts we are reporting reflect the accumulated tax periods and tax debts of all related entities.

<sup>20</sup> IRS and FMS cannot collect from payments made to one related company to satisfy the unpaid federal taxes of another related company.

<sup>21</sup> The law further provides that withheld income and employment taxes are to be held in a separate bank account considered to be a special fund in trust for the federal government. 26 U.S.C. § 7512(b).

<sup>22</sup> 26 U.S.C. § 6672.

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Willful failure to remit payroll taxes is a criminal felony offense<sup>23</sup> punishable by imprisonment of not more than 5 years, while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense<sup>24</sup> punishable by imprisonment of up to a year. The employee is not responsible for the employer's failure to remit payroll taxes since the employer is responsible for submitting the amounts withheld. The Social Security and Medicare trust funds are subsidized or made whole for unpaid payroll taxes by the general fund, as we discussed in previous reports.<sup>25</sup> Over time, the amount of this subsidy is significant.

As shown in figure 2, over a third of the total tax amount owed by civilian contractors was for unpaid payroll taxes and over 40 percent was for corporate income taxes. The remainder consisted of individual income taxes, and other taxes. As discussed later in our case studies, some of these contractors also owe state tax debts.

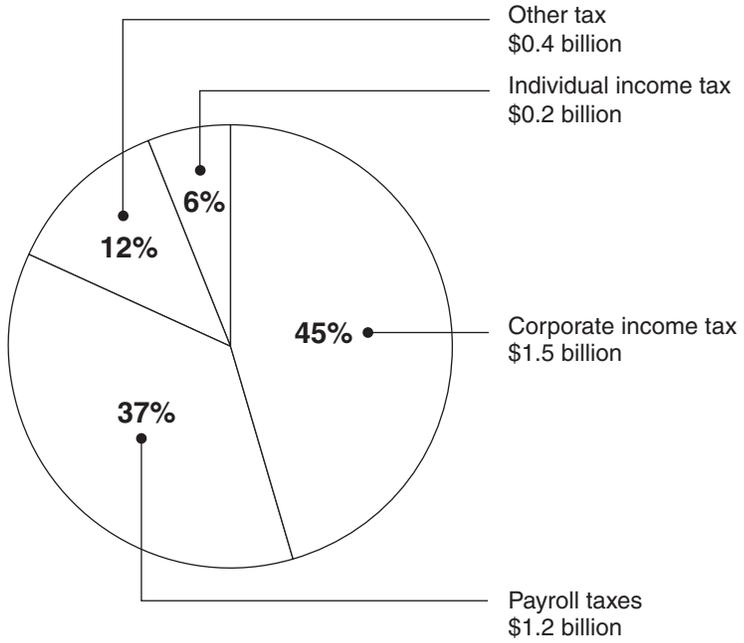
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<sup>23</sup> 26 U.S.C. § 7202.

<sup>24</sup> 26 U.S.C. § 7215 and 26 U.S.C. § 7512 (b).

<sup>25</sup> GAO, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, [GAO-01-42](#) (Washington, D.C.: Nov. 17, 2000); *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, [GAO/AIMD-99-12](#) (Washington, D.C.: Oct. 29, 1998); and *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, [GAO/AIMD/GGD-99-211](#) (Washington, D.C.: Aug. 2, 1999).

**Figure 2: Type of Debt Owed by Civilian Contractors as of September 30, 2004**

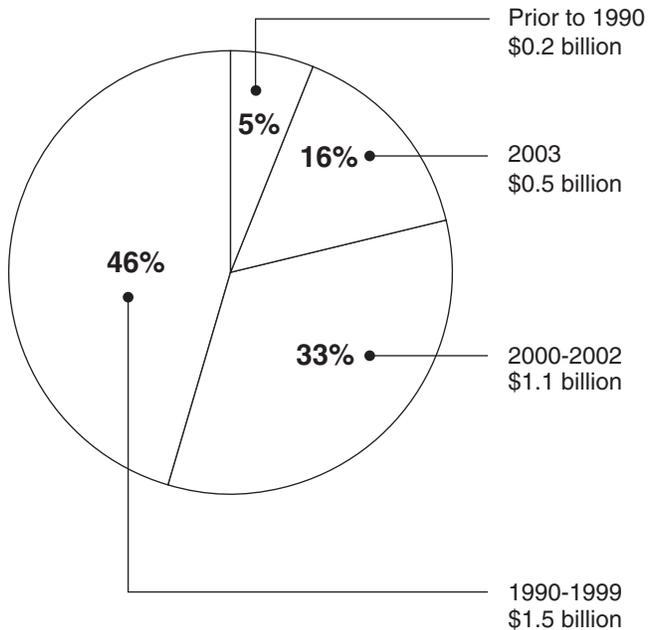


Source: GAO analysis of IRS and FMS data as of September 30, 2004.

A substantial amount of the unpaid federal taxes shown in IRS records as owed by civilian contractors had been outstanding for several years. As reflected in figure 3, over half of the unpaid taxes owed by civilian contractors were for tax periods prior to calendar year 2000.<sup>26</sup>

<sup>26</sup> Tax period may not always correspond to the age of the tax debt, as when a tax form is filed years after the due date or when IRS assesses additional taxes to earlier tax periods.

**Figure 3: Civilian Contractors' Unpaid Federal Taxes by Tax Periods through 2003 by Calendar Year**



Source: GAO analysis of IRS and FMS data as of September 30, 2004.

Prompt collection of unpaid taxes is vital because, as our previous work<sup>27</sup> has shown, as unpaid taxes age, the likelihood of collecting all or a portion of the amount owed decreases. This is due, in part, to the continued accrual of interest and penalties on the outstanding federal taxes, which, over time, can dwarf the original tax obligation. The amount of unpaid federal taxes reported above does not include all tax debts owed by the civilian agency contractors due to statutory provisions that give IRS a finite period under which it can seek to collect on unpaid taxes. Generally, there is a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect tax debt.<sup>28</sup> Consequently, if the contractors owe federal taxes

<sup>27</sup> [GAO/AIMD/GGD-99-211](#).

<sup>28</sup> The 10-year time may be suspended including for periods during which the taxpayer is involved in a collection due process appeal, litigation, or a pending offer in compromise or installment agreement. As a result, Fig. 3 includes taxes that are for tax periods from more than 10 years ago.

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beyond the 10-year statutory collection period, the older tax debt may have been removed from IRS's records. We were unable to determine the amount of tax debt that had been removed.

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### While Substantial, the Amount of Unpaid Taxes of Civilian Contractors Is Likely Understated

The amount of unpaid federal taxes we identified among civilian agency contractors—\$3.3 billion—is likely understated for three main reasons: (1) we intentionally limited our scope to contractors with agreed-to<sup>29</sup> federal tax debt for tax periods prior to 2004 that had substantial amounts of both unpaid taxes and payments from civilian agencies; (2) FMS disbursement files did not always contain the information we needed to determine whether the contractors owed federal taxes; and (3) the IRS taxpayer account database contains errors, and the database reflects only the amount of unpaid taxes either reported by the taxpayer on a tax return or assessed by IRS through its various enforcement programs. The IRS database does not reflect amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed tax amounts due.

To avoid overestimating the amount owed by government contractors, we took a number of steps to exclude unpaid federal taxes that federal contractors recently incurred or that are not individually significant. For example, some recently assessed tax debts that appear as unpaid taxes through a matching of PACER and IRS records may involve matters that are routinely resolved between the taxpayer and IRS, with the taxes paid, abated, or both<sup>30</sup> within a short period. We attempted to eliminate these types of debt by focusing on unpaid federal taxes for tax periods prior to calendar year 2004 and eliminating tax debt of \$100 or less. We also eliminated all tax debt identified by IRS as not being agreed to by the

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<sup>29</sup> We eliminated from our analysis all tax debt coded by IRS as not having been agreed to by the taxpayer (by filing a balance due return) or a tax court. For financial reporting, those cases are referred to as compliance assessments.

<sup>30</sup> Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. 26 U.S.C. § 6404.

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contractor. Additionally, we eliminated contractors with tax debt that received payments of \$100 or less during fiscal year 2004.<sup>31</sup>

Regarding the completeness of FMS disbursement information, we found that some contractors paid through FMS could not be identified due to blank or obviously erroneous TINs, such as TINs made up of all zeros or all nines. The lack of TINs prevented us from determining whether contractors had unpaid federal taxes and, if so, the amount of unpaid taxes owed by the contractors. Additionally, as will be discussed in more detail in a later section of this report, FMS does not maintain detailed electronic payment information for a large disbursement system—Fedwire—that also makes disbursements to contractors, and thus the value of unpaid taxes associated with contractors paid through that system could not be determined.

As we have previously reported,<sup>32</sup> IRS records contain errors that affect the accuracy of taxpayer account information. Consequently, some of the \$3.3 billion may not reflect true unpaid taxes, although we cannot quantify this amount. Nonetheless, we believe the \$3.3 billion represents a conservative estimate of unpaid federal taxes owed by civilian contractors paid through FMS.

Also limiting the completeness of our estimate of the unpaid federal taxes of civilian contractors is the fact that the IRS tax database reflects only the amount of unpaid taxes either reported by the contractor on a tax return or assessed by IRS through its various enforcement programs. The IRS database does not reflect amounts owed by businesses and individuals that have not filed tax returns and for which IRS has not assessed tax amounts due. During our review, we identified instances in which civilian contractors failed to file tax returns for a particular tax period and, therefore, were listed in IRS records as having no unpaid taxes for that period. Further, our analysis did not attempt to account for businesses or individuals that purposely underreported income and were not specifically

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<sup>31</sup> The \$3.3 billion shown in our analysis includes only amounts of tax debt owed by civilian contractors paid through FMS's PACER database. Amounts owed by the owners, officers, or related business entities that were not paid through FMS are not included in the \$3.3 billion estimate of tax debt. We include this additional tax debt in later discussions of our case study contractors.

<sup>32</sup> GAO, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002).

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identified by IRS. According to IRS, underreporting of income is the largest component of the roughly \$300 billion tax gap. Preliminary IRS estimates show underreporting accounts for more than 80 percent of the total tax gap. Consequently, the true extent of unpaid taxes for these businesses and individuals is not known.

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### Actual Levy Collections Significantly Less Than Maximum Potential Levy Amount

There is a large tax levy collection gap between the maximum potential levy we calculated and the amount FMS actually collected under the FPLP. We estimate that if there were no legal or administrative provisions that remove some tax debt from the levy program and if all PACER contractor payments were subjected to a 15 percent levy to satisfy all the unpaid taxes of those civilian contractors, FMS could have collected as much as \$350 million in fiscal year 2004. However, during fiscal year 2004, FMS collected about \$16 million from civilian contractors—or about 5 percent of the approximately \$350 million maximum levy collection estimate we calculated. As discussed earlier in this report, because some unpaid federal taxes are excluded due to statutory requirements, IRS and FMS will never be able to close the levy collection gap completely. For example, over half of the \$3.3 billion in tax debt was coded by IRS as being excluded from the levy program for statutory reasons, including contractors being in bankruptcy, having installment agreements, or awaiting the completion of the required initial legal notifications. However, many improvements can be made to narrow the tax levy collection gap.

We found that a vast majority of the collection gap is attributable to debts that are excluded from TOP because of current law and IRS policies. While we will provide an overview of the exclusions later in this report, we will examine in detail in a later report the accuracy and reasonableness of the exclusions and IRS's applications of those exclusions. The remaining gap—to be covered in detail in this report—between what could be collected and what was actually collected is attributable to the fact that not all FMS payments could be matched against unpaid federal taxes for levy. We estimate that the federal government could have collected at least \$50 million more in unpaid federal taxes in fiscal year 2004 using the FPLP if all PACER contractor payments could be matched against tax debts in TOP.

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## Legal Requirements and IRS Policy Decisions Contribute to the Levy Collection Gap

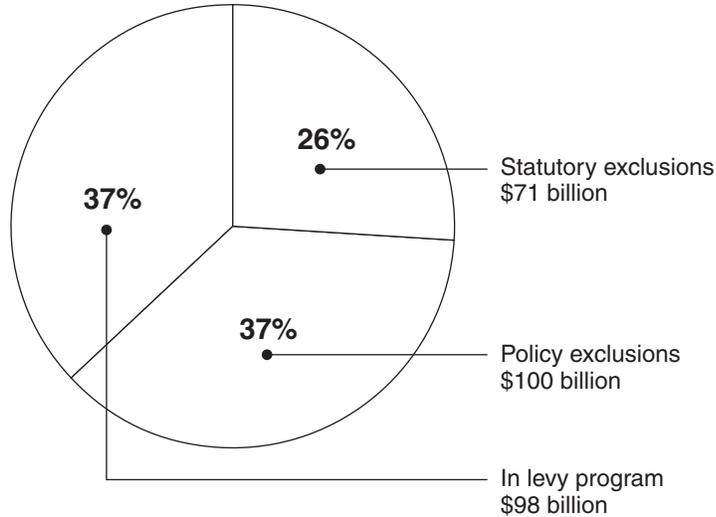
The actual collection of unpaid federal taxes from the levy program does not approach our maximum estimate largely because IRS excludes—either for statutory or policy reasons—almost two-thirds of unpaid federal taxes from potential levy collection. Since we last reported on DOD contractors that abused the federal tax system,<sup>33</sup> IRS has added about \$28 billion in unpaid federal taxes to the levy program from categories it formerly excluded (from its total population of all tax debts). Despite these efforts, the amount that is excluded from the levy program is significant. Our analysis of all tax debt recorded by IRS—\$269 billion<sup>34</sup> in unpaid taxes—including amounts owed by civilian contractors, indicates that \$171 billion was excluded from potential levy collection as of April 2005. For the civilian contractors in fiscal year 2004, these exclusions accounted for over 80 percent of the levy collection gap. As shown in figure 4, \$71 billion (26 percent) of all unpaid federal taxes are excluded from the levy program as a result of statutory requirements, while another \$100 billion (37 percent) of unpaid federal taxes are excluded due to IRS policy decisions, leaving approximately \$98 billion (37 percent) potentially subject to collection through the levy program. While the exclusion of unpaid federal taxes from the levy program is justified depending on the circumstances, it nevertheless results in the loss of potentially hundreds of millions of dollars in tax collections from the levy program.

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<sup>33</sup> [GAO-04-95](#).

<sup>34</sup> IRS's 2004 financial statements reported \$237 billion in total unpaid assessments. IRS eliminates from financial reporting certain tax debt, including, among others, TFRP assessed against officers or owners of companies to collect the federal taxes withheld by the business from their employees but not remitted to the federal government. IRS does not report these debts to eliminate double counting both the business tax debt and the officer's assessment of those taxes.

**Figure 4: Levy Status of Unpaid Federal Taxes as of April 2005**



Source: GAO analysis of unaudited IRS data as of April 2005.

In addition to not sending the majority of unpaid federal taxes to the levy program, FMS records indicate that as of September 30, 2004, about 70 percent of the unpaid taxes that IRS submitted to TOP had not yet completed the collection due process requirements necessary to allow the levying of payments to begin. As a result, only a small portion of unpaid federal taxes is available for immediate levy. We will examine in detail in a later report the accuracy and reasonableness of the IRS exclusions and IRS's applications of those exclusions. What follows is a more detailed description of the amounts and types of unpaid taxes excluded from the FPLP for statutory and policy reasons, as well as a detailed discussion of the limitations associated with much of the unpaid federal taxes that are referred to the FPLP.

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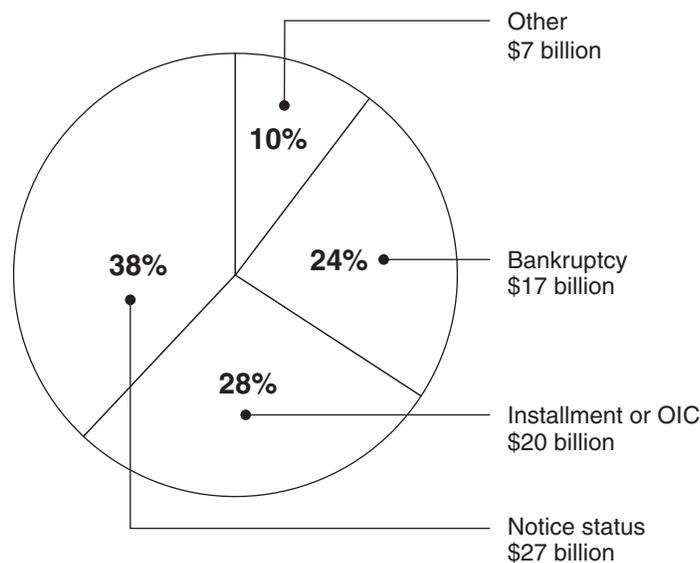
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## A Substantial Portion of Unpaid Federal Taxes Are Legally Excluded from the Levy Program

According to IRS records, as of April 2005, IRS had coded about \$71 billion of unpaid federal taxes as being legally excluded from the levy program. As shown in figure 5, IRS records indicate that bankruptcy and taxpayer agreements—including installment or offer in compromise (OIC)<sup>35</sup> agreements—each account for about a quarter of all statutory exclusions. Another \$27 billion (38 percent) of the \$71 billion in statutory exclusions is due to IRS not having completed all initial taxpayer notifications required by law before a tax debt could be referred to TOP—these are cases that IRS refers to as being in notice status.

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**Figure 5: IRS Statutory Exclusions as of April 2005**



Source: GAO analysis of unaudited IRS data as of April 2005.

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<sup>35</sup> Installment agreements allow for payments on the debt in smaller, more manageable amounts. An offer in compromise approved by IRS allows a tax debtor to settle unpaid tax debt for less than the full amount due.

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For tax debt in notice status—the first phase of IRS’s collection process—IRS sends a series of up to four separate notices to tax debtors asking them to pay their tax debt. Upon receipt of each of the notices, the debtors have a minimum of 30 days to respond in various ways:

- disagree with IRS’s assessment and collection of tax liability and appeal the tax debt;
- negotiate with IRS to set up an alternative payment arrangement, such as an installment agreement or an offer in compromise;
- apply to IRS for a hardship determination, whereby tax debtors demonstrate to IRS that making any payments at all would result in a significant financial hardship; or
- elect to pay off the debt in full.

Each time the debtor responds to a notice, the matter must be resolved before IRS can proceed with further notices or other collection actions. For example, IRS must determine whether to accept or reject an installment agreement or determine that the tax debtor is in financial hardship before proceeding with the collection process. During this entire notice phase, IRS is required to exclude the tax debt from the levy program. IRS does not begin further collection action, for example, the unpaid federal taxes are excluded from levy, until the series of initial notifications are complete. IRS also sends out an annual notification letter requesting payment of the unpaid federal taxes.

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## IRS Policy Decisions Exclude Many Tax Debts from the Levy Program

In addition to legal restrictions, IRS makes policy and operational decisions that exclude about \$100 billion in unpaid tax debts from the levy program. Categories of unpaid tax debts IRS has coded as being excluded due to policy decisions include those of tax debtors with financial hardship,<sup>36</sup> tax debtors working with IRS to voluntarily comply, and tax debtors under active criminal investigation. Figure 6 shows that slightly over half (\$51 billion) of all policy exclusions are due to IRS’s determination that the

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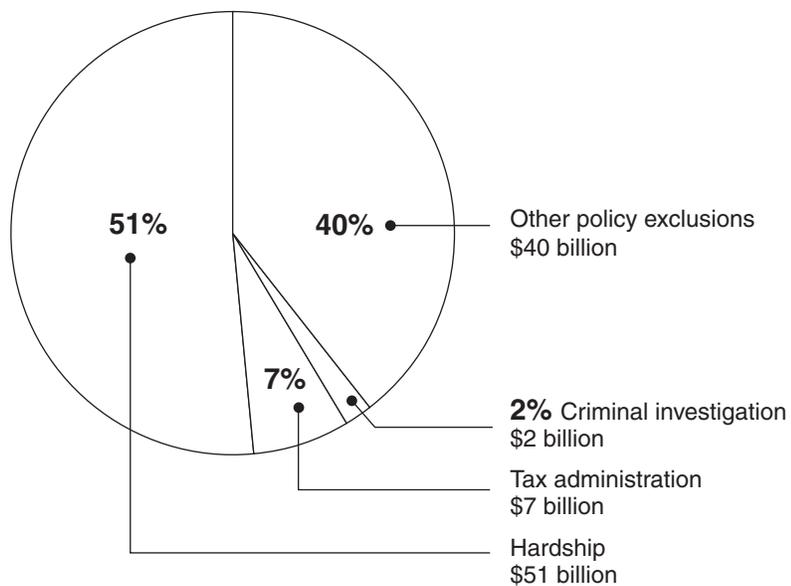
<sup>36</sup> According to IRS, financial hardship can be either a statutory exclusion (under 26 U.S.C. 6343(e)) or policy exclusion, depending on when and who makes the determination. For reporting on the FPLP, IRS categorizes hardship cases as policy exclusions.

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tax debtor is in financial hardship. Another 40 percent (\$40 billion) of the policy exclusions include tax debtors who are deceased and those tax debtors that have filed appeals, claims, or amended returns. About 7 percent (\$7 billion), referred to as tax administration exclusions, is excluded from the levy program because an IRS official is working to encourage the affected tax debtor to voluntarily pay the federal taxes owed. About 2 percent (\$2 billion) are excluded due to active criminal investigations.

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**Figure 6: IRS's Policy Exclusions from the Levy Program as of April 2005**



Source: GAO analysis of unaudited IRS data.

Since our 2004 report on DOD contractors who abuse the tax system,<sup>37</sup> in which we recommended that IRS change or eliminate policies that prevent businesses and individuals with federal contracts from entering the levy program, IRS has taken specific actions to include more tax debt in the levy program. Specifically, IRS submitted an additional \$28 billion to the levy program by removing many of the systemic exclusions for cases

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<sup>37</sup> [GAO-04-95](#).

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being actively pursued by IRS officials for collection (i.e., those excluded for tax administration purposes).<sup>38</sup> As a result of these and other improvements (including DOD submitting more of its payments in the levy program), collections from contractor payments under the levy program increased over 200 percent in fiscal 2004 over fiscal 2003. Collections continued to increase in the first half of fiscal year 2005.

Our past audits have indicated that IRS records contain coding errors that affect the accuracy of taxpayer account information—including exclusion categories. While we did not evaluate the appropriateness of the exclusion categories in this report, the categories used by IRS are only as good as the codes IRS has input into its systems.<sup>39</sup> In our previous work on DOD contractors with tax debt, we found that inaccurate coding at times prevented both IRS collection action and cases from entering the levy program. Therefore, the effective management of these codes is critical because if these exclusion codes (such as codes identifying a contractor as being in bankruptcy or having an installment agreement) remain in the system for long periods, either because IRS delays processing taxpayer agreements or because IRS fails to input or reverse codes after processing is complete, cases may be needlessly excluded from the levy program.

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### Most Tax Debt IRS Submits to the Levy Program Is Not Legally Ready for Levy

FMS records indicate that as of September 30, 2004, about 70 percent of the tax debt IRS sent to the levy program is not available for immediate levy because IRS has not completed all the necessary legal notifications before the levying of payments can begin. In addition to the initial series of notice letters that are sent out at the beginning of IRS's collection efforts, IRS is required to send the debtor an additional notice of intent to levy that includes information regarding the tax debtor's right to a hearing prior to levy action—also referred to as a collection due process notice. Although

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<sup>38</sup> This was done automatically within IRS's tax database based on various transaction and status codes. IRS previously blocked all cases assigned to its Automated Collection System (ACS) and its field collection function. The ACS process consists primarily of telephone calls to the tax debtor to arrange for payment. Cases assigned to field collections are those for which a revenue officer attempts face-to-face contact and collection. Even though unblocked as a group, IRS officials who work on ACS and field collection inventories can manually block individual cases they are working in order to remove them from the levy program.

<sup>39</sup> The process of sending cases to the levy program is driven by the various status codes IRS enters into its tax records—such as codes identifying a case as being in bankruptcy or having an installment agreement.

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the tax debtor has up to 30 days to respond to this notice under the law, IRS has chosen to wait 10 weeks before proceeding with collection actions, such as levying. Until the due process notification and waiting period have been completed, a tax debt may be submitted to TOP but is not subject to immediate levy. For civilian contractors, IRS generally does not initiate the collection due process notifications until FMS identifies that the contractor is to receive a federal payment.

Once the debtor receives the notice of impending levy, IRS gives the debtor up to 10 weeks to respond to the notice. As in the initial notice process, the debtor can respond to IRS by disagreeing with IRS's assessment (in this case, filing for a due process hearing), negotiating with IRS to set up an alternative payment arrangement, applying for a hardship determination, or making payment in full. If a tax debtor does not respond to IRS and take advantage of those options within the notification period, IRS will instruct FMS to start levying future payments. The tax debt in the levy program is then coded for immediate levy. For future payments, FMS will proceed with the continuous levy by reducing each scheduled payment to the tax debtor by 15 percent—or the exact amount of tax owed if it is less than 15 percent of the payment—until the tax debt is satisfied.

Not having tax debt ready for levy results in the loss of millions of dollars of tax revenue for the federal government. For example, for our 50 case studies we identified payments totaling \$1.6 million in which the TIN of the contractor matched an IRS tax debt, but no levy was taken because IRS had not yet completed the collection due process activities. This situation contributes to these contractors facing little or no consequences for their abuse of the federal tax system. IRS has an automated process in place by which, once a match is made against a tax debt in the levy program, a due process notice is automatically sent to the contractor. However, the payments made between the time of the initial match and when IRS completes its due process notification process—usually 10 weeks—cannot be levied and the potential collections are lost to the federal government. Additionally, if the tax debtor files for a due process hearing once it receives the notice, the tax debt will continue to be excluded from levy until the process—which could take months—is complete.

Prior to 1998, IRS was authorized to levy a payment immediately upon matching a tax debt with a federal payment so long as the collection due process notice had been sent. At that time, IRS did not have to wait before proceeding with the levy. This allowed the levy program to capture the payment before it was made to preserve the government's right to the

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payment while providing the contractor a postlevy due process. However, the IRS Restructuring and Reform Act of 1998 requires that debtors be afforded an opportunity for a collection due process hearing before a levy action can take place. To comply with this provision, IRS has chosen to wait a minimum of 10 weeks for the tax debtor to respond to the collection due process notice. However, IRS's 10-week waiting period causes the federal government to miss levying some contractor payments.

IRS has acknowledged that the delay in initiating the due process notice can result in lost collections and is investigating ways to begin the process earlier. The joint task force established after our previous audit has supported making the due process for the FPLP a postlevy process.<sup>40</sup> This would allow IRS to levy payments when first identified and provide contractors with procedural due process remedies afterwards. To expedite the notification, IRS officials stated that they had begun matching new DOD contracts valued at over \$25,000 against tax debt and sending out collection due process notifications at that time rather than waiting until payments are made. To address this same issue, the task force is also exploring avenues to combine the collection due process notice with the last of its initial notification letters sent to tax debtors. This would allow IRS to have all tax debt legally ready for levy prior to it being sent to TOP to be matched against federal payments. We fully support the task force's and IRS's efforts to increase the amount of tax debt that is ready for immediate levy.

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<sup>40</sup> Federal Contractor Tax Compliance Task Force, *Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations* (Washington, D.C.: Oct. 26, 2004).

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## Lack of FMS Oversight and Proactive Management Further Contribute to the Levy Collection Gap

FMS has contributed to the tax levy collection gap by not taking a proactive stance in overseeing and managing the levy program. GAO's Standards for Internal Controls in the Federal Government considers a positive control environment—which includes the establishment of mechanisms to monitor or oversee program operations—to be the foundation for all other standards. For FMS, such management control and oversight is critical in its role as the federal government's debt collector and chief money disbursing officer. However, because of a lack of oversight, FMS did not detect and have agencies correct obviously inaccurate information for tens of billions of dollars in payments to contractors, and therefore was not able to match these payments against tax debts for potential levy. Further, because of a lack of proactive management, FMS did not send tens of billions of dollars more in payments to the levy program. We estimate that these deficiencies resulted in at least \$50 million in lost levy collections from civilian agency contractors during fiscal year 2004.<sup>41</sup> Table 1 provides a breakdown of the deficiencies that result in payments not being subject to levy. Further discussion of these deficiencies will be provided in detail later in this report.

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<sup>41</sup> This estimate is based on all contractor payments recorded in PACER during fiscal year 2004 being sent to TOP to be matched against the tax debt in TOP as of September 2004. Due to the unavailability of information at FMS, our estimate does not include an estimate of the amount that could be collected from sending Fedwire payments to TOP. Additionally, we were unable to estimate collections against many payments because of blank or invalid TIN information in FMS's payment records. The estimate of a minimum of \$50 million represents our total estimate of potential levy collections from civilian contractors less FMS's actual collections during fiscal year 2004.

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**Table 1: Payments Not Matched against Tax Debts for Potential Levy**

Dollars in billions

| <b>Cause of payment not being levied</b>  | <b>Amount excluded</b> |
|---|------------------------|
| Payments submitted to TOP that could not be levied  |                        |
| Payments where the agency payment station has not been loaded in TOP  | \$40                   |
| Payments containing blank or obviously inaccurate TINs  | 17                     |
| Payments containing blank or invalid names  | 4                      |
| Payments containing invalid payment types   | 5                      |
| Payments FMS does not submit to TOP   |                        |
| Certain categories of payments (at least \$26 billion in certain types of payments and an unknown amount in Fedwire payments <sup>a</sup> ) | Unknown amount         |
| Payments to individuals   | 2                      |

Source: GAO analysis of FMS data.

Notes: The exclusion categories above cannot be added together to derive the total amount of excluded payments because many payments had multiple deficiencies, each of which would have prevented the payment from being levied. For example, some payments without TINs also have invalid names, and some payments originating from agency payment locations that were not entered into the TOP database were also payment categories FMS was not sending to the levy program.

<sup>a</sup>During fiscal year 2004, Fedwire disbursed \$191 billion, some of which was to contractors. FMS does not maintain detailed historical records and could not determine the value of contractor payments paid with Fedwire.

In addition to these deficiencies, FMS also faces design challenges in the levy program that limit its effectiveness at collecting unpaid taxes. These challenges include the difficulty in matching the name of the contractor recorded in the payment files to the name recorded in IRS's tax records and the difficulty in levying vendors paid with government purchase cards. FMS also has not implemented a provision of the American Jobs Creation Act of 2004, which allows the federal government to levy up to 100 percent of payments to contractors with unpaid federal taxes.

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## FMS Did Not Include All Agency Payments in the Levy Program

FMS has not updated its TOP database to capture payments from about 150 agency paying stations,<sup>42</sup> resulting in \$40 billion of fiscal year 2004 civilian agency contractor payments being excluded from potential levy. Although effective internal control would generally include oversight of key agency functions, FMS did not perform the management oversight necessary to identify that a significant portion of all its disbursements were not included in the levy program. Of the \$40 billion not sent to TOP, we determined that approximately \$9 billion in payments were made to civilian contractors with tax debts, none of which could be levied.

Federal agencies may have multiple offices or locations that perform accounting for and preparation of payment information, referred to as agency payment locations or paying stations. For a payment to be matched against tax debts for the purpose of levy, the paying station from which the payment originates needs to be programmed into the TOP database. If a paying station is not in the TOP database, TOP considers that location to be excluded from the levy program, and thus payments from that location will not be matched against unpaid federal taxes for potential levy. The approximately 150 paying stations not included in TOP are paying stations for portions of a majority of federal departments, including the Departments of Homeland Security, the Interior, Justice, State, the Treasury, and Health and Human Services.

An FMS official stated that at the time FMS implemented TOP in the 1990s, it had a centralized monitoring system to verify that payments from all payment locations were included in TOP. According to the official, after the initial group of paying units was incorporated into TOP, FMS did not take steps to ensure that the TOP database was up to date and that payments from new payment locations were incorporated into TOP. FMS was unaware that a large percentage of its disbursements were being excluded from potential levy. Since we brought the problem to their attention, FMS officials stated that efforts are under way to update TOP for the paying

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<sup>42</sup> These stations are generally referred by their Treasury Agency Location Code (ALC). The ALC is used to identify transactions, documents, and reports processed through Treasury by a specific accounting point or station, within an agency or bureau of a federal department or independent agency. Using the ALC enables Treasury to reconcile deposits and disbursements.

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stations we identified as being excluded from the levy program.<sup>43</sup> The officials also stated that they plan to reinstate the centralized monitoring to ensure that paying stations are updated in TOP so that payments from these stations would be available for potential levy.

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## FMS Disbursed Payments to Contractors without Proper TINs

During fiscal year 2004, FMS disbursed over \$17 billion in payments to civilian agency contractors without TINs or with obviously inaccurate TINs. Valid TIN information is critical to the levy program<sup>44</sup> because payments lacking this information cannot be matched against tax debts. The DCIA<sup>45</sup> requires executive agencies to obtain TINs from contractors and to include TINs on certified payment vouchers, which are submitted to Treasury.<sup>46</sup> Without a proper TIN, payments cannot be levied.

We found that payment records with blank or obviously inaccurate TINs in the TIN fields are prevalent in the payment files submitted to FMS by some agencies. For example, over half of payments at one agency and over three-quarters of payments at another agency were made to contractors that had blank or obviously erroneous TINs, such as TINs made up of all zeros or all 9s. While certain vendors are exempt from the requirements to have a TIN, the exemptions are rare and are generally limited to foreign companies providing goods and services to federal agencies in a foreign country or companies performing classified work. However, FMS does not gather information to determine whether the payments to contractors without TINs or with obviously inaccurate TINs are exempt from the TIN requirement or that all nonexempt payments include TINs. FMS officials stated that the responsibility for gathering and submitting TIN information was solely that of the paying agency. In subsequent audit efforts, we will evaluate selected agencies' controls over obtaining and submitting TIN information for all nonexempt payments.

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<sup>43</sup> An FMS official also noted that some of the agency paying stations we identified only disbursed categories of payments that FMS does not currently submit to the levy program, such as type A and ACH-CTX payments.

<sup>44</sup> GAO, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*. GAO-04-74 (Washington, D.C.: Dec. 5, 2003).

<sup>45</sup> Pub. L. No. 104-134, 110 Stat. 1321-358, April 26, 1996.

<sup>46</sup> 31 U.S.C. § 7701(c) and (d).

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FMS officials stated that FMS tabulates payment records with obviously inaccurate TINs by agency<sup>47</sup> to compile a monthly TIN Compliance Report. This report is used to monitor agencies that send in payment requests with obviously inaccurate TINs.<sup>48</sup> According to FMS officials, in cases of significant noncompliance, FMS encourages agencies to send payment files with valid TINs. However, FMS does not enforce the TIN requirement by rejecting agency payments without TINs or requiring the agencies to certify that the payments not containing TINs meet one of the TIN exclusion criteria. As a result, agencies continue to submit payment requests without TINs, which cannot be levied to collect unpaid federal taxes.

We found that some civilian agency contractors without TINs or with obviously inaccurate TINs in the agency payment files received payments during fiscal year 2004 and had unpaid federal taxes. For example, FMS paid about \$700,000 to one contractor with an invalid TIN. Based on investigative work, we were able to determine that this contractor had failed to pay all its payroll taxes and owed more than \$50,000 in unpaid taxes. Had the payment file contained a TIN and if the tax debt were subject to immediate levy, the government could have collected the full amount of unpaid taxes from this contractor during fiscal year 2004.

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<sup>47</sup> Tabulation is performed for the standard payment types sent through the levy program, that is, payments known as type B. Type A payments—which are payments that the agency certifies the payment in the same file that contains detailed payment information—and Fedwire payments are not tabulated or monitored.

<sup>48</sup> In 1997, Treasury proposed a rule that would require disbursing officials to reject agency payment requests that do not contain TINs. Upon review of the comments received in response to the proposed rule, FMS rescinded the proposed rule, and instead required agencies to submit to FMS implementation plans to achieve compliance with the TIN requirement. FMS's responsibility includes monitoring payment vouchers to ensure that agencies are meeting compliance goals and time frames as identified in the implementation reports.

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## FMS Made Disbursements to Contractors without Proper Names

FMS made disbursements of nearly \$3.8 billion in fiscal year 2004 to contractors whose payment files did not contain the name of the contractor receiving the payment. We found that instead of the contractor's name, the disbursement file name field was either blank or contained only numeric characters.<sup>49</sup> The lack of a name on the payment file does not prevent the payment from occurring because FMS made these disbursements electronically via direct deposit into the contractors' bank accounts. However, valid name information is critical because the levy program requires a match between both the name and TIN for a levy to occur.<sup>50</sup> The lack of a proper name could have been detected if FMS had conducted a cursory review of the payment files submitted by the agencies.

For example, our review readily identified that most of the payment files submitted by the State Department did not contain valid contractor names. In addition, about \$3.2 billion of the nearly \$3.8 billion we identified as payments made to contractors without names in the payment files were made on behalf of the State Department. Until we brought the matter to their attention, senior officials at both the State Department and FMS were not aware that the State Department's contractor payments did not contain valid names. At our request, a State Department official investigated and found that the department's payment systems did contain valid names but that a programming error resulted in the wrong field being sent to FMS as the name field. The official told us that the error in the payment file is not new because the structure of the payment file sent to FMS had remained the same since the 1980s. Once we brought this to the attention of State Department officials, they were quickly able to identify corrective actions, and according to the State Department, they have since corrected the deficiency.

Our analysis of FMS payment data found that FMS made disbursements without contractor names, totaling approximately \$400 million, to about 2,000 companies that had about \$370 million in unpaid federal taxes. FMS's failure to detect and correct missing names had a direct impact on the levy program. For example, one contractor with unpaid taxes received from the

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<sup>49</sup> In addition, we identified numerous payee names that contained only a single alphabetic character in the name field. We did not include these in our analysis of payments with improper name fields.

<sup>50</sup> GAO, *Tax Administration: Millions of Dollars Could Be Collected If IRS Levied More Federal Payments*. [GAO-01-711](#) (Washington, D.C.: July 20, 2001).

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State Department payments totaling over \$400,000, which could not be levied because of the missing name. The same contractor also received payments from other civilian agencies. However, because the contractor's name was included in the payment files from the other agencies, the levy program collected over \$50,000 from those payments. If FMS or the State Department had identified and corrected the name problem, an additional \$60,000 in unpaid federal taxes from this contractor could have been collected through the levy program.

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### FMS Made Payments without Proper Payment Type Codes

FMS disbursed \$5 billion in payments using checks based on agency-submitted payment files that did not contain data in the payment type field during fiscal year 2004. FMS uses the payment type field in the agency-submitted payment files to determine if the payment is required to be included in the levy program. If a payment file record has a blank payment type field, it is not matched in the levy program to collect unpaid federal taxes. As a result, none of the \$5 billion in payments we identified as having a blank payment type field could have been levied to collect the contractors' unpaid federal taxes. FMS lacked the oversight to detect that the payment files submitted by agencies were not adequately coded. After we brought this to management's attention, an FMS official stated that FMS planned to establish a new centralized program to monitor the completeness of agency information.

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### FMS Has Not Taken Action to Include All Categories of Contractor Payments in the Levy Program

FMS has not been proactive in including many categories of payments in the levy program, and has therefore kept tens of billions of dollars in contractor payments from being subject to potential levy collection. FMS uses several payment mechanisms to make its disbursements. FMS payment mechanisms (payment categories) include what it refers to as type A, type B, which includes Automated Clearing House-Corporate Trade Exchange (ACH-CTX), and Fedwire.<sup>51</sup> However, FMS has only taken action to include a portion of type B payments in the levy program. FMS has not taken action to include the other categories of payments due to what it

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<sup>51</sup> For type B payments, agencies send FMS the certification for the payment separately from the detailed payment information. Type A payments are payments in which the agency certifies the payment in the same file that contains detailed payment information. ACH-CTX payments (a specific kind of type B payment) are ones whereby agencies can pay multiple invoices to a single contractor using a single ACH-CTX payment. Fedwire is a processing system designed for high-dollar, low-volume payments that must be received by payees the same day as originated by the agency.

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considers to be programming limitations. Therefore, none of those payments can be levied to collect unpaid federal taxes.

Although it is responsible for the levy program, FMS also could not quantify the magnitude of federal contractor payments that it was not sending to the levy program, nor could FMS estimate the amount of levy collections it was missing because it had not included all payment categories in the program. FMS officials estimated that FMS paid about \$11 billion in contractor payments via ACH-CTX in fiscal year 2004, and our analysis identified at least \$15 billion in type A contractor payments.<sup>52</sup> The combined amount of those two categories—\$26 billion, though likely understated—represents almost 11 percent of all contractor disbursements recorded in FMS's PACER database. In addition, FMS disbursed approximately \$191 billion<sup>53</sup> in Fedwire payments, but FMS could not identify the value of Fedwire contractor payments that were not sent to the levy program.

## Type A Payments

FMS officials stated FMS had not included type A payments in the levy program because it is waiting for a new disbursement system to be deployed. Type A payments are payments whereby the agency certifies the payment in the same file that contains detailed payment information.<sup>54</sup> Although FMS had performed some preliminary studies in 2001 regarding how to send type A payments to TOP, officials were unable to provide information regarding the cost of making system corrections.<sup>55</sup> At that time, FMS was developing a new payment system that it estimated would be completed as early as 2003 and therefore decided not to make the system

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<sup>52</sup> FMS officials could not identify type A or ACH-CTX payments in its disbursement databases and therefore could not determine the amount disbursed during fiscal year 2004 through type A. Based on data provided by FMS on the payment locations that make only type A payments, we determined that type A payments totaled at least \$15 billion during fiscal year 2004. This number is understated because a number of other locations made both type A and type B payments, but the amount of type A payments made by these locations is not estimable.

<sup>53</sup> This amount does not include \$66 billion in certain benefit payments.

<sup>54</sup> The typical payment mechanism involves the certification being sent to FMS separately from detailed payment information. This type of payment, known as type B, is sent to TOP for levy.

<sup>55</sup> FMS estimated that it would take about 6 hours of programming and 1 to 3 days of testing to make changes necessary in one system to send type A payments to TOP. FMS officials stated that it could take additional programming time to prepare other systems to send type A payment information to TOP. However, FMS officials stated they did not know what additional programming might be required or the potential cost thereof.

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changes. However, at the time of our audit, the new system was still not fully deployed. Consequently, over the last 4 years the federal government has lost the collections that could have been levied from those payments. FMS officials stated that FMS is continuing to focus on completing the deployment of a new disbursement system, which it now estimates will be fully operational in 2006, rather than including type A payments in its current system. FMS tentatively plans to incorporate type A payments into TOP in calendar year 2006 when its new system is scheduled to be operational.

### ACH-CTX Payments

FMS officials stated that FMS does not send ACH-CTX payments to TOP for levy. According to FMS officials, ACH-CTX can be used to pay multiple invoices to a single contractor. However, the structure of the ACH-CTX payments requires that the total payment amount disbursed to the contractor match exactly the total of the invoices that the payment is to cover. If a levy were to take place, the total payment amount would differ from the total amount of the invoices that support the payment. Consequently, FMS officials stated that they cannot levy a portion of the payment. Officials stated that although they could not separately identify them in the PACER database, FMS made about \$11 billion in ACH-CTX payments to contractors during fiscal year 2004.

FMS officials stated they had not developed an implementation plan or timeline to incorporate ACH-CTX contractor payments into the levy program.

### Fedwire Payments

As with type A payments, FMS officials stated that FMS is currently focused on completing a new disbursement system prior to incorporating Fedwire payments—payments requiring same-day settlement—into TOP. FMS officials recognized that Fedwire payments, as a whole, are not specifically exempt from levy, though individual Fedwire payments may be exempt. FMS officials stated that the decision to exclude Fedwire payments from the levy program was also based on the limited time window FMS has to send Fedwire payments to the Federal Reserve and the operational and system changes necessary to send those payments to TOP.<sup>56</sup> FMS's TOP implementation plan, dated January 2005, called for

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<sup>56</sup> FMS officials stated that they performed a statistical match on Fedwire payments for 1 month in 2003. FMS officials stated that because few of these Fedwire payments had valid TINs, a small amount would have been offset. FMS did not maintain the detailed transactions for this statistical match for our review.

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incorporating Fedwire payments into TOP in calendar year 2007, over 10 years after DCIA first required the establishment of a centralized offset program. However, FMS officials recently informed us that they are going to study the costs of submitting Fedwire payments to TOP and may not attempt to include them in the levy program. As a result, FMS officials stated that they no longer have a timeline to incorporate Fedwire payments into TOP. We recognize that submitting Fedwire to the levy program could result in a delay in disbursement, but until FMS fully explores and identifies options for submitting Fedwire payments through TOP, potentially billions of dollars may be disbursed to contractors with unpaid federal taxes without the possibility of being levied.

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### FMS Does Not Offset Contractor Payments to Collect Tax Debts of Individuals

Because payment systems do not identify whether the payment is being made to a business or individual, FMS does not offset contractor payments to collect the unpaid federal taxes owed by individuals. Our analysis determined that civilian agency contractors with unpaid federal taxes who are individuals received payments totaling nearly \$2 billion while owing over \$290 million in unpaid federal taxes.

Agency payment records do not distinguish payments made to individuals, such as those who are self-employed or sole proprietors, from payments made to businesses. IRS decided that due to the lack of distinction between these two types of payments in FMS's system and the possibility of improperly levying payments, contractor payments should not be levied to satisfy the unpaid federal taxes of individuals. According to IRS, an improper levy could occur because a business's TIN could be the same as an individual's Social Security number (the individual's TIN). According to FMS officials, IRS instructed FMS not to match any contractor payments against unpaid federal taxes owed by individuals for potential levy following discussions between FMS and IRS.

However, both FMS and IRS officials have indicated that the potential risk of an improper levy is small. For a levy to occur, a match must exist between the TIN and name in the payment files and the TIN and name control in the tax debt file. FMS indicated it has performed a study and found that only a small number of cases potentially have a business TIN and name that would match with an individual's TIN and name. After we met with IRS and FMS officials regarding this issue, IRS directed FMS to begin levying contractor payments against tax debts owed by individuals. FMS officials stated that they will need to make system changes to implement this action.

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## FMS Faces Challenges in Addressing Other Program Limitations

FMS faces management challenges in addressing certain limitations in the levy program that result in reduced collections. Specifically, almost \$2 billion of contractor payments could not be levied due to difficulties in matching both the name and TIN in the payment records to the tax debt in the TOP database. Additionally, nearly \$10 billion in federal payments made via purchase cards to contractors are not subject to levy because the government payment is made to the bank, not the contractor doing business with the government. Finally, FMS faces challenges in implementing a provision contained in the American Jobs Creation Act of 2004, which provides for increasing the amount of levy to a maximum of 100 percent of payments to contractors with unpaid tax debts.

## Limitations in TIN/Name Match Reduces Levy Collections

Potentially thousands of payments are not levied every week because the TINs and names from the payment records do not match against the names and TINs in TOP for potential levy. Data from FMS's PACER and TOP databases indicate that about \$1.7 billion of payments made to contractors with unpaid federal taxes in TOP could not be levied because the control name supplied by IRS did not match the payee name in PACER. As a result, none of these payments could be levied to collect delinquent tax debt.

IRS provides TOP with both a TIN and a "control name" of both companies and individuals with unpaid federal taxes. In general, the control name is the first four characters of an individual's last name or the first four characters of the business name. TOP analyzes the name in the payment files to determine if it contains the IRS control name. If it identifies the control name (first four characters of the IRS name) anywhere within the name field of the payment file, TOP levies the payment to collect the unpaid taxes. If the control name is not found in the payment record's name field, TOP records the mismatch on a report that it sends to IRS to identify the mismatches.

We reviewed an example of the report containing approximately 2,400 different payments that could not be levied to identify some of the causes for the mismatches. We found that a number of payments were not levied because the payments were made using an individual's name and the business's TIN. The following hypothetical example based on an actual case illustrates the difficulty in matching names under the levy program. In one case, the payment was made to an individual doctor, J. Doctor, MD. However, the TIN provided was to the doctor's practice, Jenny Doctor, MD PA. For IRS, the control name of the business TIN was "JENN." As a result, although the TIN of the payment matched the TIN of the tax debt, the

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control name “JENN” did not appear within the payment name “J Doctor.” Because the names did not match, the payments to this contractor were not levied.

After we brought this to FMS’s and IRS’s attention, IRS began working with FMS to increase the number of control names it sends to TOP. According to IRS officials, IRS is taking action to begin sending up to 10 additional business control names to FMS to be matched against payment data.<sup>57</sup> IRS officials believed that this should increase the number of matches available under the levy program. IRS is also evaluating additional changes to increase the number of name controls that it sends to FMS for matching with payments to individuals.

#### Billions of Dollars in Purchase Card Payments Are Not Levied

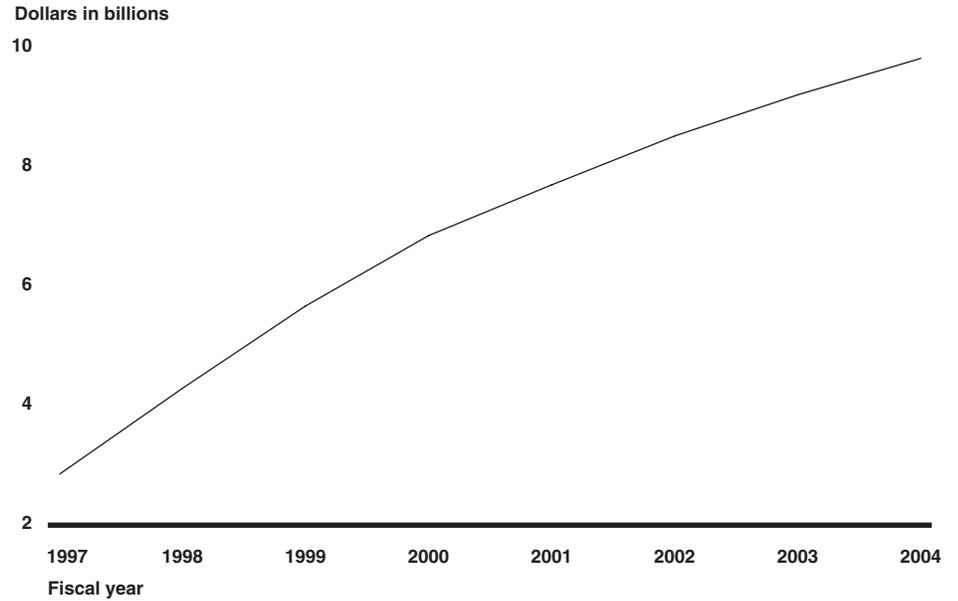
Due to the structure of the credit card program, whereby payments are made to the government purchase card bank and not directly to contractors with unpaid tax debts, none of the \$10 billion in purchase card payments made during fiscal year 2004 were able to be offset or levied. FMS officials have acknowledged the need to address those challenges and stated that FMS has met with certain bank officials and another federal agency regarding how to approach the issues. However, they have not yet determined how to collect federal debts from contractors paid with the government purchase card.

The Governmentwide Commercial Purchase Card Program was established to streamline federal agency acquisition processes by providing a low-cost, efficient vehicle for obtaining goods and services directly from contractors. Governmentwide efforts to promote increased use of purchase cards for small and routine purchases have dramatically increased purchase card spending. As shown in figure 7, purchase card expenditures by civilian agencies increased from nearly \$3 billion in fiscal year 1997 to nearly \$10 billion in fiscal year 2004. The use of purchase cards has accrued significant benefits to the federal government; however, contractors receiving payments through purchase cards are not currently subject to the levy program.

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<sup>57</sup> Once a match is made against the TIN in a contractor payment, FMS would match the name against all of the control names provided by IRS to determine if there is a match for potential levy.

**Figure 7: Purchase Card Expenditures by Civilian Agencies—Fiscal Years 1997-2004**



Source: GAO analysis of GSA data.

All purchase card payments are made to one of the five banks that issue government purchase cards—Bank One, Bank of America, CitiBank, Mellon Bank, or US Bank. In accordance with standard credit card payment procedures, those banks are responsible for interfacing with Visa or MasterCard and the contractor’s bank to pay for the goods or services provided. This payment process shields the identity of the contractor that is ultimately paid by the civilian agency receiving the goods or services from the levy program. Consequently, the disbursement file contains only the name of the purchase card issuing bank and its TIN and not the contractor that was actually doing business with the government.

Without identifying the contractor doing business with the government, the federal government is unable to collect federal debts from payments to these contractors. To demonstrate the effect of payments to contractors using the purchase card, we obtained the National Aeronautics and Space Administration’s (NASA) fiscal year 2004 purchase card transactions and compared the contractors from which NASA purchased goods and services to the IRS unpaid taxes database. During fiscal year 2004, NASA used purchase cards to pay about 12,000 contractors nearly \$80 million.

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According to IRS's data on unpaid tax debts, over 750 of those contractors had about \$440 million in unpaid federal taxes. However, none of the purchase card payments made to these contractors could be levied to collect the unpaid federal taxes. In contrast, in analyzing the TOP database, we found that non-purchase card payments made during fiscal year 2004 to 49 of these same contractors were levied.

FMS recognizes purchase card payments as a significant problem for the government's debt collection and lists the government purchase card program among the payment streams that need to be incorporated into TOP. FMS officials have stated they face both operational and legal issues to incorporate such payments into TOP and that the process of paying the purchase card issuing bank may prevent FMS from using TOP to collect from contractors paid with purchase cards. Until the challenge is thoroughly examined by FMS and IRS and solutions are identified, the federal government will continue to be unable to levy or otherwise collect from tens, if not hundreds, of billions of dollars in payments to civilian contractors.

#### Statutory Authorization for Increased Levy Has Yet to Be Implemented

FMS has not fully implemented a new provision, authorized by Congress in 2004, that increased the maximum levy percentage on contractor payments. In October 2004, Congress passed the American Jobs Creation Act 2004 to increase the maximum continuous levy from 15 percent to up to 100 percent of payments to contractors with unpaid taxes. The act specifically increased the continuous levy on payments to vendors for "goods and services" sold or leased to the government. According to IRS, the legal language, which specified that goods and services be subject to the 100 percent levy provision, excludes real estate, such as rent payments, from the new levy requirement. This exclusion presents significant implementation challenges for FMS because the civilian agencies' payment systems cannot separately identify real estate transactions from other contractor payments. Without the ability to distinguish between these payments, FMS could not implement the new law for civilian payments in such a way as to exempt real estate transactions from the 100 percent levy. FMS officials stated they had recently been able to implement the 100 percent levy provision for certain DOD payments, but were unable to do so for their own disbursements. According to FMS and IRS officials, a specific legislative change is being sought to make real estate payments subject to the new 100 percent levy requirement.

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We estimate that increasing the levy percentage from 15 to 100 could cause a dramatic increase in collections. We performed a separate analysis of our maximum levy potential estimate as if there were no legal or administrative impediments—estimated at \$350 million for a 15 percent levy—and found that if a 100 percent levy rate had been applied in fiscal year 2004, FMS could have collected as much as \$800 million from civilian contractors if all payments had been matched against all tax debt.<sup>58</sup>

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## Civilian Agency Contractors Involved in Abusive and Potentially Criminal Activity Related to the Federal Tax System

We found abusive and potentially criminal activity related to the federal tax system for all 50 cases that we audited and investigated. The case studies were selected from the population of about 33,000 contractors that were receiving federal payments during fiscal year 2004 and owed over \$3.3 billion in unpaid federal taxes as of September 30, 2004, using a non-probability selection approach. The basis for selecting each of the case study contractors was that they all had unpaid taxes totaling more than \$100,000 and federal payments totaling more than \$10,000. When our audit and investigative work indicated that the 50 contractors we originally selected were related to other entities—defined as entities sharing the same owner or officer or common addresses—we performed additional work to determine whether the related entities and the owners owed tax debts as of September 30, 2004, and received other federal payments during fiscal year 2004.<sup>59</sup> While we were able to identify some related entities, in some cases other related entities might exist that we were not able to identify. In addition, we found that 3 of the 50 case studies involve owners or officers who had been either convicted or indicted for non-tax-related criminal activities, or were under IRS investigation. We are referring the 50 cases detailed in this report to IRS so that a determination can be made as to whether additional collection action or criminal investigations are warranted. For more information on our criteria for the selection of the 50 case studies, see appendix I.

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<sup>58</sup> This estimate is based on all contractor payments recorded in PACER during fiscal year 2004 being matched against all contractor tax debt as of September 30, 2004. Due to the unavailability of information at FMS, our estimate does not include an estimate of the amount that could be collected from sending Fedwire payments to TOP. Additionally, we were unable to estimate collections against many payments due to blank or invalid TIN information in FMS's payment records.

<sup>59</sup> IRS and FMS cannot collect from payments made to one related company to satisfy the unpaid federal taxes of another related company.

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## Nature of Business for Case Study Contractors

The federal government is a large and complex organization, consisting of 15 cabinet-level agencies—one defense and 14 civilian agencies—and numerous independent agencies, administrations, and other entities that collectively spent more than \$2.5 trillion in fiscal year 2004. Civilian agencies operate throughout the country and in more than 250 foreign countries, carrying out a multitude of missions and programs. Because civilian agencies contract for a large variety of goods and services to carry out functions as diverse as guarding the nation’s borders, providing medical benefits to veterans, administering justice, and exploring space, it is not surprising that civilian agency contractors with unpaid taxes operate in a large number of industries. The industries are typically wage-based, while the 50 case studies are mostly small, many of them closely held by the owners and officers. Table 2 shows a breakdown for the 50 contractor case studies by the type of goods and services provided.

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**Table 2: Types of Goods and Services Provided by Civilian Agency Contractors in Case Studies**

| Type of business      | Number    |
|-----------------------|-----------|
| Building maintenance  | 6         |
| Communications        | 2         |
| Consulting            | 2         |
| Health care           | 12        |
| Manufacturing         | 5         |
| Personnel services    | 2         |
| Professional services | 6         |
| Sanitation            | 2         |
| Security services     | 2         |
| Transportation        | 3         |
| Other                 | 8         |
| <b>Total</b>          | <b>50</b> |

Source: GAO analysis of civilian agency and public records.

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## Examples of Abusive or Potentially Criminal Activity Related to the Federal Tax System by Businesses

Our audits and investigations of the 50 case study business contractors showed substantial abuse and potential criminal activity related to the tax system. All 48 of the contractors in our case studies that file business tax returns had tax periods in which the contractors withheld taxes from their employees' paychecks but did not remit them to IRS.<sup>60</sup> Rather, these companies diverted the money to fund business operations, for personal gain, or for other purposes. As discussed earlier in this report, businesses with employees are required by law to remit employment taxes to IRS or face potential civil or potential criminal penalties. Specifically, the act of willfully failing to collect or pay any tax is a felony while the failure to comply with certain requirements for the separate accounting and deposit of withheld income and employment taxes is a misdemeanor.

Six of the case study businesses involved owners or officers who were "multiple abusers," those involved with a group of related companies that owed taxes. The owners or operators of some of these businesses not only failed to have their businesses pay taxes, but several also failed to pay their own individual income taxes, with three individuals having more than \$100,000 in unpaid individual income taxes. The related businesses involving these multiple abusers repeatedly failed to pay taxes. For example, several groups of related businesses owed taxes for more than 50 tax periods—one group of about 20 businesses owed taxes for over 300 tax periods. One case study business owner (whose businesses received more than \$1 million in federal payments in fiscal year 2004) has a pattern of opening a business, failing to remit at least some payroll taxes, closing the business, and then opening a new business to repeat the same pattern. The owner repeated this pattern for at least three businesses over nearly 20 years.

Table 3 highlights 10 case studies with unpaid payroll tax debts. Nine of the 10 cases have unpaid payroll taxes of 10 tax periods or more. The amount of unpaid taxes associated with these 10 cases ranged from nearly \$400,000 to \$18 million—6 businesses owed more than \$1 million in unpaid federal taxes. Our investigations revealed that some owners have substantial personal assets—including commercial real estate, a sports team, or multiple luxury vehicles—yet their businesses fail to remit the payroll taxes withheld from employees' salaries. Several owners owned

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<sup>60</sup> The remaining two case study contractors were either individuals or sole proprietorships that filed personal income tax returns.

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homes worth over \$1 million—one owner had over \$3 million and another had over \$30 million in real estate holdings. Others informed our agents that they diverted payroll taxes they did not remit to IRS for personal gain or to fund their business, while others were engaged in activities that indicated potential diversion of payroll taxes for personal gain. For example, one owner transferred the payroll taxes he withheld from employees to a foreign bank account and was using the money to build a home in that country, while another contractor doubled the salary of an officer in a 5-year period to over \$750,000 at the same time that the business failed to remit payroll taxes and declared losses of more than \$2 million. Another purchased a number of multimillion-dollar properties and an unrelated business at the same time that his many businesses owed taxes, while yet another owner purchased, within a 2-year period, four vehicles totaling nearly \$200,000 after the owner's business started accumulating unpaid tax debts.

IRS has taken some collection actions against the contractors in our case studies, but has not been successful at collecting the unpaid taxes. For example, we found that in all 10 cases shown in table 3, IRS has assessed trust fund penalties on the owners or officers for willful failure to remit to the government amounts they withheld from their employees' salaries.<sup>61</sup> However, as we have previously reported, IRS seldom collects on trust fund penalties. As of September 30, 2004, the balance on the trust fund penalties owed by the owners or officers of the 10 case studies was over \$19 million. IRS has also taken some collection actions against all 10 contractors, such as placing liens on the assets of the companies or owners. Although some of the owner/officers had substantial assets, including expensive homes and luxury automobiles, the information we reviewed did not identify that IRS has performed seizures of these assets. However, we identified that 3 of the 10 owners or officers had been convicted or indicted for non-tax-related offenses or were under active IRS investigation for tax-related offenses.

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<sup>61</sup> Overall, IRS assessed trust fund penalties in 27 of our 50 case studies. See app. II for further details.

**Table 3: Civilian Agency Contractors with Unpaid Federal Taxes**

| Case study | Goods, services, or nature of work and agencies to which they were provided                    | Fiscal year 2004 FMS payments <sup>a</sup> | Unpaid federal tax amount <sup>b</sup> | Comments   |
|------------|--|--|--|--|
| 1          | Health care related services to Departments of Veterans' Affairs and Health and Human Services | Over \$300,000                             | Over \$18 million                      | <ul style="list-style-type: none"> <li>• Business is affiliated with many other health care-related facilities, including nursing and convalescent homes.</li> <li>• Taxes owed by related entities cover over 80 tax periods.</li> <li>• Since failing to fully remit all the taxes withheld from employees' paychecks starting in the late 1990s, the owner purchased multimillion-dollar properties, an unrelated business, and a number of luxury vehicles.</li> <li>• Other real estate holdings include residential and commercial properties valued in the tens of millions of dollars.</li> </ul>                                    |
| 2          | Waste collection services to the Department of Justice   | Over \$700,000                             | Over \$2 million                       | <ul style="list-style-type: none"> <li>• Company and several other entities share the same address or executives.</li> <li>• Taxes owed by related entities cover over 40 tax periods and include individual income tax debt of one owner.</li> <li>• Since the late 1990s, about the same time that the company failed to pay all of its payroll taxes, the company regularly withdrew cash from its bank accounts. These withdrawals totaled several million dollars.</li> <li>• Since failing to fully remit all the payroll taxes withheld from employees' paychecks, one owner sold his residence for more than \$1 million.</li> </ul> |
| 3          | Health care related services to the Department of Veterans Affairs                             | Nearly \$250,000                           | Over \$9 million                       | <ul style="list-style-type: none"> <li>• Business is affiliated with three other related companies.</li> <li>• Taxes owed by related entities cover over 60 tax periods and include the owner's individual income tax debt totaling hundreds of thousands.</li> <li>• One entity is under IRS investigation. In addition, owner is suspected of fraudulent banking activity.</li> <li>• Since failing to pay taxes, officer spent tens of thousand of dollars on gambling; and one of the three companies had multiple withdrawals of cash from bank accounts—each totaling tens of thousands of dollars.</li> </ul>                         |
| 4          | Waste collection services to the Department of Veterans Affairs                                | Over \$10,000                              | Nearly \$13 million                    | <ul style="list-style-type: none"> <li>• Company is one of almost 20 related entities, all of which owed unpaid taxes—primarily payroll taxes.</li> <li>• Taxes owed by related entities cover over 300 tax periods.</li> <li>• The owner also owns a residential property located near a golf course and other commercial properties in several states with assessed value of over \$2 million.</li> </ul>  |

(Continued From Previous Page)

| Case study | Goods, services, or nature of work and agencies to which they were provided                  | Fiscal year 2004 FMS payments <sup>a</sup> | Unpaid federal tax amount <sup>b</sup> | Comments  |
|------------|--|--|--|---|
| 5          | Payroll and temporary employment services to the Department of Housing and Urban Development | Over \$1 million                           | Nearly \$900,000                       | <ul style="list-style-type: none"> <li>• Business related to three other entities.</li> <li>• Taxes owed by two related entities cover over 20 tax periods.</li> <li>• Some tax debts of remaining entities were not paid for so long that IRS is now legally prohibited from seeking collection.</li> <li>• The owner's history of delinquency stretches nearly 20 years and covered multiple businesses. Specifically, the owner typically incurs payroll taxes on one company, is assessed trust fund penalty on that company but makes no or little payments, closes company, starts another company, and repeats the same pattern.</li> <li>• For example, the owner filed for bankruptcy protection in the late 1990s. In the early 2000s, after the court denied the owner's request for bankruptcy protection, the owner closed the company and immediately established a new business with a similar name at the same address that provides the same services.</li> <li>• The owner rents office space in an expensive area of a major metropolitan city and purchased a luxury automobile at the same time the company had filed for bankruptcy protection and was not remitting all of the payroll taxes.</li> </ul> |
| 6          | Health care related services to Department of Veterans Affairs                               | Nearly \$300,000                           | Over \$10 million                      | <ul style="list-style-type: none"> <li>• The company's delinquent taxes—primarily payroll taxes—cover 20 tax periods from the late 1990s.</li> <li>• IRS is investigating the company for potential criminal activity.</li> <li>• Since failing to pay payroll taxes in late 1990s, an officer assessed a trust fund violation purchased several vehicles totaling nearly \$200,000.</li> <li>• Since the late 1990s, the company reported cumulative losses on its tax returns totaling about \$5 million.</li> <li>• Despite these continued losses and accumulated tax debt, the company is involved in a multimillion-dollar joint venture.</li> </ul>  |
| 7          | Security guard services to Departments of Homeland Security and Veterans Affairs             | Over \$200,000                             | Over \$400,000                         | <ul style="list-style-type: none"> <li>• The company had not filed all required tax returns since the early 2000s, and had been delinquent in payroll taxes almost continuously since the late 1990s.</li> <li>• Delinquent tax debts cover over 25 tax periods and include the owner's individual income taxes totaling tens of thousands of dollars. In addition, the owner repeatedly failed to file personal income tax returns.</li> <li>• The owner diverted unpaid payroll taxes to a foreign bank account to build a house overseas.</li> </ul>   |

(Continued From Previous Page)

| Case study | Goods, services, or nature of work and agencies to which they were provided   | Fiscal year 2004 FMS payments <sup>a</sup> | Unpaid federal tax amount <sup>b</sup> | Comments  |
|------------|---|--|--|---|
| 8          | Consulting services to the Smithsonian Institution  | Over \$200,000                             | Over \$1 million                       | <ul style="list-style-type: none"> <li>• The business's unpaid federal taxes are primarily payroll taxes incurred in late 1990s and early 2000.</li> <li>• Unpaid tax debt balance covers more than 20 tax periods and includes hundreds of thousands of dollars in individual income tax debts owed by two officers.</li> <li>• During the same period that tax debt was incurred, the company declared large losses but doubled the salary of one officer to over three-quarters of a million dollars.</li> <li>• Officers own several luxury vehicles and multimillion-dollar properties in exclusive areas of a major metropolitan area.</li> <li>• The company is making payments on current installment agreement.</li> </ul> |
| 9          | Armed security guard services to several agencies including the Department of Justice and the Environmental Protection Agency | About \$500,000                            | Nearly \$400,000                       | <ul style="list-style-type: none"> <li>• Tax debt balance includes over \$200,000 in payroll taxes owed for almost 10 tax periods.</li> <li>• In the early 2000s, company did not file income tax returns.</li> <li>• In mid-2000s, an officer of the company was convicted for stealing hundreds of thousands of dollars from the company.</li> <li>• The owner is under indictment for embezzlement and money laundering.</li> </ul>  |
| 10         | Building maintenance, lawn and garden, and sanitary services to Department of Transportation                                  | Over \$300,000                             | Nearly \$400,000                       | <ul style="list-style-type: none"> <li>• This business did not make any payroll tax deposits for several years from the late 1990s through the early 2000s.</li> <li>• Tax debt balance covers more than 30 tax periods and includes nearly \$100,000 in personal tax debt of the officer.</li> <li>• The company is a chronic nonpayer of corporate tax debts and has not made any voluntary income tax payments since the mid-1990s.</li> <li>• The officer is also a chronic nonfiler of his individual income taxes. In one of those years, the officer reported net income of about \$100,000 but paid no taxes.</li> </ul>  |

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

Notes: Dollar amounts are rounded for the tax debt, estimated maximum levy, and government payments. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes.

<sup>a</sup>Civilian agency vendor payments provided by FMS from its PACER system.

<sup>b</sup>Unpaid tax amount as of September 30, 2004.

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The following provides illustrative detailed information on several of these cases.

- **Case 1:** This case includes many related companies that provide health care services to the Department of Veterans Affairs, for which they received over \$300,000 in payments during fiscal year 2004. The related companies have different names, operate in a number of different locations, and use at least several other TINs. However, they share a common owner and contact address. The businesses collectively owed more than \$18 million in tax debts—of which nearly \$17 million is unpaid federal payroll taxes dating back to the mid-1990s. IRS has assessed a multimillion-dollar trust fund penalty for willful failure to remit payroll taxes on each of two officers. During the early 2000s, at the time when the owner's business and related companies were still incurring payroll tax debts, the owner purchased a number of multimillion-dollar properties, an unrelated business, and a number of luxury vehicles. Our investigation also determined that real estate holdings registered to the owner totaled more than \$30 million.
- **Case 2:** This case comprises a number of related entities, all of which provide waste collection and recycling services. These entities received fiscal year 2004 payments from the Department of Justice totaling over \$700,000, about half of which is from purchase card payments, while owing in aggregate over \$2 million in tax debt. These taxes date to the late 1990s and consist primarily of payroll taxes. Despite the fact that the company reportedly used legally available means to repeatedly block federal efforts to file liens against the company, liens totaling more than \$1 million exist against the company. IRS has also assessed trust fund penalties against the two officers. At the same time that the entities were incurring the tax debt, cash withdrawals totaling millions of dollars were made against the business's bank account. Further, since the company started owing taxes, the owner had sold real estate valued at over \$1 million. The executives of these entities also drive late-model luxury or antique automobiles. Recently, the company started to make payments on its taxes.
- **Case 3:** This case includes several nursing care facilities, three of which owed taxes—primarily payroll—totaling nearly \$9 million. In addition, an owner's individual income tax debt totaled more than \$400,000. One business provides nursing care services to the Department of Veterans Affairs, for which it was paid over \$200,000 during fiscal year 2004. An officer of the company has been assessed a multimillion-dollar trust

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fund penalty for willful failure to remit payroll taxes and was recently arrested on fraud charges. Our investigative work indicates that an owner of the company made multiple cash withdrawals, each valued at tens of thousands of dollars, in the early 2000s while owing payroll taxes, and that those cash withdrawals were used for gambling. We further determined that cash transfers totaling over \$7 million were made in a 7-month period in the early 2000s.

- **Case 7:** This contractor provided guard and armed security services to the Department of Homeland Security and the Department of Veterans Affairs, for which it was paid over \$200,000 during fiscal year 2004. This business has a history of noncompliance with federal tax laws. Specifically, the business was consistently delinquent in paying its taxes since the late 1990s and has not filed all its income and payroll tax returns for a number of years in the late 1990s. The owner of this business also has not filed individual income tax returns for a number of years since the late 1990s. In the last 1-year period that the business made payroll tax deposits, the business reported that it owed nearly \$80,000 in payroll taxes but made payments totaling less than \$4,000—about one-twentieth of the taxes owed. At the same time that the owner withheld but failed to remit payroll taxes, the owner diverted the money into a foreign bank account to build a house overseas.
- **Case 8:** During fiscal year 2004, this company provided consulting services to the Smithsonian Institution, for which it received over \$200,000. Starting in the late 1990s, the company did not remit to the government all the money it withheld from its employees' salaries. However, at about the time the company was failing to remit the taxes, it nearly doubled one officer's salary to over \$750,000. IRS assessed a trust fund penalty on the officers of this company for willfully failing to remit payroll taxes withheld from their employees' salaries. Those officers own homes valued at millions of dollars in exclusive neighborhoods in a large metropolitan area and several late-model luxury vehicles.

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## Contractors Also Had Unpaid State or Local Tax Debt

In addition to problems with paying federal taxes, contractors in at least 9 of the 10 case studies had unpaid state and or local tax debt. We determined that the amount and severity of the unpaid state and or local taxes were significant enough for state and local tax authorities to file liens against those contractors. As we will be reporting in a related product, neither the states nor FMS has pursued potentially beneficial agreements to authorize the levying of federal payments, including contractor payments, to satisfy delinquent state tax debts.<sup>62</sup>

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## Levy Collection

The 50 case studies we selected illustrate FMS's inability to collect the maximum levy amount. Although we found that payments to a number of contractors were not levied because IRS excluded their tax debts from TOP for at least a part of fiscal year 2004 for statutory or policy reasons, many others were not levied because of FMS's lack of effective oversight or proactive management of the levy program. One case study contractor in particular illustrated the problems associated with the levy program that we discussed earlier in this report. This contractor received \$4 million during fiscal year 2004, but only about \$600,000 of those payments were levied. Of the remaining \$3.4 million that was not levied, about two-thirds was not levied because the tax debt was either not referred to TOP or it was referred to TOP but it was still in the notice process during the first 7 months of fiscal year 2004. The remaining one-third was not levied because the name provided in the payment files did not match the IRS control name in TOP or because payments were made using one of its specialized mechanisms. We estimate that if all the tax debt and all of the payments of the 50 case studies were subjected to a levy of 15 percent, FMS could have collected about \$3.8 million in unpaid federal taxes in fiscal year 2004. In contrast, FMS actually collected \$240,000 from these case study contractors.

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<sup>62</sup> GAO, *Debt Collection: State and Federal Governments Are Not Taking Action to Collect Unpaid Tax Debt through Reciprocal Agreements*, [GAO-05-697R](#) (Washington, D.C.: to be issued).

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## Conclusions

In the current environment of federal deficits and rising obligations, the federal government cannot afford to leave hundreds of millions of dollars in taxes uncollected each year. However, this is precisely what has been occurring with respect to the FPLP, which our work shows has largely failed to approach its potential. The levy program has thus far been inhibited from achieving its potential primarily because substantial tax debt is not subject to levy and because FMS, the nation's debt collector, has exercised ineffective oversight and management of the program.

Further, by failing to pay taxes on their income or diverting the payroll taxes withheld from their employees' salaries to fund business operations or their own personal lifestyles, contractors with unpaid tax debts effectively decrease their operating costs. The lower operating costs provide these individuals and their companies with an unfair competitive advantage over the vast majority of companies that pay their fair share of taxes. Federal contractors should be held to a higher degree of responsibility to pay their fair share of taxes owed because they are being paid by the government, and the failure to effectively enforce the tax laws against them encourages noncompliance among other contractors as well. The federal government will continue to lose hundreds of millions of dollars in tax collections annually until actions are taken to send all payments to the levy program, ensure that all payments have the information necessary to allow them to be levied, and establish a proactive approach toward managing the levy program.

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## Recommendations for Executive Action

To comply with DCIA, further implement the Taxpayer Relief Act, and support the federal government's efforts to collect unpaid federal taxes, we recommend that the Commissioner of the Financial Management Service take the following 18 actions:

- To obtain reasonable assurance that payments from all paying locations are subjected to potential levy in TOP,
  - update the TOP database to include payments from all agency paying locations in TOP for potential levy and
  - develop and implement a monitoring process to ensure TOP's list of agency paying locations is consistently updated.

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- To obtain reasonable assurance that payment files contain a TIN for each payment requiring a TIN,
    - enforce requirements that federal agencies must include TINs on all payment vouchers submitted to FMS for disbursement or expressly indicate that the contractor meets one of the criteria that exempts the contractor from providing a TIN and
    - develop and implement procedures to review payments submitted by paying agencies to verify that each payment has either a TIN or a certification that the contractor is exempt from providing a TIN.
  - To obtain reasonable assurance that all payment files submitted by agencies contain a contractor's name, develop procedures to
    - evaluate payment files to identify payments with blank or obviously inaccurate name fields;
    - notify agencies of deficiencies in payment files regarding blank or obviously inaccurate name fields;
    - collaborate with agencies submitting payment files with blank or obviously inaccurate names in the name field, including the State Department, to develop and implement procedures to capture the contractors' names in the payment files; and
    - reject agency requests for payments with blank or obviously inaccurate names.
  - To obtain reasonable assurance that payment files contain a payment type and thus, if appropriate, are subject to a levy,
    - instruct all agencies that they must indicate a payment type on all payments and
    - implement monitoring procedures to verify that all payments indicate payment type.
  - To obtain reasonable assurance that all categories of eligible payments to contractors with unpaid federal taxes are subjected to the TOP levy process,

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- develop and implement procedures to submit type A payments to TOP for potential levy,
  - develop and implement procedures to submit ACH-CTX payments to TOP for potential levy, and
  - develop and implement procedures to submit Fedwire payments to TOP for potential levy.
  - To collect unpaid taxes of individuals, make changes to TOP to levy contractor payments to collect the unpaid federal taxes owed by individuals.
  - To ensure that more payments are matched against tax debt in TOP, take actions necessary to incorporate IRS's expanded list of control names into TOP.
  - To address challenges of collecting unpaid taxes of contractors paid using purchase cards, in conjunction with IRS, monitor payments to
    - assess the extent to which contractors paid with purchase cards owe federal taxes and
    - assess alternatives available to levy or otherwise collect unpaid taxes from those contractors.
  - To address challenges associated with implementing the authorized increase of the levy to 100 percent, work with IRS to determine steps necessary to implement the increased levy percentage.

Finally, we recommend that the Commissioner of Internal Revenue evaluate the 50 referred cases detailed in this report and consider whether additional collection action or criminal investigations are warranted.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Commissioner of Internal Revenue (see app. III) and the Commissioner of the Financial Management Service (see app. IV).

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## Response from IRS and Our Evaluation

In responding to a draft of our report, IRS agreed that continued efforts are needed to improve and enhance the use of the levy program as a tool to deal with contractors that abuse the tax system. IRS noted that it had taken or was taking a number of actions toward this goal. For example, IRS stated that it had begun, with DOD's assistance, to issue collection due process notices to DOD contractors at the time of contract award rather than after a contract payment is made, thereby allowing IRS to levy more DOD contractor payments without delay. IRS stated that it planned to expand this process to contractors at other agencies later in 2005. IRS also stated that it is working to change its notice process so that more debts can be ready for levy at the time of inclusion in TOP. IRS reiterated the progress it has made to remove systematic exclusions, resulting in an additional \$28 billion in tax debts being included in the FPLP, which we noted in our report. These actions have resulted in the federal government collecting, in the first 7 months of fiscal year 2005, \$12.2 million in unpaid tax debts from civilian contractors—a nearly threefold increase from the same period in fiscal year 2004. IRS further stated that it would continuously evaluate its policies so that it does not unnecessarily exclude tax debts from the levy program.

IRS concurred with our finding that the matching of the TIN and name of contractor payments against records of unpaid federal taxes could be improved, and stated that it will begin sending a greater number of control names—up to 10 variations of the contractor's name as recorded in IRS's files—to FMS to match against FMS's payment data. IRS also stated that it was working to develop a consent-based TIN verification system for contractors doing business with the federal government and that it anticipated implementation of this system later this year. We believe that the completion of these actions can significantly improve collections of outstanding federal tax debt through the levy program.

With respect to the report's recommendations, IRS agreed to work with FMS and other agencies through the Federal Contractor Tax Compliance Task Force (FCTC) to conduct further analysis of the significant challenge presented by contractors paid with purchase cards. IRS also stated that as of April 2005, the 100 percent levy provision had been implemented with

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respect to DOD contractors paid through DOD's largest payment system, and that IRS was working with Treasury on a technical correction to allow the 100 percent levy on all federal contractors. Finally, IRS agreed with our recommendation to review the 50 contractors discussed in our report to determine what additional actions are warranted.

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## Response from FMS and Our Evaluation

In its response to a draft of our report, FMS generally agreed with many of our findings and recommendations. However, FMS stated that we mischaracterized its role in the levy process, and that primary responsibility rests with IRS. FMS also did not concur with our conclusions that its oversight and management of the program were ineffective. Additionally, FMS disagreed that it had not fully implemented the legislatively authorized increase in the maximum amount of contractor payments subject to levy. FMS also stated that it disagreed with our recommendation that it withhold payments that do not include a valid name and stated that it was not in a position to implement our recommendations with respect to working with IRS regarding issues associated with collecting outstanding federal tax debt from purchase card payments. Finally, FMS stated that the numbers and potential levy collection amounts presented in the report were confusing and could be misleading.

We do not believe we mischaracterized FMS's role in the levy process. On its Web site, FMS states that it "serves as the government's central debt collection agency, managing the government's delinquent debt portfolio." In our opinion, the agency that is responsible for managing the government's delinquent debt portfolio needs to do so in a proactive manner, which we did not always find to be the case. While we agree that IRS has a key role in the levy process, many of the issues in our report touch at the heart of FMS's debt collection responsibilities and most of the weaknesses and challenges discussed in this report can only be addressed by FMS. For example, it was FMS that did not send billions of dollars of payments to the levy program because it had no monitoring mechanism in place to determine that over 100 agency paying locations created since the late 1990s were not included in the levy program. Further, it was FMS that did not identify and inform agencies to correct payment information for tens of billion of dollars in payments that did not have the basic information necessary for the payments to be matched against outstanding federal tax debt for potential levy. These findings form the basis of our conclusion that FMS has not exercised effective oversight and management of the levy program.

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Despite the issues raised in our report, which FMS did not dispute, it disagreed that its management of the program was ineffective. FMS pointed to increased collections from the levy program in fiscal years 2003, 2004, and 2005, to date, as evidence of excellent leadership and program management. However, the recent increase in collections in the levy program is primarily the result of actions stemming from the formation of the FCTC, which was created in response to issues we raised in our February 2004 report on DOD contractors that abused the tax system. Further, the actions that have led to the increased collections were taken by DOD and IRS. Finally, while collections have increased in the last 3 years, the annual totals to date have not been significant given the potential of the program and, in the context of the program's 8-year life, the annual increases have come about only very recently.

In its response, FMS stated that it is not normally in a position to mandate changes to agencies. We disagree. FMS is in a unique position to identify and help correct many of the issues we identified in the program, some of which are relatively simple and could be quickly addressed. For example, it took the Department of State (State) about a month to correct the problem we identified with respect to missing names in the payment file it had been submitting to FMS for payment once we brought the matter to the department's attention. A programming error appears to have resulted in the names not being in the disbursement files sent to FMS. According to a State official, the department has likely had names of its payment files since the 1980s, and it did not know that the names were not getting to FMS. Because of State's responsiveness to our finding, FMS is now levying payments from State's contractors with unpaid taxes. Had FMS provided effective oversight and management of the debt collection program, it could have detected the problem years ago and worked with the State Department to correct it long before our audit. While we agree that agencies should be responsible for the completeness and accuracy of the payment files they send to FMS, we believe FMS should take a more proactive role in identifying issues that impede the program's ability to maximize collections and work with agencies to resolve such issues.

In responding to our report, FMS disagreed with our conclusion that it had not implemented the provision of the American Jobs Creation Act of 2004 authorizing an increase in the maximum amount of contractor payments subject to levy of up to 100 percent. FMS noted that it had made the changes necessary in the levy program to allow for levying at 100 percent, but that it was unable to implement the provision because civilian agencies' payment records do not separately identify real estate transactions—which

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are not subject to the 100 percent levy—from other contractor payments. Our report clearly indicates that the 100 percent levy provision had not yet been fully implemented because of a number of challenges, including the determination by IRS that real estate transactions are not subject to the 100 percent levy provision, and that agency pay systems are presently unable to identify real estate transactions from other contractor payments. We also acknowledged in our report that a legislative change is being sought to subject real estate payments to the 100 percent levy provision. Our report describes this issue not as a weakness in the program but, rather, as another challenge that FMS faces in maximizing collections under the levy program. Our report also acknowledges that certain DOD payments are already being levied at the 100 percent maximum.

FMS also did not concur with our recommendation to withhold payments that do not include a valid name in the payment record. However, FMS said it would improve monitoring and ensure agencies' compliance with the requirement to include names, TINs, and payment types on certified vouchers. This is in line with our recommendation, and we commend FMS for its willingness to increase efforts to enforce the requirements. As the State Department's prompt response to our findings indicates, when weaknesses are identified, such as records without payee names, agencies can take corrective actions, thereby making it unnecessary to withhold payments. However, FMS has had many years to require agencies to improve the data in their payment records but has, until now, not done so. As we point out in the report, in 1997 FMS proposed a rule that would require disbursing officials to reject agency payment requests that do not contain TINs (that is, withhold the payment), yet later rescinded the proposed rule and instead required agencies to submit to FMS implementation plans to achieve compliance with the TIN requirement. Although FMS requested the implementation plans in 1997, it has not been successful in gaining agency compliance. We believe that if FMS had been more proactive, the intervening years since 1997 would have provided FMS and the agencies ample opportunities to take corrective action. As such, we continue to believe FMS needs to take stronger leadership in enforcing the requirements with respect to the completeness and accuracy of information in agency-submitted payment files.

In its response, FMS accurately summarizes some of the challenges that we described in the draft report regarding levying government purchase card payments. These challenges are precisely why we recommended that FMS work with IRS and arrive at a solution to subjecting to potential levy or other form of collection the roughly \$10 billion in annual purchase card

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payments made to civilian agency contractors. However, FMS suggested that we instead redirect the recommendation to have GSA work with IRS. In addition, FMS pointed out that the FCTC could also provide valuable assistance in determining the most efficient and effective means of addressing contractors that have unpaid taxes and are being paid via government purchase cards. While we agree that GSA could assist FMS and IRS with this challenge, at the same time, we believe that as the government's central debt collector, FMS should assume a leadership role in emerging issues such as the rise in purchase card payments, as it has significant implications with respect to its debt collection responsibilities. In our opinion, FMS is the only federal entity with the ability to identify which contractors that are receiving federal payments have leviable tax debt. This is a role FMS plays when it compares the TIN and the name on FMS payments to the list of contractors with unpaid taxes to determine whether the payment should be levied. If FMS worked with the five banks that currently issue government purchase cards to routinely obtain electronic files listing the contractors being paid with purchase cards, FMS could determine which government contractors that are paid with a government purchase card have unpaid taxes. Consequently, we continue to believe that FMS, in conjunction with IRS, would be in the best position to monitor purchase card payments and assess the extent to which contractors paid with purchase cards have unpaid federal taxes, and then to identify solutions to the challenges presented by purchase card payments.

Finally, in its response, FMS stated that the numbers and potential levy collection amounts presented in the report are confusing and potentially misleading. Specifically, FMS stated that our reporting of the levy collection gap of \$350 million was misleading as it suggested that FMS would be able to collect that amount through the levy program. In our report, we have taken care to clearly note that the levy collection gap is an indicator of the amount of tax debt civilian contractors owe that could be levied from the payments they get from the federal government if all payments for which we have information could be levied against all outstanding federal tax debt. We further note throughout the report that because some tax debts are excluded due to specific statutory requirements, IRS and FMS are presently restricted by law from collecting a significant portion of this estimated amount. We do, however, clearly identify that a portion of the levy collection gap—at least \$50 million—that is directly attributable to weaknesses in internal controls and lack of proactive management at FMS. This amount is understated due to the unavailability of Fedwire information at FMS and because we were unable

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to estimate collections against many payments that did not contain valid TINs and payment types. FMS's response does not recognize that although IRS has a key responsibility to refer tax debts, FMS has an equally key responsibility—to make all payments available for levy.

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As agreed with your offices, unless you announce the contents of this report earlier, we will not distribute it until 30 days after its date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of the Financial Management Service, the Commissioner of Internal Revenue, and interested congressional committees and members. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact Gregory D. Kutz at (202) 512-9095 or [kutzg@gao.gov](mailto:kutzg@gao.gov) or Steven J. Sebastian at (202) 512-3406 or [sebastians@gao.gov](mailto:sebastians@gao.gov) if you or your staff have any questions concerning this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



Gregory D. Kutz  
Managing Director  
Forensic Audits and Special Investigations



Steven J. Sebastian  
Director  
Financial Management and Assurance

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*List of Requesters*

The Honorable Susan M. Collins  
Chairman

The Honorable Joseph I. Lieberman  
Ranking Minority Member  
Committee on Homeland Security  
and Governmental Affairs  
United States Senate

The Honorable Norm Coleman  
Chairman

The Honorable Carl Levin  
Ranking Minority Member  
Permanent Subcommittee on Investigations  
Committee on Homeland Security  
and Governmental Affairs  
United States Senate

The Honorable Daniel K. Akaka  
Ranking Minority Member  
Subcommittee on Oversight of Government Management,  
the Federal Workforce, and the District of Columbia  
Committee on Homeland Security  
and Governmental Affairs  
United States Senate

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# Scope and Methodology

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To identify the magnitude of unpaid taxes owed by contractors receiving payments from federal agencies disbursed by the Financial Management Service (FMS), we obtained information from both the Internal Revenue Service (IRS) and FMS. To identify taxes owed, we obtained IRS's unpaid assessment database as of September 30, 2004. To identify disbursements FMS made to contractors, we obtained from FMS extracts of the Payments, Claims, and Enhanced Reconciliation (PACER) database containing data on payments FMS made to contractors via Automated Clearing House (ACH) and by check during fiscal year 2004. PACER contains information such as payee and payment amount for disbursements FMS makes on behalf of federal agencies.<sup>1</sup> To determine the amount of levies that have been collected and the amount of tax debt that has been referred to the Treasury Offset Program (TOP), we obtained from FMS the TOP database as of September 30, 2004. As discussed later in this appendix, we first performed work to assess the reliability of the data provided.

To determine the value of unpaid taxes owed by contractors, we matched PACER disbursements coded as "vendor" to the IRS unpaid assessment database using the tax identification number (TIN) field in both databases. This match resulted in the identification of about 63,000 contractors with more than \$5.4 billion in unpaid federal taxes. To avoid overestimating the amount owed by contractors with unpaid tax debts and to capture only significant tax debts, we excluded from our analysis tax debts and payments meeting specific criteria to establish a minimum threshold in the amount of tax debt and in the amount of payments to be considered when determining whether a tax debt is significant. The criteria we used to exclude tax debts and payments are as follows:

- tax debts that IRS classified as compliance assessments or memo accounts for financial reporting,
- tax debts from calendar year 2004 tax periods,
- contractors with total unpaid taxes of \$100 or less, and
- contractors with cumulative fiscal year 2004 payments of \$100 or less.

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<sup>1</sup> PACER data indicated FMS also disbursed about \$6 billion on behalf of Department of Defense, primarily to health insurance providers.

The criteria above were used to exclude tax debts that might be under dispute or generally duplicative or invalid, tax debts that are recently incurred, and tax debts and payments that are insignificant for the Federal Payment Levy Program (FPLP). Specifically, compliance assessments or memo accounts were excluded because these taxes have neither been agreed to by the taxpayers nor affirmed by the court, or these taxes could be invalid or duplicative of other taxes already reported. We excluded calendar year 2004 tax debts to eliminate tax debt that may involve matters that are routinely resolved between the taxpayer and IRS, with the taxes paid or abated<sup>2</sup> within a short period. We further excluded tax debts and cumulative fiscal year 2004 payments of \$100 or less because they are insignificant for the purpose of calculating potential levy collection. Using the above criteria, we identified about 33,000 contractors with over \$3.3 billion in unpaid taxes as of September 30, 2004.

To determine the potential fiscal year 2004 levy collections, we used 15 percent of the payment or total tax debt amount, whichever is less. Our analysis was performed as if (1) all unpaid federal taxes were referred to FMS for inclusion in the TOP database and (2) all fiscal year 2004 disbursements for which FMS maintained detailed information<sup>3</sup> were included in TOP for potential levy. Because some tax debts are excluded from the FPLP due to statutory exclusions, a gap will continue to exist between what could be collected and the maximum levy amount calculated. However, as discussed in the body of the report, the potential levy collection amount of \$350 million may be understated because we excluded, by design, specific tax debts and payment amounts from the calculation of levy, and missing data in FMS's disbursement information prevented us from providing the full magnitude of tax debts and potential levy collection. The American Jobs Creation Act of 2004 provided for a 100 percent levy on vendor payments for goods or services sold or leased to the federal government, effective October 2004. If unpaid tax debts and payments to contractors in future years remain consistent with fiscal year 2004 patterns, we determined a potential future levy amount based on a levy ratio of 100 percent of payments or total tax debt amount, whichever is less.

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<sup>2</sup> Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. 26 U.S.C. § 6404 (2000).

<sup>3</sup> As discussed earlier in the report, FMS does not maintain historical data on Fedwire payments.

To determine the effect of IRS and FMS policies and procedures on the amounts actually collected through the FPLP, we conducted work at both agencies related to their respective roles in the implementation of the FPLP. At IRS, we interviewed agency officials and obtained documentation that detailed the statutory requirements and policy and administrative decisions that exclude certain tax debts from the FPLP. We did not evaluate the accuracy and reasonableness of these exclusions, which will be examined in detail in a later report. At FMS, we reviewed documentation and interviewed agency officials to obtain an understanding of FMS's FPLP policies, implementing guidance, operating procedures, and internal controls related to the TOP and disbursement operations. We also visited the San Francisco Regional Finance Center where we observed work flow processes. We obtained a copy of the TOP database as of September 30, 2004. The TOP database contains all debt, including tax debt, referred to it by federal agencies, including IRS. FMS uses the TOP database for levying contractor payments. As discussed later, we performed work to assess the reliability of data in TOP.

To identify payments to contractors disbursed through the government purchase card, we obtained from the Bank of America the database of purchase card payments made by the National Aeronautics and Space Administration (NASA). We reconciled control totals for this data with Bank of America and the General Services Administration. We restricted purchase card data to one agency to demonstrate the magnitude and effect of issues surrounding levying purchase card payments.

To identify indications of abuse or potential criminal activity, we selected 50 civilian contractors for a detailed audit and investigation. The 50 contractors were chosen using a nonprobability selection approach based on our judgment, data mining, and a number of other criteria. Specifically, we narrowed the 33,000 contractors with unpaid taxes based on the amount of unpaid taxes, number of unpaid tax periods, amount of FMS payments, indications that owner(s) might be involved in multiple companies with tax debts, and representation of these contractors across government. We specifically included contractors from NASA<sup>4</sup> and the

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<sup>4</sup> NASA cases include NASA credit card payments.

Departments of Homeland Security (Transportation Security Administration), Justice, State,<sup>5</sup> and Veterans Affairs. These agencies were selected based on a number of criteria: national security concerns; amount of payments to contractors, especially those with tax debts; amount of payments made without TINs, names, or both; amount of levy collected; and amount of payments made with blank pay types. The reliability of TINs and contractor names, and whether the agencies' payment systems are sufficiently integrated to maximize levy collection, will also be covered in later work.

We obtained copies of automated tax transcripts and other tax records (e.g., revenue officer's notes) from IRS as of December 2004 and reviewed these records to exclude contractors that had recently paid off their unpaid tax balances and considered other factors before reducing the number of businesses to 50 case studies. We performed additional searches of criminal, financial, and public records. In cases where record searches and IRS tax transcripts indicate that the owners or officers of a business are involved in other related entities<sup>6</sup> that have unpaid federal taxes, we performed detailed audit and investigation on the related entities and the owner(s) or officer(s), and not just the original business we identified. In instances where related entities exist, we defined a case study to include all the related entities, and reported on the combined unpaid taxes and combined fiscal year 2004 payments for the original business and all the related entities. We identified civilian agency contract awards using the Federal Procurement Data System. Our investigators contacted some contractors and performed interviews.

In addition, while assessing the reliability of the data provided by FMS, we identified nearly \$17 billion in payments that contain either no TIN or an obviously inaccurate TIN.<sup>7</sup> To determine whether contractors with no TINs

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<sup>5</sup> Our ability to identify Department of State (State) contractors was significantly limited by the fact that the PACER database did not identify the name of any State contractors. Consequently, we identified only one State contractor for a case study selection. We were able to identify that contractor because the contractor was paid by FMS on behalf of (i.e., conducted work for) another agency.

<sup>6</sup> We define related entities as entities that share common owner(s) or officer(s), a common TIN, or a common address.

<sup>7</sup> We termed obviously inaccurate TINs as those that fail to meet at least some of the TIN validation rules. For example, the TIN contained all the same digits (e.g., 999999999) or an unusual series of digits (e.g., 123456789).

or obviously inaccurate TINs had tax debts, we used investigative techniques to identify some of those contractors' TINs and, through comparison with the IRS records of unpaid taxes, we determined whether those contractors owed tax debts.

On May 9, 2005, we requested comments on a draft of comments on a draft of this report from the Commissioner for Internal Revenue or his designee and from the Commissioner of the Financial Management Service or his designee. We received written comments from Commissioner of Internal Revenue dated May 27, 2005, and from the Commissioner of the Financial Management Service dated May 25, 2005, and reprinted those comments in appendixes III and IV of this report. We conducted our audit work from May 2004 through May 2005 in accordance with generally accepted government auditing standards, and we performed our investigative work in accordance with standards prescribed by the President's Council on Integrity and Efficiency.

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## Data Reliability Assessment

For the IRS database we used, we relied on the work we perform during our annual audits of IRS's financial statements. While our financial statement audits have identified some data reliability problems associated with the coding of some of the fields in IRS's tax records, including errors and delays in recording taxpayer information and payments, we determined that the data were sufficiently reliable to address the report's objectives. Our financial audit procedures, including the reconciliation of the value of unpaid taxes recorded in IRS's masterfile to IRS's general ledger, identified no material differences.

For PACER and TOP, we interviewed FMS officials responsible for the databases and reviewed documentation provided by FMS supporting quality reviews performed by FMS on its databases. In addition, we performed electronic testing of specific data elements in the databases that we used to perform our work. Based on our review of FMS's documents and our own testing, we concluded that the data elements used for this report are sufficiently reliable for the purpose of this report. In instances where we found problems with the data, such as data with missing TINs and names, we include those in this report. We also compared the PACER data to the President's budget and the TOP data to the IRS unpaid assessment file.

# Contractors with Unpaid Federal Taxes

Table 3 provides data on 10 detailed case studies. Table 4 provides details of the remaining 40 businesses we selected as case studies. As with the 10 cases discussed in the body of this report, we also found substantial abuse or potentially criminal activity related to the federal tax system during our review of these 40 case studies. The case studies primarily involve businesses with unpaid payroll taxes, some for as many as 35 tax periods. IRS has imposed trust fund penalties for willful failure to remit payroll taxes on the officers of 17 of the 40 case studies. In addition to owing federal taxes, 28 of these 40 case study contractors owed sufficient state tax debts to warrant state tax authorities to file liens against them. As we have done in the body of the report, in instances where the business we selected also had related entities, we considered the business and all related entities as one case study and reported the civilian agency payments and unpaid federal tax amount for all related entities in the table.

**Table 4: Civilian Agency Contractors with Unpaid Federal Taxes**

| Case study | Goods, services, or nature of work | Agencies making payments  | Fiscal year 2004 civilian agency payments | Unpaid federal tax amount at 9/30/04 | Comments   |
|------------|------------------------------------|---|---|--------------------------------------|--|
| 11         | Professional and clerical services | Multiple departments, including the Department of Homeland Security (DHS)                                   | Over \$1.5 million                        | Over \$1 million                     | <ul style="list-style-type: none"> <li>Filed multiple tax returns late. For several years in the early 2000s, the company remitted no payroll taxes to IRS.</li> <li>Firm's primary client is the federal government.</li> <li>Has existing contracts in FY 2005 with the federal government.</li> <li>Diverted payroll taxes to fund business due to cash flow problems.</li> </ul> |
| 12         | Consulting service                 | Multiple agencies including the Department of the Interior (Interior) and the Small Business Administration | Over \$200,000                            | Over \$300,000                       | <ul style="list-style-type: none"> <li>Repeatedly under paid its payroll taxes since the late 1990s and owes payroll tax debt for more than 15 tax periods.</li> <li>Officer has mortgages of over \$1 million.</li> <li>Has existing contracts in FY 2005 with the federal government.</li> </ul>   |

**Appendix II  
Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>  | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>  |
|-------------------|---|--|--|---|--|
| 13                | Temporary help                            | DHS  | Nearly \$50,000                                  | Over \$600,000                              | <ul style="list-style-type: none"> <li>• Several other related entities—one of which is bankrupt—also have tax debt.</li> <li>• Not in the FPLP because of IRS exclusion policy.</li> <li>• Invalid name in payment files, thus levy cannot be taken even if debt is unblocked.</li> <li>• The owner attempted to negotiate repayment of IRS taxes so owner could start a new multimillion-dollar business.</li> <li>• FY 2004 maximum levy collections estimated at \$7,000.</li> </ul>                                 |
| 14                | Nursing care facilities                   | Department of Veterans Affairs (VA)  | Nearly \$200,000                                 | Over \$4 million                            | <ul style="list-style-type: none"> <li>• Not in the levy program because of IRS exclusion policy.</li> <li>• Joint target of a federal and state criminal investigation for fraudulent financial activities.</li> <li>• Defaulted on several federal government loans.</li> <li>• Millions in trust fund penalties assessed on officer.</li> <li>• One of the related entities closed by state due to health code violations in 2004.</li> <li>• FY 2004 maximum levy collections estimated at over \$25,000.</li> </ul> |
| 15                | Building maintenance services             | Multiple departments including Departments of Agriculture, Homeland Security, the Interior, the Treasury, and Veterans Affairs | Over \$4 million                                 | Over \$700,000                              | <ul style="list-style-type: none"> <li>• Levy not collected on other payments because name different from IRS control name and payments made using specialized payment mechanism not submitted to TOP.</li> <li>• Payroll tax returns frequently filed late.</li> <li>• FY 2004 maximum levy collections estimated at \$630,000, compared to nearly \$100,000 actually collected.</li> </ul>   |
| 16                | Moving and storage                        | DHS and the Department of State  | Over \$200,000                                   | Nearly \$700,000                            | <ul style="list-style-type: none"> <li>• Not in levy program due to pending appeal against a tax assessment.</li> <li>• The owner has a vacation home as well as a primary residence.</li> <li>• FY 2004 maximum levy collections estimated at over \$33,000.</li> </ul>   |

**Appendix II  
Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>  | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>   |
|-------------------|---|--|--|---|---|
| 17                | Business training and support services    | Multiple departments including DHS and the Departments of Justice and the Interior | Nearly \$130,000                                 | Nearly \$1.5 million                        | <ul style="list-style-type: none"> <li>• Business generally did not pay payroll taxes.</li> <li>• In the early 2000s, business failed to remit most of taxes owed to IRS.</li> <li>• Levy of \$1,500 collected but payments over \$100,000 not levied during FY 2004 because the name in the payment database did not match with IRS name.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$20,000.</li> </ul>   |
| 18                | Tour services                             | DHS  | Over \$20,000                                    | Nearly \$800,000                            | <ul style="list-style-type: none"> <li>• Business frequently did not pay payroll taxes.</li> <li>• In the FPLP but no levies collected during FY 2004 because FMS does not include the payment category used by the agency in the TOP system.</li> <li>• FY 2004 maximum levy collections estimated at \$3,000.</li> </ul>  |
| 19                | Telecommunications                        | DHS  | Over \$400,000                                   | Nearly \$300,000                            | <ul style="list-style-type: none"> <li>• Officers assessed penalties for willful failure to remit payroll taxes.</li> <li>• Over \$1,000 collected from levies in FY 2004, but many payments not levied because they had no name or were made via a payment category FMS does not include in TOP.</li> <li>• FY 2004 maximum levy collections estimated at \$60,000.</li> </ul>   |
| 20                | Nonprofit social service                  | Department of Justice (Justice)  | Over \$70,000                                    | Nearly \$900,000                            | <ul style="list-style-type: none"> <li>• Delinquency dates to late 1990s.</li> <li>• Owes taxes for more than 20 tax periods.</li> <li>• Officers have been assessed more than \$200,000 for willful failure to remit payroll taxes related to 10 tax periods.</li> <li>• Not in the levy program because of IRS exclusion policy and because FMS had not included the agency paying location in TOP.</li> <li>• FY 2004 maximum levy collections estimated at \$11,000.</li> </ul> |
| 21                | Ministry                                  | Justice  | Nearly \$1.3 million                             | Over \$400,000                              | <ul style="list-style-type: none"> <li>• Owes on more than 10 tax periods.</li> <li>• Typically made partial or no payments on payroll taxes. For example, in 2001, withheld about \$180,000 from employees but remitted nothing.</li> <li>• Over \$50,000 collected from levies in FY 2004. However, some periods not in TOP due to a pending tax claim.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$195,000.</li> </ul>                                     |

**Appendix II**  
**Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>                                | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>  |
|-------------------|---|--|--|---|--|
| 22                | Freight                                   | Multiple departments including Interior, Justice, and Treasury | Over \$300,000                                   | Over \$300,000                              | <ul style="list-style-type: none"> <li>• Did not file several years of early 2000s tax returns until April 2004.</li> <li>• Did not remit any payroll taxes withheld from employees since early 2000s.</li> <li>• Owes tax debt on more than 20 tax periods.</li> <li>• The owner had drug-related criminal activity.</li> <li>• Levy started in September 2004, but prior to that no levies collected in FY 2004 because of IRS exclusion policy.</li> <li>• FY 2004 maximum levy collections estimated at \$46,000.</li> </ul> |
| 23                | Court reporter                            | Justice  | Over \$25,000                                    | Over \$400,000                              | <ul style="list-style-type: none"> <li>• Consistently owed unpaid payroll taxes from late 1990s through 2002.</li> <li>• Consistently reported losses or no income.</li> <li>• Two owners assessed hundreds of thousands in penalties for willful failure to remit payroll taxes.</li> <li>• New installment agreement in 2004, for which \$2,000 had been received.</li> <li>• No levies collected in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$4,000.</li> </ul>                              |
| 24                | Aircraft and space parts                  | NASA   | Over \$100,000                                   | Nearly \$200,000                            | <ul style="list-style-type: none"> <li>• Owes more than 10 tax periods.</li> <li>• Did not pay any IRS payroll taxes withheld from employees for five periods.</li> <li>• Companies did not file income taxes for several years in the early 2000s.</li> <li>• Over \$7,000 collected from levies in FY 2004. Levy less than estimated because some tax debt excluded due to IRS exclusion policy.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$17,000.</li> </ul>  |
| 25                | Electro-optic equipment                   | DHS and NASA   | Nearly \$700,000                                 | Over \$1 million                            | <ul style="list-style-type: none"> <li>• Withheld more than \$500,000 from employees one year in early 2000s but remitted less than \$50,000 to IRS.</li> <li>• Received nearly \$900,000 in grants.</li> <li>• Payments not levied due to pending installment agreement.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$105,000.</li> </ul>  |

**Appendix II  
Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>   | <b>Fiscal year 2004 civilian agency payments</b>               | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>  |
|-------------------|---|---|--|---|--|
| 26                | Acquisition and financial support         | Multiple departments, including Health and Human Services (HHS), Transportation (Transportation), as well as NASA | Over \$3 million   | Nearly \$400,000                            | <ul style="list-style-type: none"> <li>• Not in the levy program because of IRS exclusion policy.</li> <li>• Has an existing contract in FY 2005 with the federal government.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$380,000.</li> </ul>  |
| 27                | Computer software                         | Multiple agencies including HHS, Justice, Treasury, and NASA  | Over \$300,000   | Over \$50,000                               | <ul style="list-style-type: none"> <li>• Payments were not levied because of an IRS statutory exclusion.</li> <li>• FY 2004 maximum levy collections estimated at \$46,000.</li> </ul>   |
| 28                | Logistics and engineering services        | Agriculture and NASA  | Over \$650,000   | Over \$2 million                            | <ul style="list-style-type: none"> <li>• Payroll taxes owed since early 2000s.</li> <li>• Multiple cash withdrawals totaling tens of thousands of dollars each.</li> <li>• Penalties were assessed on an officer of the company for failure to remit payroll taxes.</li> <li>• FY 2004 maximum levy collections estimated at \$98,000.</li> </ul>  |
| 29                | Casino                                    | NASA, Interior, and Agriculture   | Over \$35,000  | Over \$1.5 million                          | <ul style="list-style-type: none"> <li>• Large penalty for intentional disregard for requirement to file accurate information returns.</li> <li>• Annual net income \$6 million to over \$30 million over the past 10 years.</li> <li>• One payment not levied because tax debt not turned on for immediate levy in TOP.</li> <li>• FY 2004 maximum levy collections estimated at \$5,000.</li> </ul>  |
| 30                | Manufacturing                             | NASA (including credit cards)   | More than \$600,000, \$30,000 of which is credit card payments | Nearly \$200,000                            | <ul style="list-style-type: none"> <li>• Subsidiary of international defense-related group.</li> <li>• Taxes owed mostly interest and penalties.</li> <li>• Company noted as having problems with filing tax returns.</li> <li>• Levies totaling nearly \$6,600 collected, but maximum levy was not collected because majority of tax debts were not in TOP.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$100,000 not including amounts paid to contractor via government purchase card.</li> </ul> |
| 31                | Medical doctor                            | VA  | Over \$180,000   | Nearly \$700,000                            | <ul style="list-style-type: none"> <li>• Tax debt dates back to early 1990s.</li> <li>• Contractor payments not levied to pay tax debt of individuals.</li> <li>• FY 2004 maximum levy collections estimated at \$27,000.</li> </ul>   |

**Appendix II**  
**Contractors with Unpaid Federal Taxes**

(Continued From Previous Page)

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>                        | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>   |
|-------------------|---|--|--|---|---|
| 32                | Engineering                               | Treasury   | Over \$500,000                                   | Nearly \$2 million                          | <ul style="list-style-type: none"> <li>• Owner did not file personal income tax return for 2 years in early 2000s.</li> <li>• Payments were not levied because of an IRS statutory exclusion.</li> <li>• FY 2004 maximum levy collections estimated at \$75,000.</li> </ul>   |
| 33                | Plumbing, heating, and air conditioning   | Multiple departments including Labor, Treasury, and VA | Over \$130,000                                   | Over \$300,000                              | <ul style="list-style-type: none"> <li>• Substantial payments made to IRS in early FY 2005 to settle tax debt.</li> <li>• No levies collected in FY 2004 because of IRS exclusion policy.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$20,000.</li> </ul>  |
| 34                | Janitorial                                | Agriculture and VA                                     | Over \$700,000                                   | Over \$300,000                              | <ul style="list-style-type: none"> <li>• Almost all of the taxes owed are unpaid payroll taxes that company withheld from employees but failed to remit.</li> <li>• No levies collected in FY 2004 because of an installment agreement, which is an IRS statutory exclusion.</li> <li>• FY 2004 maximum levy collections estimated at \$107,000.</li> </ul>   |
| 35                | Building construction                     | HHS and VA   | Over \$1.5 million                               | Over \$200,000                              | <ul style="list-style-type: none"> <li>• Payroll taxes owed since the late 1990s.</li> <li>• No levies collected in FY 2004 because of a tax claim.</li> <li>• FY 2004 maximum levy collections would have completely paid off the tax debt.</li> </ul>   |
| 36                | Health care services                      | VA   | Over \$40,000                                    | Nearly \$300,000                            | <ul style="list-style-type: none"> <li>• Bankruptcy filed in late 1990s dismissed prior to 2004.</li> <li>• Offer-in-compromise not rejected for 2 years, which resulted in payments being excluded from levy program for almost two years.</li> <li>• Installment agreement requested immediately after offer-in-compromise rejected. No levies collected in FY 2004 because of an installment agreement.</li> <li>• FY 2004 maximum levy collections estimated at \$6,500.</li> </ul> |
| 37                | Public relations                          | HHS  | Nearly \$280,000                                 | Over \$300,000                              | <ul style="list-style-type: none"> <li>• Multiple federal and state tax liens and judgments.</li> <li>• Unpaid payroll taxes since early 2000s.</li> <li>• Officer assessed penalty for willful failure to pay payroll taxes; penalty paid in full the year it was assessed.</li> <li>• No levies collected in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at nearly \$42,000.</li> </ul>  |

**Appendix II**  
**Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b>                   | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>   |
|-------------------|---|---|--|---|---|
| 38                | Telecommunications                        | Commerce, Treasury, and HHS                       | Over \$1 million                                 | Over \$300,000                              | <ul style="list-style-type: none"> <li>• Company owed payroll taxes back to the late 1990s.</li> <li>• Over \$10,000 collected from levies in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$211,000.</li> </ul>   |
| 39                | Building maintenance                      | HHS and State                                     | Over \$1.1 million                               | Nearly \$1 million                          | <ul style="list-style-type: none"> <li>• Company owed payroll taxes back to the late 1990s.</li> <li>• Defaulted on installment agreement in early 2000s.</li> <li>• Company filed an offer-in-compromise with IRS, which IRS rejected.</li> <li>• Officers were assessed trust fund penalties for willfully failing to pay payroll taxes withheld from employees.</li> <li>• About \$50,000 collected from levies in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$176,000.</li> </ul> |
| 40                | Medical, dental, and hospital equipment   | Executive Office of the President and Agriculture | Over \$900,000                                   | Nearly \$2 million                          | <ul style="list-style-type: none"> <li>• In the early 2000s, company collected more than \$600,000 in payroll taxes from employees that were not remitted to IRS.</li> <li>• Company filed for bankruptcy in the late 1990s.</li> <li>• About \$6,000 collected from levies in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$139,000.</li> </ul>  |
| 41                | Health care services                      | VA  | Over \$60,000                                    | Over \$500,000                              | <ul style="list-style-type: none"> <li>• Payroll taxes owed for almost every period since 2000.</li> <li>• In the early 2000s, defaulted on an installment agreement after 10 months.</li> <li>• An officer assessed trust fund penalties for willfully failing to remit payroll taxes withheld from employees.</li> <li>• No payments levied during FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$10,000.</li> </ul>   |
| 42                | Automotive manufacturer                   | Agriculture                                       | Over \$60,000                                    | Over \$1 million                            | <ul style="list-style-type: none"> <li>• Contractor in levy program during many months in 2004, but no levy was taken because the name did not match with IRS name for levy.</li> <li>• FY 2004 maximum levy collections estimated at \$10,000.</li> </ul>  |

**Appendix II  
Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b> | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>  |
|-------------------|---|---------------------------------|--|---|--|
| 43                | Support and managerial services           | Treasury                        | Over \$90,000                                    | Nearly \$400,000                            | <ul style="list-style-type: none"> <li>• Business in bankruptcy since late 1990s that was discharged in 2004.</li> <li>• No payments levied in FY 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$14,000.</li> </ul>  |
| 44                | Health care services                      | VA                              | Over \$200,000                                   | Nearly \$2 million                          | <ul style="list-style-type: none"> <li>• Payroll taxes owed for taxes in late 1990s and early 2000s.</li> <li>• Payments were not levied because the business was in notice status, which is an IRS statutory exclusion.</li> <li>• FY 2004 maximum levy collections estimated at \$31,000.</li> </ul>   |
| 45                | Ambulance services                        | VA and Agriculture              | Over \$20,000                                    | Over 600,000                                | <ul style="list-style-type: none"> <li>• Since the late 1990s, the company had annual revenue exceeding \$10 million but repeatedly reported tax losses.</li> <li>• Company under bankruptcy protection since early 2000s.</li> <li>• No payments levied in FY 2004 due to IRS exclusion policy.</li> <li>• FY 2004 maximum levy collections estimated at \$3,000.</li> </ul>                                  |
| 46                | Taxi services                             | VA                              | Over \$40,000                                    | Over \$600,000                              | <ul style="list-style-type: none"> <li>• Company in litigation status since the mid-1990s, which prevented any payments from being levied.</li> <li>• An officer assessed trust fund penalties for willfully failing to pay payroll taxes withheld from employees.</li> <li>• Officer placed on an installment agreement in 2004.</li> <li>• FY 2004 maximum levy collections estimated at \$6,000.</li> </ul> |
| 47                | Home health care services                 | VA                              | Over \$200,000                                   | Nearly \$3 million                          | <ul style="list-style-type: none"> <li>• No payments levied in FY 2004 due to an installment agreement for which contractor is making payments.</li> <li>• IRS had to construct payroll tax returns for five periods (over 1 year) because the company did not file quarterly payroll tax returns.</li> <li>• FY 2004 maximum levy collections estimated at \$31,000.</li> </ul>                               |

**Appendix II**  
**Contractors with Unpaid Federal Taxes**

*(Continued From Previous Page)*

| <b>Case study</b> | <b>Goods, services, or nature of work</b> | <b>Agencies making payments</b> | <b>Fiscal year 2004 civilian agency payments</b> | <b>Unpaid federal tax amount at 9/30/04</b> | <b>Comments</b>  |
|-------------------|---|---------------------------------|--|---|--|
| 48                | Residential care                          | Justice                         | Nearly \$770,000                                 | Nearly \$9 million                          | <ul style="list-style-type: none"> <li>• Multiple withdrawals of cash from late 1990s to 2001 totaling several million dollars.</li> <li>• An officer assessed trust fund penalties for willfully failing to remit payroll taxes.</li> <li>• The agency location code was not in TOP so no levies would have been possible.</li> <li>• FY 2004 maximum levy collections estimated at \$115,000.</li> </ul> |
| 49                | Building maintenance                      | Social Security Administration  | Over \$330,000                                   | Over \$400,000                              | <ul style="list-style-type: none"> <li>• Company under bankruptcy protection in 2004.</li> <li>• Officers assessed trust fund penalties for willfully failing to remit payroll taxes.</li> <li>• No payments levied in FY 2004.</li> <li>• FY 2004 collections under effective levy estimated at nearly \$50,000.</li> </ul>   |
| 50                | Special trade contractor                  | Justice and Treasury            | Over \$400,000                                   | Over \$100,000                              | <ul style="list-style-type: none"> <li>• Tax debt dated to the late 1990s.</li> <li>• Penalty assessed on officers being paid.</li> <li>• Business current on installment agreement.</li> <li>• FY 2004 maximum levy collections estimated at \$65,000</li> </ul>  |

Source: GAO analysis of civilian agency, IRS, FMS, public, and other records.

# Comments from the Internal Revenue Service



COMMISSIONER

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

May 27, 2005

Mr. Steven J. Sebastian  
Director, Financial Management and Assurance  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. Sebastian:

We have reviewed your report entitled, "Financial Management: Some Civilian Agency Contractors Abuse the Tax System with Little Consequence" (GAO-05-637) and agree that we must continue to improve and enhance the use of the Federal Payment Levy Program (FPLP) as a tool to deal with contractors who abuse the federal tax system.

We appreciate your acknowledgement of the significant progress we have made in the past year to improve the effectiveness of the FPLP. In March 2004, the Internal Revenue Service (IRS), Financial Management Services (FMS) and the Department of Defense (DOD) established the Federal Contractor Tax Compliance Task Force (FCTC) to recommend and implement actions to ensure federal contractors pay their taxes and that we take appropriate enforcement actions, including levies, to collect unpaid taxes. The collaborative efforts of the federal agencies represented on the FCTC task force have already resulted in tremendous benefits as evidenced by the improved program results. The IRS removed many of the systemic exclusions that had prevented tax debts from being available for levy through the FPLP. Consequently, as of April 2005, \$98 billion in tax debts were included in the FPLP, an increase of \$28 billion over the prior year. Total FPLP collections in FY 2005 through April exceeded \$109 million compared to \$50 million during the same period of FY 2004. A similar comparison for collections from federal contractors shows an even more significant increase -- \$23 million through April 2005 compared to \$5.4 million through April 2004. From civilian contractors, the subject of your report, we have collected \$12.2 million in FY 2005 compared to \$4.7 million in the same period of FY 2004.

We are pleased with the results to date, and we continue to work with FMS and other federal agencies on the FCTC to pursue further enhancements to the FPLP. For example, we already have implemented a data exchange with the DOD that enables issuance of the Collection Due Process (CDP) notice at the time of contract award rather than after a contract payment is made. As a result, IRS will be in a position to levy an increased number of contractor payments without a delay. We plan to expand this process to all federal contractors later this year. As you noted, we are working with Treasury on a legislative proposal to allow a post-levy CDP process on federal

payments to contractors. If enacted, this change will further improve our ability to levy earlier on an increased number of contractor payments. In addition, we are working to change our business tax collection process to combine the CDP notice with the final notice making more debts ready for levy at the time of inclusion in the Treasury Offset Program (TOP).

In order to increase the number of name and Taxpayer Identification Number (TIN) matches with FMS, in January 2006, the IRS will begin sending FMS up to ten additional business control names for each account to be matched against payment data. We are also developing a consent-based TIN verification system that will require contractors interested in doing business with the federal government to consent to validation of their name and TIN as a condition of registration in the Central Contract Registration (CCR) database. We anticipate implementation of this process later this year.

We agree that the use of purchase cards to pay federal vendors presents a significant challenge. As you noted, the purchase card program yields significant savings and efficiencies for the government-wide procurement system. However, due to the complexity of the purchase card payment process, vendors are paid in a manner that prevents the offset of other debts, including taxes. We will partner with FMS and the other agencies through the FCTC to conduct further analysis of this issue.

On April 15, 2005, we implemented the recently enacted 100 percent levy provision on certain DOD contracts paid through the largest DOD payment system. This provision will be implemented with respect to the remaining DOD vendor payment systems in July 2005. We are also working with Treasury on a technical correction which would allow the 100 percent levy on payments made to all federal vendors, not only vendors of goods and services. We will continue to partner with FMS on full implementation of this provision.

While we have taken significant actions to increase the dollars available for levy, as you acknowledge in your report, a substantial amount of tax debt (\$71 billion) is excluded from the levy program for statutory reasons. These excluded debts include those for taxpayers who are in bankruptcy, have an installment agreement or have not yet received their appeal rights prior to levy. The IRS must continue to honor these statutory taxpayer rights as enacted by Congress. Another \$99 billion is excluded from the levy program due to IRS policy including, as an example, tax debts of taxpayers who are experiencing a financial hardship. We continuously evaluate these policy exclusions to ensure that they are no broader than necessary.

In response to your recommendation, we are reviewing our case actions on the 50 contractor businesses and individuals identified in your report and will evaluate what additional actions are warranted. We believe the FPLP is an effective automated process for serving tax levies and collecting unpaid taxes. We will continue to pursue further opportunities to improve the FPLP and deal with contractors who abuse the tax system.

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**Appendix III**  
**Comments from the Internal Revenue Service**

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If you have any questions, please contact me or call Brady R. Bennett, Director,  
Collection, Small Business/Self Employed Division at (202) 283-7660.

Sincerely,



Mark W. Everson

# Comments from the Financial Management Service



DEPARTMENT OF THE TREASURY  
FINANCIAL MANAGEMENT SERVICE  
WASHINGTON, D.C. 20227

May 25, 2005

Mr. Steven J. Sebastian  
Director, Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Sebastian:

Thank you for the opportunity to comment on the May 2005 draft audit report titled "*FINANCIAL MANAGEMENT: Some Civilian Agency Contractors Abuse the Tax System with Little Consequence* (GAO-05-637)." We acknowledge that with any successful program, there are still opportunities for improvement. Although I agree with many of the recommendations presented in this draft report, I have concerns regarding the following aspects of this report.

## 1. Management Oversight of the Levy Program

I disagree with the draft report's conclusion that the Financial Management Service (FMS) has ineffectively managed oversight of the levy program. FMS and the Internal Revenue Service (IRS) have very successfully implemented a phased-in approach of this program over the last several years. Collections increased 49% from FY 2002 (first full year of the Levy Program) to FY 2003, and another 27% from FY 2003 to FY 2004. Through seven months of FY 2005, FMS has collected over \$115 million in tax debts, more than in any prior full year of this program. Much of this success is attributable to the work of the Federal Contractor Tax Compliance Task Force (FCTC). The FCTC is a joint task force consisting of the IRS, Department of Defense (DOD), Department of Justice, General Services Administration (GSA), Office of Management and Budget, and FMS. As a result of this task force: (1) more debts were loaded into the Treasury Offset Program (TOP) database; (2) more debts were made available earlier by the IRS for collection; and (3) improvements were made in the accuracy of name and taxpayer identification number (TIN) information in the Central Contractor Registration (CCR) database. These and other changes will significantly contribute to the continued rapid growth of the program.

In addition, throughout the report, the Government Accountability Office (GAO) mischaracterizes FMS' role in the levy process. The Federal Payment Levy Program (FPLP) is not exclusively an FMS program. It is a program to collect delinquent taxes, the primary responsibility for which rests with the IRS. FMS has no statutory role in the collection of delinquent tax and has no authority to make determinations regarding outstanding tax obligations or the method of collecting those obligations. For example,

Page 2 – Mr. Sebastian

the draft report charges FMS with failing to levy vendor payments to collect individual tax debt. IRS, which makes all determinations regarding what debts are subject to levy, expressly instructed FMS not to levy vendor payments to collect individual tax debts, and we have complied with its instructions. Accordingly, we have modified our systems to support the requirements of IRS.

I believe that FMS has provided excellent leadership and program management to the debt collection program, both non-tax and tax debt. Virtually every trend line shows strong increases in collections for the past several years. Yet, managing any program is also about making choices and determining priorities. FMS has made such choices in managing our part of the tax levy program. We have allocated resources to the highest management priorities to increase collections, but also to ensure that the proper management controls are in place. Further, FMS has long been an advocate of legislative or procedural changes that would allow agencies to improve their debt collection referrals to us. While FMS has demonstrated leadership, we are also not normally in a position to mandate changes by agencies or to direct agency resources.

## **2. Withholding Payments**

At this time, I am opposed to GAO's recommendation to withhold payments. Instead, we plan to work with Federal Program Agencies (FPAs) on improving compliance before we consider rejecting payments. As the Government's chief disbursing office, FMS ensures that certified payments submitted to FMS are disbursed timely and accurately. Pursuant to 31 U.S.C. 3528, it is certifying officials at the FPAs who are responsible for the information (name, TIN, payment type) on the payment voucher and for ensuring that the payment is legally authorized.

Rather than withholding payments that do not include names, which could unduly interfere with the timely disbursement of federal funds to thousands of contractors who do not owe tax debts, we believe a better approach is to increase our efforts to monitor and ensure agencies' compliance with the requirement to include names, TINs, and payment types on certified vouchers. Within the next week, FMS will be sending a letter to all Chief Financial Officers enlisting their support in this endeavor. It is our view that this approach will most effectively address any underlying barriers to agency compliance. Withholding payments should only be considered as a last resort. We therefore plan to evaluate this approach over the next year and, at the end of that time, determine whether withholding payments is warranted.

## **3. Implementing 100% Levy for Vendor Payments**

I disagree with the draft report's conclusion that we failed to implement 100% levy as authorized in the American Jobs Creation Act of 2004, enacted October 2004. In November 2004 FMS made the programming changes and was fully prepared to implement the 100 percent levy based on its existing vendor payment guidance to the

Page 3 – Mr. Sebastian

agencies. Subsequently, in review of the statute, IRS determined that Treasury could not fully implement this new version of the law without revisions. Where the law could be implemented, FMS, IRS, and DOD have done so, effective April 29, 2005. Since then, DOD reports that on the two files they matched with FMS for 100 percent levy, it collected \$432,000 as compared to \$100,000 that it would have collected at 15 percent.

#### **4. Government Purchase Card Program**

I agree with GAO's concern that the government purchase card program does not facilitate tax levy of payments to contractors. It is my view, however, that the GAO recommendations should be redirected to GSA and IRS. In addition, the FCTC could provide valuable assistance in determining the most efficient and effective means of addressing vendors who have unpaid taxes and are paid via the government purchase card.

The FPLP model does not work for credit cards. When a purchase is made using a purchase card, there is no point in the process where FMS has in its possession property belonging to the vendor. IRS levies FMS to collect from payments disbursed by FMS or an authorized disbursement officer. Credit card payments to vendors are not processed through FMS or an authorized disbursement official. Because FMS does not issue payments to contractors paid with purchase cards, or have information regarding which vendors are receiving purchase card payments, FMS is not in a position to implement the recommendations.

#### **5. Misleading and Confusing Amounts in the Draft Report**

Throughout the draft report there is a confusing mix of numbers. At some points the draft report discusses the overall tax gap, at other points the report discusses taxes that might be collectible by tax levy and at other times the report discusses amounts that might be collectible by tax levy from contractors. In addition, GAO provides estimates of the amount that FMS could have potentially collected compared to what was actually collected even though it is clear that the "potential" amount was not sent to us for levy in the first place. For example, on page 26 of the report, GAO states: "We estimate that if there were no legal or administrative provisions that remove some tax debt from the levy program and if all PACER contractor payments were subjected to a 15 percent levy ..., FMS could have collected as much as \$350 million in fiscal year 2004." In the next paragraph, GAO goes on to say: "We found that a vast majority of the collection gap is attributable to debts that because of current law and IRS policies, are excluded from TOP." I believe that on one hand suggesting that FMS could have collected \$350 million in fiscal year 2004 and then later acknowledging that most of the debts to realize that amount of collections were not sent to FMS for levy because of current law and IRS policies is misleading. There are other similar instances in the report of GAO showing large hypothetical or potential tax levy amounts only to later state that only a small percentage was available to FMS for levy purposes. While I recognize that GAO wants

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**Appendix IV**  
**Comments from the Financial Management**  
**Service**

Page 4 – Mr. Sebastian

to portray the full dimensions of the tax gap and the use of tax levy in narrowing that gap, I believe that indicating that FMS could collect large amounts from tax levy except for certain constraints gives an overall impression that FMS has the authority to remove those constraints even though that is not normally true.

Thank you for the opportunity to comment on this draft GAO report. If you have any questions or wish to discuss these comments in more detail, I can be reached on (202) 874-7000, or you may contact Marty Mills on (202) 874-3810 or Judy Tillman on (202) 874-6780.

Sincerely,



Richard L. Gregg

cc: Donald V. Hammond  
Fiscal Assistant Secretary  
U.S. Department of the Treasury

# Staff Acknowledgments

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## Acknowledgments

The following individuals made major contributions to this report: Beverly Burke, Ray Bush, Richard Cambosos, William Cordrey, Francine Delvecchio, F. Abe Dymond, Paul Foderaro, Alison Heafitz, Kenneth Hill, Aaron Holling, Jason Kelly, John Kelly, Rich Larsen, Tram Le, Mai Nguyen, Kristen Plungas, Rick Riskie, John Ryan, David Shoemaker, Sid Schwartz, Esther Tepper, Tuyet-Quan Thai, Wayne Turowski, Matt Valenta, Scott Wrightson, and Mark Yoder.

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