S. Hrg. 108–493

DOD CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

FEBRUARY 12, 2004

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

92–689 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
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8. *SEALED EXHIBIT:* List of Department of Defense contractors owing back taxes provided to the Permanent Subcommittee on Investigations by the Department of Defense ..... *

* May be found in the fields of the Subcommittee.

DOD CONTRACTORS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

THURSDAY, FEBRUARY 12, 2004

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:35 a.m. in room SD–342, Dirksen Senate Office Building, Hon. Norm Coleman, Chairman of the Subcommittee, presiding.

Present: Senators Coleman, Levin, Collins, Lautenberg, Fitzgerald, and Akaka.

Staff Present: Raymond V. Shepherd, III, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; Jay Jennings, Investigator; Elise J. Bean, Minority Staff Director and Chief Counsel; Brian C. Plesser, Counsel to the Minority; Andrew Plehal, Intern; Brian Kowalski, Intern; Alec Rogers (Senator Collins); and Marianne Upton (Senator Durbin).

OPENING STATEMENT OF SENATOR COLEMAN

Senator COLEMAN. This hearing is called to order. I would first like to note the presence of the Chairman of the Governmental Affairs Committee, Chairman Collins and I am pleased to have you here today.

Also I'd like to recognize the Ranking Member, Senator Levin. I will note that during your tenure as Chairman of this Subcommittee, you certainly shined a light on instances where individuals were bringing in millions in one pocket but then were cheating the system. And this hearing today, I think, really is an offshoot of the focus that you have brought.

Senator LEVIN. Thank you.

Senator COLEMAN. And so, I thank you for the work you did and appreciate your cooperation in the work that we are doing together here.

We are holding this hearing to address a continuing and growing problem at the Internal Revenue Service relating to the collection of delinquent taxes. In particular, our focus today is on the Department of Defense contractors who receive billions of dollars in contract payments each year and who currently owe $3 billion in unpaid taxes.

Let me, if I can sum it up just very succinctly, we are talking about individuals, deadbeat taxpayers, who are being paid taxpayer dollars while they cheat the system, and the system is not doing

enough to stop it. And hopefully, what we do today will move us in a direction to stop it.

Under the Taxpayer Relief Act of 1997, the Internal Revenue Service has the authority to levy 15 percent of these contractors' payments, if the Department of Defense refers its contract payments to the Financial Management Service and the Internal Revenue Service has made these cases available for collection. However, the Department of Defense is not referring all of its payments and the Internal Revenue Service has not made all of these cases available for collection.

These failures are costing the government over $100 million in lost tax revenue each year. No one likes to pay taxes. But taxes are a necessity because freedom is not free. Our taxes help to fulfill the American dream. They provide for the Nation's defense. They promote commerce and fair trade. They protect workers, promote health, and provide for education. They preserve our natural resources, advance research and preserve our culture. They feed the hungry and house the poor. They ensure justice and provide transportation. In short, taxes are the membership dues we pay to preserve our way of life. All Americans are beneficiaries of the Federal tax system.

The focus of today's hearing is DOD's contractors who have abused the Federal tax system. Some of these abuses are appalling in their audacity and contemptible in their abject selfishness. They cannot and should not be tolerated. Those who are committed to the service of this Nation must bear their full responsibility in that service.

I am especially concerned about DOD contractors who have withheld payroll taxes in trust for their employees and have failed to remit those taxes, cheating not only their own employees but the American people as well.

The adverse impact on taxpayers' faith in the fairness of our tax system would be reason enough to remedy this problem. However, these employers' betrayal of their own employees demands our attention. An investigation recently completed by the General Accounting Office found that over 27,000 Federal contractors at the Department of Defense owed about $3 billion in unpaid taxes. If properly administered, the Debt Collection Act of 1996 would have provided DOD with the opportunity in fiscal year 2002 to collect at least $100 million from these contractors.

However, because DOD has not fully implemented the provisions of the act, only $332,000 was collected. This problem has been further exacerbated by the IRS' failure to aggressively pursue collections against these contractors. Specifically, IRS' increasing collection workload and decreasing collection resources have led IRS to freeze collection activity in one of every three collection cases. Further, the IRS has allowed many cases to interminably languish in their antiquated collection process.

In order to improve collections, DOD and the Internal Revenue Service must work with the Financial Management Service to identify delinquent contractors and levy their contract payments.

I had a chance to meet with Commissioner Everson yesterday. I am pleased with his vision for an increased focus on investigative and collection efforts and by his commitment to expeditiously ad-

dress the concerns raised by this Subcommittee and the GAO report.

Let me outline some of the most egregious tax abuses that have occurred:

- A business that provides snow removal and landscaping service at a military base was awarded contracts of over $1 million and owes over $1 million in unpaid payroll and employment taxes. During 2002, the contractor received over $200,000 from DOD.
- An individual business that performs repair services on military vehicles owes over $500,000 in business and individual taxes. This contractor has contracts with the DOD that are worth over $60 million and recently received an annual payment of over $100,000.
- IRS suspended collection activity against a contractor in 1999 because the IRS believed the contractor lacked the funds to pay their debt. However, between 1999 and 2002, DOD paid the contractor almost $700,000.
- IRS initiated collection against a DOD contractor who owed about $270,000 in unpaid taxes. Because of its workload, IRS suspended collection activity against the contractor for 10 months. IRS then reinitiated collection against the contractor and placed the contractor's case in a queue of collection cases awaiting assignment. The contractor remained in the queue for 19 months. During this 29-month period, DOD paid the contractor at least $110,000.

With the passage of the Debt Collection Improvement Act of 1996, Congress obligated DOD to levy their contractor payments to ensure that individuals and businesses who receive Federal payments and have failed to pay their just tax can have a portion of their payments forwarded to the IRS to satisfy their tax debt. The Federal Payment Levy Program, administered by the Financial Management Service, relies on computer matching of information provided by IRS and DOD. If the taxpayer identification information is incorrect or not provided, then, the Financial Management Service cannot match the DOD and IRS information. As a result, the IRS cannot effectively identify nonfilers, determine their full tax liability and levy contractors' payments to collect the taxes that are owed, and DOD will continue to fully pay tax scofflaws who are abusing the Federal tax system.

When we find fraud and abuse, we must fix it and stop it from occurring again. As we begin this hearing, I want to reiterate my commitment to finding solutions to the problems in government.

This morning, we will hear from representatives of the General Accounting Office on their recently completed investigation of DOD contractors who habitually abuse the Federal tax system. We will also hear from the Department of Defense, the IRS and the Financial Management Service concerning the actions that they have taken, or plan to take to ensure that DOD contractors pay the taxes that they owe.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you.

Thank you for your leadership in this effort. You have been the leader in this investigation, and we have been delighted to be supportive of it. But the credit belongs to you, and the leadership has been very strong, and I think every taxpayer in this country is in your debt because of it.

The men and women in our military are putting their lives on the line every day for our Nation. At the same time, the GAO is telling us that over 27,000 of the Department of Defense's contractors—that is about 10 percent of the Department's contractors—are dodging their tax bills and have outstanding tax debts to Uncle Sam totalling at least $3 billion—27,000 DOD contractors with $3 billions in unpaid taxes; I am not sure which figure is more shocking.

Tax dodging by any Federal contractor is unfair, not only to the honest taxpayers left to make up the difference but also to the honest companies that have to compete against the tax dodgers for government contracts. Tax dodging by contractors taking taxpayers' dollars to support our military is not only unfair; it is unpatriotic.

The General Accounting Office tells us that the vast majority of the 27,000 Department of Defense contractors with unpaid taxes, about 25,000 of them, have failed primarily to pay the payroll taxes which they have withheld and which they owe. That means these contractors have failed to send to the IRS sums that are withheld from employees' wages for Federal, State, Social Security, and Medicare taxes.

When the GAO took a closer look at 47 of these Department of Defense contractors, it found that all 47 had evidence of tax avoidance, and in some cases, they unearthed unseemly tales of individuals and companies dodging taxes for years and using the money meant for payroll taxes on luxuries for themselves instead: Expensive homes, cars, boats, and vacations. One contractor with $10 million in unpaid taxes had been paid $3.5 million in taxpayers' dollars in fiscal year 2002 alone to provide the custodial services at military bases. This contractor had already defaulted on an IRS installment agreement; yet, it is unclear whether one dime of the $3.5 million was withheld to pay down the contractor's tax debt.

Tax chiseling by Federal contractors is not a new story, and that is why Congress tackled this issue in 1996 and 1997 when they enacted the Taxpayer Relief Act, which, in part, authorized Federal agencies to withhold 15 percent of any Federal payment going to a person with an outstanding tax debt. The goal was to stop taxpayer dollars from being paid to a tax deadbeat unless 15 percent was withheld to reduce that person's tax debt.

The Taxpayer Relief Act sought to apply a commonsense principle to government operations to offset the taxpayer dollars sent to people who have not paid their tax bills by directing a percentage of the total to reduce their tax debt. But this commonsense principle is not easy to apply in a government that pays hundreds of thousands of contractors to work on even more contracts; in essence, it requires the Federal Government to set up financial payment systems that make sure that the left hand knows what the right hand is doing, to make sure, for example, that contract pay-

ments do not go to a contractor with an outstanding tax debt unless a portion is withheld to satisfy a part of that debt.

The first agency to begin implementation of that law was the Financial Management Service or FMS in the Treasury Department. That agency took until July 2000 to establish an automated tax levy program under a larger Treasury offset program, which handles offsets for a variety of reasons. Since then, FMS has sent about $76 million in tax levy money to the IRS. It took another 2 years, until December 2002, for the Department of Defense to follow suit. It set up its first automated tax levy program for its largest contractor payment system, MOCAS, which handles payments on the Department of Defense's major long-term contracts.

Fifteen other payment systems, however, have not yet been automated. And so, we have a joint effort involving the Department of Defense, FMS, and the IRS which have to work together to match the people who are delinquent with the people who are being made payments by the Department of Defense. It is a very straightforward piece of technology. It just depends on willpower to be implemented; a decision made to implement this. So many much more miraculous technological feats are being performed within seconds on our computers these days—take a look at Google—that there is no excuse conceivably for not making this match. It is just simply a default on the part of our agencies, as far as I am concerned, to do what technology now allows them to do and the technology which is now in place.

Senator Coleman, let me ask you if I could then put the balance of my statement in the record at this point.

Senator COLEMAN. Without objection.

Senator LEVIN. Thank you

[The prepared opening statement of Senator Levin follows:]

PREPARED OPENING STATEMENT OF SENATOR LEVIN

Men and women in our military are putting their lives on the line every day for our Nation. At the same time, GAO tells us that over 27,000 of DOD's contractors—more than 1 in 10—are dodging their tax bills and have outstanding tax debts to Uncle Sam totaling at least $3 billion. 27,000 DOD contractors with $3 billion in unpaid taxes. I'm not sure which figure is more shocking.

Tax dodging by any federal contractor is unfair—not only to the honest taxpayers left to make up the difference, but also to the honest companies that have to compete against the tax dodgers for government contracts. Tax dodging by contractors taking taxpayer dollars to support our military is not only unfair, it is unpatriotic and unacceptable.

GAO tells us the vast majority of the 27,000 DOD contractors with unpaid taxes, more than 25,600 of them, have failed primarily to pay payroll taxes. That means these contractors have failed to send to the IRS sums withheld from employees' wages for federal, state, Social Security, and Medicare taxes. When GAO took a closer look at 47 of these DOD contractors, GAO found that all 47 had evidence of tax avoidance and, in some cases, unearthed unseemly tales of individuals and companies dodging taxes for years and using the money meant for payroll taxes on luxuries for themselves instead—expensive homes, cars, boats, and vacations. One contractor with $10 million in unpaid taxes had been paid $3.5 million in taxpayer dollars in FY2002 alone to provide custodial services at military bases. This contractor had already defaulted on an IRS installment agreement, yet it is unclear whether a dime of the $3.5 million was withheld to pay down the contractor's tax debt.

Tax chiseling by federal contractors isn't a new story. It's an old one. And it's one that Congress has tackled in the past to recoup unpaid taxes and prevent new tax abuses. In 1997, Congress enacted the Taxpayer Relief Act which, in part, authorized federal agencies to withhold 15 percent of any federal payment going to a person with an outstanding tax debt. The goal was to stop taxpayer dollars from being

paid to a tax deadbeat, unless 15 percent was withheld off the top to reduce that person's tax debt.

The Taxpayer Relief Act sought to apply a common sense principle to government operations: To offset the taxpayer dollars sent to people who haven't paid their tax bills by directing a small percentage of the total to reduce their tax debt. But this common sense principle isn't easy to apply in a government that pays hundreds of thousands of contractors to work on even more contracts. In essence, it requires the federal government to set up financial payment systems that make sure the left hand knows what the right hand is doing—to make sure, for example, that contract payments don't go to a contractor with an outstanding tax debt unless a portion is first withheld to satisfy a part of that debt.

The first agency to tackle the problem was the Financial Management Service or FMS in the Treasury Department. That agency took until July 2000 to establish an automated tax levy program under a larger Treasury Offset Program, which handles offsets for a variety of reasons. Since then, FMS has sent about $76 million in tax levy money to the IRS, with about $60 million in FY2002 alone.

It took another two years—until December 2002—for DOD to follow suit. Working with FMS, DOD set up its first automated tax levy program for its largest contractor payment system, called MOCAS, which handles payments on DOD's major, long-term contracts. In FY2002, MOCAS payments totaled about $95 billion, all of which is now reviewed for tax levies before the money goes out the door. DOD is planning to but has not yet extended its automated tax levy program to 15 other payment systems which, together, make contract payments totaling another $85 billion each year.

As currently operated, the DOD tax levy program is a joint effort involving DOD, FMS and the IRS. It is a joint effort because, while FMS is authorized by law to review IRS data on unpaid taxes, DOD is not. So here's what happens. Each Monday morning, the Defense Financial and Accounting Service at DOD sends FMS an electronic file listing payments expected to be made to DOD contractors over the next few days. FMS immediately uses a computer match program to compare the names and taxpayer information numbers in the DOD payment data with data in IRS files listing persons with unpaid taxes. FMS compiles a list of the names that match and sends it to the IRS. The IRS then makes sure it has mailed a 30-day notice of intent to levy to each of the listed tax delinquent contractors. If the contractor does not respond within 30 days by paying up, protesting the tax debt, or offering to settle it, the IRS notifies FMS which, in turn, tells DOD to begin withholding the 15 percent from payments to the identified contractors. DOD does so and forwards any levied funds to FMS which, in turn forwards the fund to the IRS.

GAO estimates that, in light of the huge DOD contract dollars and tax dollars at stake, DOD's tax levy program ought to be collecting at least $100 million each year. But last year, the first year of the DOD tax levy program, DOD collected less than $1 million, or less than 1 percent of the projected total.

The GAO report spells out a number of reasons why. The good news is that many, if not all, of these problems can be fixed.

First, there is DOD. Right now, DOD is sending FMS payment data on only one day per week for only one of its payment systems. It needs to send more frequent payment data from all 16 payment systems. Another problem is that the payment data DOD sends to FMS is currently tainted with thousands of incorrect or missing taxpayer identification numbers, which makes it nearly impossible to match many DOD contractors to IRS lists of tax delinquents. DOD needs to set up new procedures to get valid taxpayer identification numbers (TINs) from its contractors and stop sending payments to contractors with invalid or missing TINs. Finally, when faced with having to make a payment to a contractor without a valid TIN, DOD has never set up the system required by law to withhold 28% of each payment to that contractor until a valid TIN is supplied. DOD needs to set up that backup withholding system.

Next is the IRS. One key problem here is that the IRS has caused DOD to miss imposing tax levies on numerous contract payments, because the IRS hadn't yet mailed the 30-day notice to the relevant contractors warning of an upcoming levy. The IRS needs to revamp its levy notice procedures to eliminate delays and missed levies. The IRS also needs to change tax collection policies that currently prevent DOD from using its tax levy program on many of its contractors. For example, the IRS needs to end its practice of waiting a year before approving use of the levy program for contractors waiting in an IRS queue for assignment to a revenue officer. I understand that the IRS is willing and may have already made this change. Another problem is the IRS' automatic bar on using tax levies on contractors who are negotiating to settle, reduce, or stretch out repayment of their tax debt or are in

bankruptcy or experiencing financial hardship, especially in the case of contractors with defaults on prior repayment agreements or a history of nonpayment of tax.

In essence, when it comes to contractors paid with federal taxpayer dollars, the IRS must become much less cautious in using the 15 percent tax levy authorized by law, and it must stop allowing tax delinquent DOD contractors to receive full payment in taxpayer dollars without having a dime directed toward the taxes they've dodged. The IRS also needs, for the first time, to assign full-time revenue officers to the tax levy programs aimed at federal contractors, so that these officers can develop expertise, improve the DOD and FMS programs, and cut down on the tax abuses committed by federal contractors.

Senator Coleman and I have been working on developing recommendations to strengthen the DOD tax levy program based upon the GAO report and discussions our staffs have held with the three agencies. DOD and the IRS have already indicated their willingness to make reforms, have made some concrete changes, and are considering additional improvements as well. Here are some of my thoughts about key improvements to strengthen use of tax levies for federal contractors.

Recommendations for DOD

(1) *16 Payment Systems.* DOD should meet its March 2005 deadline for automating tax levies in all 16 of its payment systems, thereby bringing $85 billion more payments under review each year in DOD's tax levy program.

(2) *More Frequent Payment Data.* DOD should send its contractor payment data to the Financial Management Service more than once week and as often as practical to increase IRS matches and identify more tax delinquent contractors.

(3) *TIN Consent.* DOD should require all registrants in the federal Central Contractor Registration (CCR) database to provide consent during the registration process for DOD to obtain IRS information to validate their taxpayer identification numbers (TINs), and DOD should work with the IRS to validate all TINs in the CCR.

(4) *TIN Requirement.* DOD should prevent contract payments to any contractor with an invalid or non-existent taxpayer identification number.

(5) *Backup Withholding.* In FY 2004, DOD should establish systems to require automatic backup withholding from payments to any contractor with an invalid TIN, as required by law, and notify CCR registrants that contract payments are subject to such withholding.

Recommendations for IRS

(1) *Using Tax Levies Sooner, Not Later.* The IRS should change its tax levy policies to use levies as a first resort, rather than a last resort, for tax delinquent federal contractors.

(2) *Dedicated Revenue Officers.* The IRS should assign full-time revenue officers to specialize in collecting unpaid taxes from levies on federal contractors, and work with DOD and FMS to improve the efficiency and effectiveness of their tax levy programs.

(3) *Levy Notices.* The IRS should revamp its procedures for issuing levy notices to federal contractors to eliminate delays, and consider such options as combining levy notices with delinquency notices and sending levy notices to tax delinquent CCR registrants with active contracts.

(4) *Queue Reform.* The IRS should eliminate the policy automatically barring initiation of a tax levy for one year on any federal contractor waiting in the IRS queue for assignment to a revenue officer, and instead initiate tax levies on federal contract payments as a routine matter.

(5) *Recidivist Tax Abusers.* The IRS should work with Congress to eliminate administrative and statutory barriers to initiating a tax levy on a federal contractor in negotiation to repay a tax debt, in bankruptcy, or undergoing financial hardship, if the contractor has defaulted on a prior IRS repayment agreement or has a history of repeated misconduct involving nonpayment of tax.

Recommendation for OMB

Study. OMB, working with DOD, FMS, IRS and others, should conduct a study on whether federal contractors with unpaid taxes should be barred under some or all circumstances from bidding on federal contracts, and whether federal contracting officers should be informed of contractors who have engaged in longstanding or egregious tax avoidance so they can assist in tax collection efforts.

DOD contracts represent nearly two-thirds of all federal contracts and, in FY2002, DOD contract payments totaled about $180 billion. The recipients of DOD contracts, whether individuals or businesses, are given an unique opportunity to support the men and women in our military. Most DOD contractors provide valuable goods or services to DOD, and do so while paying their taxes. Other DOD contractors, however, take payment in taxpayer dollars, while dodging paying their taxes to Uncle Sam. This tax dodging hurts honest taxpayers, honest businesses, and our country as a whole. Effective use of the DOD tax levy program is necessary to help keep the tax dodger's hand out of the taxpayer's wallet.

I commend Senator Coleman and Congresswoman Janice Schakowsky for their leadership on this important issue. I look forward to the testimony today.

Senator COLEMAN. Chairman Collins.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. Thank you very much, Mr. Chairman.

First of all, let me commend you for calling this hearing to shed light on what the General Accounting Office has uncovered regarding the failure of some of our Nation's defense contractors to pay their taxes. The crux of the GAO's findings that more than 27,000 defense contractors owe the Federal Government some $3 billion in taxes and that the Pentagon is not doing all that it can to collect this money is very disturbing and raises many questions about the Federal procurement system.

Federal procurement laws require contractors to demonstrate integrity in order to do business with the Federal Government. That obviously includes paying their taxes. That some of those who provide goods and services to our Nation's fighting men and women fall woefully short of these standards is of great concern to me.

At a time of high deficits, it is also very troubling that the Pentagon appears to have been negligent in reporting tax information and payment information that could have helped the IRS collect taxes owed but not paid. Under Federal law, the government may withhold part of a contractor's payment to offset for taxes the contractor owes the government. In order to accomplish this, however, agencies must report contract payment information to the Financial Management Service.

As we will hear today, the Pentagon has failed to use this tool in far too many cases. Adding to the problem, the Internal Revenue Service has sometimes failed to pursue those cases it did know about, according to the GAO. I am determined to learn why it has failed to do so, and I am interested to learn what steps the Defense Department and the IRS intend to take in order to ensure better performance in the future.

For businesses that are inexcusably delinquent in meeting their tax obligations, another important question arises. That is, why is the Department of Defense continuing to do business with these companies? The names of the contractors today are being withheld because their tax data were an integral part of GAO's research. Because we value taxpayer privacy so highly—and rightly so—we cannot know for certain the specific circumstances surrounding each contractor's failure to pay.

Nevertheless, the GAO has singled out 47 companies as especially egregious offenders, and the Pentagon should evaluate whether or not these companies should continue to do business with the Federal Government. The Pentagon should look at wheth-

er they meet the standards under Federal law to qualify as responsible bidders.

Mr. Chairman, simply put, the 27,000 defense contractors who owe approximately $3 billion in uncollected taxes need to be held accountable. The Pentagon needs to be held accountable. And the IRS needs to be held accountable.

I very much appreciate your holding this hearing this morning so that we can get to the bottom of this very disturbing problem. Thank you.

[The opening prepared statement of Senator Collins follows:]

PREPARED OPENING STATEMENT OF SENATOR COLLINS

Mr. Chairman, thank you for calling this hearing to shed light on what the General Accounting Office has uncovered regarding the failure of some of our Nation's defense contractors to pay their taxes and the Department of Defense's response.

The crux of GAO's findings—that over 27,000 DOD contractors owe the Federal Government some $3 billion in taxes, and that the Department may not be doing all that it can to collect this money—is very disturbing to me.

As Chairman of the Governmental Affairs Committee, which has jurisdiction over government procurement, I have made clear my belief that there should be high ethical standards for Federal contractors. That some of those who provide goods and services to our Nation's fighting men and women fall short of those standards is of great concern to me.

At a time of high deficits, it is also disturbing that the Pentagon appears to have been negligent in reporting payment data to the Treasury that could have helped the IRS collect taxes owed but not paid.

Under Federal law, the government may withhold part of a contractor's payment to offset for taxes the contractor owes the government. In order to accomplish this, however, agencies must report contract payment information to the Financial Management System. As we will hear today, the Pentagon has failed to use this tool in far too many cases. Adding to the problem, the Internal Revenue Service has sometimes failed to pursue those cases it did know about according to GAO. I am determined to learn why it failed to do so, and am very interested to learn what steps the Defense Department and the IRS intends to take to ensure better performance in the future.

For businesses that are inexcusably delinquent in paying their taxes, another question arises. Why is the Department of Defense, which is among the most sophisticated purchasers of goods and services of all Federal departments, continuing to do business with these companies?

The names of the contractors today are being withheld because their tax data were an integral part of GAO's research. Because we value taxpayer privacy so highly, and rightly so, we cannot know the exact circumstances surrounding each one's failure to pay. Still, GAO has singled out 47 companies as especially egregious offenders, and the Pentagon should evaluate whether or not these companies meet the standards under Federal law to continue as government contractors.

Mr. Chairman, simply put, the 27,000 defense contractors who owe approximately $3 billion in uncollected taxes need to be held accountable. I appreciate your holding this hearing and shining a light on this problem. Thank you.

Senator COLEMAN. Thank you very much, Senator Collins. Senator Lautenberg.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thanks very much, Mr. Chairman. I, too, want to commend you for holding this hearing.

This delinquency, in my view, is what I would describe as almost traitorous conduct. Much of these expenses, much of these charges are as a result of having our people exposed to danger fighting a war, and its relationship to that singles them out as particularly scandalous in their behavior. I am dumbfounded by GAO findings that the Department of Defense contractors owe the Treasury over $3 billion.

I am equally concerned that IRS officials have not fully worked out payment systems so their debtors can be quickly identified and their payments of unpaid taxes collected. One of the things that I had to note as I heard about IRS' inability to pursue these deadbeats; it reminds me of the fact that IRS was the subject of a review that said there are just too many employees there. So, while they have successfully reduced the number of people working at IRS, we have lots of evidence about IRS' inability to pursue delinquent tax accounts.

Although I believe that today's topic is both worthy and pressing, I register my disappointment that another similarly urgent issue involving DOD contracting transparency and oversight has yet to be discussed by either our Subcommittee here or the full Governmental Affairs Committee. Three times since May, I have written to the Committee requesting that we hold a hearing to investigate the controversial contracts awarded by the Pentagon for the reconstruction of the Iraqi oil industry. No luck so far.

The specific accounting problems and contracting ethics involved in these particular contracts are numerous and varied, too numerous to recite here. But they have been documented extensively by the press and by Members of the Congress, including this Senator. And just as an example, I want to call attention to three particular examples of potentially fraudulent accounting with respect to one company that is receiving billions of dollars in Pentagon contract assignments to rebuild Iraq. The company is Halliburton, including its subsidiary, KBR.

First, Halliburton was awarded a no-bid contract last March to extinguish oil fires, in the worst-case scenario that were ignited by Saddam and his crew during the battle. The initial contract was slated to be $50 million. Subsequently, although the worst-case scenario never materialized, this no-bid contract mutated into a $2.2 billion monstrosity over the course of 8 months, despite the protests of many Members of Congress.

Second, we began learning this fall that Halliburton was dramatically overcharging taxpayers for the services it was providing. In December, DOD auditors found that Halliburton charged the government more than $61 million, too much, to bring gasoline into Iraq. And third, we learned that Halliburton's employees were engaged in illegal business transactions by accepting kickbacks from Kuwaiti firms, amounting to $6 million.

I believe that we are not fulfilling our oversight responsibilities as legislators if we dismiss or neglect that kind of a business practice. So I am, therefore, pleased that we are going ahead with this but keeping in mind all the time that the system looks like it is out of control, and we ought to find a way to collect taxes due this country from earnings that were specifically directed by DOD.

Today's hearing is an important one, and I look forward to hearing from both GAO and the administration witnesses about how to hold accountable those DOD contractors who are undermining national security by avoiding paying their fair share of the taxes. But I believe it is equally imperative that we also investigate how DOD contracts are awarded and filled, especially in Iraq and especially when they are being given to a company like Halliburton that has

such a poor business track record but such close ties to the administration.

And I thank you, Mr. Chairman.

Senator COLEMAN. Thank you, Senator Lautenberg.

I would now like to welcome today's first panel to our hearing: Gregory Kutz, a Director with the Financial Management and Assurance Team at the General Accounting Office; Steve Sebastian, a Director with the Financial Management and Assurance Team at GAO; and finally, John Ryan, an Assistant Director with the Office of Special Investigations at GAO.

As I mentioned in my opening statement this morning, GAO is here to release the results of its investigation of the Department of Defense, whose contractors were abusing the Federal tax system by either failing to file tax returns or not paying their taxes. The purpose of the hearing is to identify the corrective actions that can be taken to ensure that the Department of Defense contractors pay the taxes they owe the Federal Government.

I appreciate your attendance at today's important hearing. Before we begin, pursuant to Rule 6, all witnesses who testify before this Subcommittee are required to be sworn. At this time, I would ask you all to please stand and raise your right hand.

[Witnesses sworn.]

Senator COLEMAN. Before we begin, Senator Levin has reminded me that much of the focus of this investigation was initiated at the behest of Congresswoman Schakowsky, who we intended to have testify before the Subcommittee. I believe there was a personal emergency that made that impossible. But I do want to make note of her diligence and her efforts in this regard and we are sorry that she cannot be with us today.

We will be using a timing system, and I think you gentlemen understand this system. About a minute before you should wrap up your remarks, a yellow light will come on. Please limit your remarks to no more than 10 minutes. I will ensure that your complete statement will be entered into the record.

Mr. Kutz, I believe you and Mr. Sebastian will be presenting the GAO statement this morning. Please proceed.

TESTIMONY OF GREGORY D. KUTZ,[1] DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GENERAL ACCOUNTING OFFICE

Mr. KUTZ. Mr. Chairman, Members of the Subcommittee and Chairman Collins, thank you for the opportunity to be here to discuss abuse and potential criminal activity by DOD contractors. The bottom line of our testimony is that DOD contractors are abusing the Federal tax system with little or no consequences. The end result, as you have mentioned, is that compliant American taxpayers must pay more.

Our testimony has two parts. First, I will discuss DOD contractors with unpaid Federal taxes, and second, my colleague, Mr. Sebastian, will discuss why little has been done to deal with abusive contractors.

[1] The combined prepared statement of Mr. Kutz, Mr. Sebastian, and Mr. Ryan appears in the Appendix on page 53.

First, as mentioned, we found that over 27,000 contractors had nearly $3 billion in unpaid Federal taxes. Over 25,000 of these contractors were businesses that owed primarily payroll taxes. These taxes include amounts withheld from an employee's wages for Federal income taxes, Social Security, and Medicare.

For all 47 contractors that we investigated, we found abusive or potentially criminal activity related to the Federal tax system. The 34 businesses had severely delinquent payroll taxes, owing up to 62 quarters or 15 years of taxes. However, rather than fulfill their role as trustees of this money and pay it to the IRS, these contractors diverted the money for their businesses or for personal gain.

The poster board shows several examples of potential diversion of payroll taxes for personal gain, including the owner of a contract with $10 million of unpaid taxes using corporate funds to buy a home in the Caribbean and a luxury boat; another owner taking $1 million from his company to buy a large home and a Mercedes. Other potential diversions were for homes, airplanes, and other luxury cars.

The typical diversion scheme funneled money to the owners and officers of the company through substantial salaries or loans that were never repaid. In addition to these more flagrant offenders, other contractors were in financial trouble and used the money to pay the utility bill or the rent rather than forward the money to the IRS. Regardless of the cause, willful failure to remit payroll taxes is a felony.

Other interesting cases include DOD awarding over $60 million in contracts to an individual with delinquent payroll taxes dating back to 1994; DOD paying a contractor to provide motivational speeches that has over $130,000 of unpaid taxes dating back to 1993; and a $400,000 contract award to a dentist who has substantial unpaid payroll and income taxes also dating back to 1993.

Many of these contractors were also involved in other crimes of integrity. What was the reward for these 47 abusive contractors? Over $200 million of DOD contracts. These contractors are small and mid-sized businesses that provide basic services such as building maintenance, construction and catering; thus, DOD could get these services from legitimate, taxpaying contractors.

Mr. Sebastian will now discuss why tax abusers can also be contractors and why there have been few consequences to date.

TESTIMONY OF STEVEN J. SEBASTIAN,[1] DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GENERAL ACCOUNTING OFFICE, AND JOHN J. RYAN,[1] ASSISTANT DIRECTOR, OFFICE OF SPECIAL INVESTIGATIONS, U.S. GENERL ACCOUNTING OFFICE

Mr. SEBASTIAN. Thank you, Mr. Kutz.

Mr. Chairman, Members of the Subcommittee and Chairman Collins, Federal law presently does not prohibit contractors with unpaid taxes from receiving government contracts. However, tools exist to facilitate the collection of taxes for contractors. In 1996, the Congress passed legislation to improve the government's debt col-

[1] The combined prepared statement of Mr. Kutz, Mr. Sebastian, and Mr. Ryan appears in the Appendix on page 53.

lection, and in 1997, granted IRS the authority to continuously levy up to 15 percent of Federal payments to collect outstanding taxes.

Critical to the levy program is the matching of DOD disbursing records with Treasury's centralized database of Federal debt, including tax debt. Thus, with no legal prohibition, the government is dependent on DOD and IRS to ensure contractors pay their fair share. However, as our work shows, both agencies have been deficient in this regard.

In the 6 years since Congress granted continuous levy authority, DOD has collected less than $700,000, and prior to December 2002, nothing had been collected for DOD contractors. Collections to date relate to DOD only recently providing information to Treasury for one payment system which had $86 billion in fiscal year 2002 disbursements. Contractors paid through this system owed $750 million in taxes. At present, DOD is not providing data to Treasury for other payment systems that disbursed $97 billion in fiscal year 2002.

The potential benefits of an effective levy cannot be overstated. In reviewing disbursements for five DOD payment systems, we estimate that DOD could have levied contractors' payments and collected at least $100 million in fiscal year 2003 alone.

As the Nation's tax collector, IRS plays a key role. As reflected on the poster board,[1] with $246 billion in unpaid taxes, only 8 percent of which is deemed collectible, efficient and effective means of collecting taxes is critical to IRS' mission. However, restrictive policies and procedures as well as control deficiencies at IRS hinder the levy program's collection potential.

Current IRS policies restrict which and at what stage in the collection process cases enter the levy program. For example, IRS excludes cases in the queue or holding tank from potential levy for at least 1 year. In one of our case studies involving a contractor that owed $270,000 in taxes, the account was placed in the queue, where it sat for 19 months with no attempts to collect the taxes. DOD paid this contractor over $110,000 in fiscal year 2002.

Processing delays also prevent cases from entering the levy program. When a taxpayer offers to settle its tax debt for pennies on the dollar, called an offer in compromise, IRS is required to suspend any efforts to levy payments. Our work shows that IRS continues to experience significant delays in processing such offers. These delays, in turn, reduce potential collections.

For example, in one case, a contractor with $400,000 in unpaid taxes proposed an offer in compromise. IRS took over a year before it finally rejected the offer and over 2 years to reject a second proposal. During this time, DOD paid the contractor over $200,000, $30,000 of which could have been collected.

Additionally, inaccurate records impede IRS' collection efforts. In one case, a contractor proposed to pay by installment. At that time, IRS entered a code in its system to block the account from levy. IRS formally rejected the proposal 1 year later but never reversed the code. The account was thus erroneously excluded from levy action for 2 years.

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[1] See Exhibit No. 2b. which appears in the Appendix on page 175.

Finally, IRS attempts to work with contractors to achieve voluntary compliance, delaying more aggressive enforcement actions like levies until later. This results, however, in some contractors continuing to receive payments while making no effort to pay their taxes. In one case, a business with DOD contracts that generated $4 million had unpaid taxes of over $10 million. As the contractor's tax debt mounted, IRS continued working with the business, taking no enforcement action.

During this time, as Mr. Kutz mentioned, the owner diverted funds for personal gain, shut the company down, and moved to the Caribbean, leaving the IRS with uncollectible taxes of over $10 million.

In conclusion, allowing contractors to do business with the government while not paying their taxes creates an unfair competitive advantage for them at the expense of the vast majority of DOD contractors that fulfill their tax obligations. DOD's failure to fully comply with debt collection mandates and IRS' continuing challenges in collecting unpaid taxes have contributed to this unacceptable situation. As a result, the government has missed opportunities to collect hundreds of millions of dollars in unpaid taxes.

We believe prompt implementation of the recommendations in our report, released today, will result in millions of dollars of immediate tax collections.

Mr. Chairman, this concludes our statement. We would be pleased to answer any questions you or the other Senators may have.

Senator COLEMAN. Thank you very much, Mr. Sebastian.

Mr. Kutz, you have indicated—you started your testimony by talking about abusive and criminal activities, failure to pay these taxes is a crime; is that correct?

Mr. KUTZ. Yes, that is correct.

Senator COLEMAN. And I believe it is a felony-level crime?

Mr. KUTZ. There is a felony-level for not remitting the taxes, and there is a misdemeanor for not properly segregating the taxes.

Senator COLEMAN. We have heard that in one of the 47 cases that you reviewed, the individual involved is now living in the Caribbean. But do you have a sense of whether these cases are still prosecutable?

Mr. KUTZ. Well, Mr. Ryan could probably answer that from a legal standpoint.

Senator COLEMAN. Or certainly the other cases also.

Mr. RYAN. I believe that the 47 cases that we looked at, we took 12, and we dug down and looked at those cases. We believe that those cases have some additional elements for prosecution, and we have referred those to the IRS for whatever action they deem necessary.

Senator COLEMAN. Very good, Mr. Ryan, and I will ask Commissioner Everson about those cases.

Now, you identified 47 cases among the 27,100 contractors you identified as owing taxes. Are there more examples of potential criminal abuse among the 27,100 beyond the 47? I take it these 47 are just a small sampling.

Mr. KUTZ. That would be a small selection. They were not a sample. We did use some data mining techniques to get to them, but

there are hundreds or potentially thousands of similar stories out there.

Senator COLEMAN. Would the data mining techniques be such that you were looking at perhaps the worst abusers among the 47?

Mr. KUTZ. Yes, and we were also looking for cases where the taxpayer had agreed to the assessment. In some cases, there is an unagreed-to assessment, but for all of the cases we looked at, the taxpayer had agreed that they owe the money.

Senator COLEMAN. I find the figure stunning in the report saying that DOD could have collected over $100 million in back taxes this past year if payments had been levied. Are you confident you have not overstated the collection potential of these cases?

Mr. KUTZ. Yes, in fact, I would say we probably understated it to be conservative. When we did a mechanical match of just what we had, we actually came up with a little over $300 million. But what we did was we assumed that certain cases would be collected in the normal course of business; some of these were not as delinquent as others. But we believe it is at least—that is why we said at least $100 million, to give an order of magnitude here.

Also, keep in mind, we only looked at 72 percent of the DOD database. And so, you are talking about another $50 billion or $60 billion of business that we did not look at. And then, with respect to the data quality, the taxpayer information, the only time we would get a match here would be is if the taxpayer identification numbers in IRS' database matched those in the DOD database. So in some cases, we probably have other situations where there was erroneous information where we did not get a match.

Senator COLEMAN. And the key here to get the match is the taxpayer identification number.

Mr. KUTZ. Correct.

Senator COLEMAN. If you have the match, you can follow up, and the IRS can follow up. If there is not a match, then, it is problematic. There is a provision in law that provides that if there is something wrong with the taxpayer information number that one can withhold up to 28 percent of the contract?

Mr. KUTZ. Backup withholding; that is correct.

Senator COLEMAN. So those provisions are in law. We do not need to change that.

Mr. KUTZ. Correct.

Senator COLEMAN. What can be done to increase the number of matches? Because that seems to be a critical element here.

Mr. KUTZ. Well, I think that there are several things. There is the contract registry, which is now a database that DOD manages that includes contractors from all over the government. The data in that database needs to be validated. That would be step one. And step two would be to make sure that data is interfaced with all of the government's payment systems, because the payment systems are the ones that are turned over to Treasury for the actual match.

And I would say just one other thing: There needs to be human capital involved in this, too. This is not simply a mechanical exercise. There are going to have to be people involved to make sure that once someone starts getting levied, they are going to figure out

a way to get a new taxpayer identification number or change it so that they do not get levied anymore.

Senator COLEMAN. The key, again, though, is to get the data flowing into the system. Am I correct in understanding that as we sit here today, less than half of DOD contractor data regarding taxpayer identification numbers is flowing into the system? I mean, one of their management systems, which is close to 50 percent, is flowing into the Financial Management Service.

Mr. KUTZ. That is correct; it is called the MOCAS system, which is for the large contract payments for multiyear weapons systems.

Senator COLEMAN. But over half as we sit here today is not flowing into this system.

Mr. KUTZ. Nearly $100 billion is not being—yes.

Senator COLEMAN. What I find so stunning here, reflecting on your testimony, Mr. Sebastian, is we have the greatest fighting force in the world. We have the most powerful, the most advanced, the most technologically savvy fighting force in the world, and thank God we do. We respect and we support and we hold up as a great example our great military capability.

And yet, as I am listening to your testimony that says we have record systems that do not work. We have got information not being compiled. And I am very perplexed by all of that. And again, when you provided your testimony about processing delays and inaccurate records, we are just talking about the 47 cases here; is that correct, that you looked at?

Mr. SEBASTIAN. The examples that I spoke of in my oral statement came out of the 47 cases.

Senator COLEMAN. So we have still got 27,053, at least, contractors who we have not even looked at the problems there.

Mr. SEBASTIAN. Yes, I would also point out that some of these issues are not new to us. In the course of conducting the annual audit of IRS' financial statements, we have identified issues such as inaccuracies in taxpayer records, delays in processing activities such as offers and installment agreements. So these are not new issues. We are not too surprised to see some of this in the 47 cases we looked at.

Senator COLEMAN. One of the keys here is to get the Federal Payment Levy Program moving right away; in other words, if you identify a problem, you levy; you start to levy up to 15 percent. And then, you can work it out. The IRS can work things out. But you have got to initiate that as a first step. My understanding, as I review the report, that in these instances, it appeared that the levy was not the first step, that perhaps it was a last resort. Is that a correct reading of the report?

Mr. SEBASTIAN. Yes, that is correct. When we speak of the first step, we need to be cognizant of the fact that the first step could only take place after such time as IRS has followed its own statutory requirements to provide appropriate notice to the taxpayer, and gives the taxpayer the opportunity to appeal the assessment or come into the office to try to make a workout arrangement, such as an offer or an installment agreement.

But short of that, the cases that we saw sitting in the holding tank or queue could have been subject to levy. Cases with the revenue officers could also have been subject to levy.

Senator COLEMAN. Are there specific legislative changes that you believe have to be enacted to make sure that this system is working and is more accountable?

Mr. SEBASTIAN. Well, I think the only issue that creates some problem would be that IRS is also legally required to suspend any levy actions if a contractor were to come to the IRS to offer some type of payment arrangement, such as an offer to compromise on the tax debt or to enter into an installment agreement. At that time, IRS would have to discontinue any levy action they began.

The intent there, ultimately, is that the taxpayer is trying to comply. The concern we have is that in the work we have done, not only on this job but in prior years, we have seen companies use this as a stall tactic: Enter into and then default on installment agreements on a number of occasions.

So one possible alternative legislative area that might be pursued would be to take a look at that provision and see if there is some leeway such that the IRS could continue to levy during such time as these workout arrangements are underway and perhaps use the levy as the collecting mechanism for an offer in compromise or an installment agreement.

Senator COLEMAN. But other than that, the system is there. Since 1996–97, we have got a system in place that provides for matching of taxpayer identification numbers, levy authority and an ability to be getting some payment back while you are involved in this process. The authority is there.

Mr. SEBASTIAN. Yes, short of the legal restrictions I noted, the delays or the lack of levy action on some of these accounts had been policy decisions up to this point.

Senator COLEMAN. And, of course, no one is forced to take a government contract. You enter into a voluntary arrangement. So I presume, as part of that process, you could require—for instance, is there any question about getting taxpayer identification numbers? I believe that they are required for service contracts but not for supply contracts; is that correct?

Mr. RYAN. That is correct, sir.

Senator COLEMAN. But we could certainly, as a condition of signing the contract, require people to provide taxpayer identification numbers in any kind of contract.

Mr. SEBASTIAN. That would be true, especially if we could get the contractor, when they fill out in the central registry, to provide the correct and accurate information that could be checked with the IRS records.

We have now gone to a system where all of the government contractors need to be registered in a central register. We need to expand possibly in that area so that all contractors can be checked, not just the DOD contractors but all contractors can be checked. It is important that we validate that information, because as Mr. Kutz says, we need to integrate that information into the pay systems. Because if the pay systems are going to provide the money to the contractors, it is a good means of identifying delinquent taxes.

Senator COLEMAN. Again, the systems are in place since 1997. I believe, Mr. Kutz, was it your testimony that prior to September 2002, nothing had been collected?

Mr. KUTZ. Mr. Sebastian said it, but that is correct. Prior to 2002, nothing had been done with DOD's contract systems.

Senator COLEMAN. Thank you. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman. Let me go to the notices, those levy notices. The IRS is required by law to send out a notice of levy, as I understand it, before it levies.

Mr. SEBASTIAN. That is correct.

Senator LEVIN. Could it, in its delinquency notice, notify the delinquent taxpayer that it will be subject to a levy on any contract payments, so that there does not have to be a second notice sent out?

Mr. SEBASTIAN. In fact, there are multiple notices that go to the taxpayers; depending on whether you are a business or an individual, up to four separate notices would be issued.

Senator LEVIN. Does the delinquency notice contain that statement, that your payment is going to be subject to a levy?

Mr. SEBASTIAN. I do not know if the first notice does. I know when we get to the second and third notices, there is a reference to a levy. And then, the notice of intent to levy is clearly——

Senator LEVIN. Is there any reason why there has to be a notice of intent to levy if the taxpayer has already been notified that a future payment is subject to a levy? Is there any reason why there has to be an additional, separate notice?

Mr. SEBASTIAN. Other than legal requirements——

Senator LEVIN. No, is there a legal requirement, is there something in the law that says that?

Mr. SEBASTIAN. Yes, the IRS is required to issue a notice of intent to levy and give the taxpayer an additional 30 days before the levy action occurs.

Senator LEVIN. Could we legally, do you believe, if you can give us advice on this, give the notice of an intent to levy in the delinquency notice, so we do not have to send out another notice?

Mr. SEBASTIAN. That would certainly be a policy option that the Congress could consider.

Senator LEVIN. Well, I think we ought to take a look, surely, at that one. I mean, it seems to me that is fair notice, if somebody is told you are delinquent, and if you dispute this, you can come in and talk to us. That seems to me to be sufficient notice of an intent to levy if, in a delinquency notice, the taxpayer is told, hey, if you do not come in and work this thing out, you are subject to a levy on your payments. It seems to me—and I do not want to start giving legal advice, because I never made much money as a lawyer—but in any event, I do think that we ought to at least check with our legal counsel on that in terms of any legislation. Because if we are the ones in our law that says there has to be a separate notice of intent, then, it seems to me we probably could avoid that additional third notice by putting it right in the delinquency notice.

If there is a proposal by the taxpayer to compromise, no matter how absurd the offer is, does that automatically stop a levy from occurring?

Mr. SEBASTIAN. No, if the IRS——

Senator LEVIN. So it has to be a reasonable offer in the law?

Mr. SEBASTIAN. If, on the surface, it appears to be fairly reasonable, and the IRS accepts it for processing, it is only at that point in time that you would suspend the levy action.

Senator LEVIN. All right. So, if the IRS determines it is an unreasonable offer, they can reject it?

Mr. SEBASTIAN. Yes, and they have the opportunity to reject at a later stage, once they have gone through the process of checking the financial records, the background of the individual.

Senator LEVIN. All right. So, it is basically up to the IRS as to whether or not it stops the levy from occurring, because they are the ones who decide there is a good faith offer.

Mr. SEBASTIAN. Yes.

Senator LEVIN. Well, that seems to me to be reasonable. I mean, providing an unreasonable offer or an offer that is rejected does not stop the levy from occurring.

Mr. SEBASTIAN. I believe the term they use is frivolous offer.

Senator LEVIN. That sounds reasonable at that point.

The IRS is going to tell us this morning, apparently, that the 2005 budget of the administration includes a proposal that will allow the IRS to deal quickly with frivolous settlement offers and requests for hearings. If that already exists, as you have just testified, what more needs to be done in that area?

Mr. SEBASTIAN. Well, it may go beyond just the point of an offer that appears frivolous on the surface. As you get in and actually begin to work with the taxpayer, requesting additional records to determine the validity, you may, at that point in time, find you are talking about a frivolous offer.

The same with respect to installment agreements——

Senator LEVIN. OK; stop there.

Mr. SEBASTIAN. Sure.

Senator LEVIN. Under current practice or law, can they not at that point then say we are stopping these discussions; it is now frivolous; the levy is going to continue? Can they not do that now?

Mr. SEBASTIAN. At the point in time that they have determined that the offer is frivolous, yes, they could.

Senator LEVIN. I am trying to figure out—I have not read the budget request, so I am not familiar with the exact language—but are you familiar with this request or proposal in the 2005 budget that will allow the IRS to deal more quickly with frivolous settlement offers? What more is needed that is not already in their power?

Mr. SEBASTIAN. Yes, I am familiar with the fact that it is in the proposal. I do not know to what extent it will effectively deal with the issue that we are talking about here.

Senator LEVIN. Or that it is necessary.

Mr. SEBASTIAN. Or that it is necessary with respect to reviewing frivolous offers.

Senator LEVIN. If you could give us a reaction to that proposal for the record,[1] that would be helpful.

Now, on this queue rule, apparently, a tax levy cannot be initiated for a year if one is waiting to be assigned to a revenue officer. Do I have that correctly?

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[1] See Exhibit No. 4 that appears in the Appendix on page 177.

Mr. SEBASTIAN. By IRS policy, that is correct. There is no legal requirement.

Senator LEVIN. Right; by IRS policy. I understand that policy has now been eliminated, by the way. Is that your understanding?

Mr. SEBASTIAN. Our understanding is that has occurred very recently.

Senator LEVIN. OK. Perhaps as a result of the initiative of this Subcommittee, or of your GAO report, apparently, fairly recently, there has been this step taken by the IRS. And whether there is a cause-effect or not is not the point. It is a good step forward, I gather, in your view.

Mr. SEBASTIAN. Yes.

Senator LEVIN. There is no longer that automatic withholding of a levy because you are waiting in line to see a revenue officer.

Mr. SEBASTIAN. Yes. Bear in mind, too, that the cases that are sitting in the queue are not being touched by anyone. But what is occurring is that the statutory period for the IRS to collect those taxes continues to run. IRS has, in general, 10 years from the time of the assessment to collect the taxes. After that point in time, the uncollected taxes come off the books.

Senator LEVIN. On the queue, if there is a taxpayer who says look, I want to settle this, I want to do partial payments, or there is a dispute, and I want to resolve the dispute, if that person cannot see a revenue officer to discuss the settlement, why, then, should there be a levy? I want to now go at it from the opposite side, I want to go at it from the taxpayer's perspective. If there is an honest effort to make the payments or an honest effort to resolve a dispute, if that person is unable to talk to the IRS, why should he or she be levied on?

Mr. SEBASTIAN. Well, I believe if the taxpayer is coming forward with an attempt to try and make a workout arrangement, they will be able to contact the IRS. They have phone lines, customer service representatives that would assist them.

Senator LEVIN. Well, then, what was the queue rule before it was eliminated?

Mr. SEBASTIAN. The case was not being worked by anyone, nor was the taxpayer coming forth and making any attempt to repay their tax debt.

Senator LEVIN. You are assuring us, however, that if there is an effort being made under new policy with no queue rule, and a good faith effort is being made by the taxpayer to work out a problem that the levy will not occur.

Mr. SEBASTIAN. I am fairly certain of that.

Senator LEVIN. OK. One last question, if I am not out of time, and that is were you surprised, Mr. Kutz, by the extent of the problem that you uncovered, by the 27,000 figure? Did that surprise you?

Mr. KUTZ. Not necessarily. Mr. Sebastian and I testified on this several years ago, looking at all of unpaid payroll taxes, and we saw significant evidence there that there were government contractors that were involved in this. So it is not that surprising to us that this has happened.

Senator LEVIN. Thank you. Thank you, Mr. Chairman.

Senator COLEMAN. Thank you. Chairman Collins.

Chairman COLLINS. Thank you, Mr. Chairman.

Mr. Ryan, back in 2001, you and I worked together on an important investigation where we examined the security of the transportation of missiles and ammunition—Mr. Kutz was involved also—to storage sites by the Department of Defense. As part of that investigation, we concluded that there were serious security lapses and vulnerabilities of missiles that were held at contractor facilities.

Today, you have identified contractors that not only abuse the Federal tax system but are also involved in other "crimes of integrity". I am concerned that in addition to the problem of tax-dodging that some of these companies may represent a security threat. If they are not paying their taxes, and you have found kinds of diversions and evidence of possible crimes, this raises serious questions in my mind.

I have two questions for you: First of all, did the 47 contractors whom you did in depth investigations of perform work on weapons systems or on military bases? And second, based on what you saw about the possible criminal activity and the lack of integrity of these contractors, do you think we are dealing also with a potential security risk in addition to tax evasion?

Mr. RYAN. Thank you, Senator. It was good working with you back then.

In this particular case, we did find that there were, in the 12 particular contractors that we jumped into, we tried to pull back all the layers. Some of the things or questionable actions, from the background work that we did, we found that there were, with these 12 contractors, product substitution problems, false statements to Federal agents, money laundering, submitting false statements to insurance companies, paying employees in cash to avoid payroll taxes, establishing shell companies to avoid the IRS getting hold of any government payments, the issuing of payroll checks to their employees where the accounts were closed.

All of these issues add up to, as you say, crimes, I call, of integrity, based on my experience. When we talk about the security of our military installations, we spend an awful lot of time talking about ensuring who it is that is coming into the facilities. Just short of the biometric system, we have to try to establish something. There has to be some kind of a risk analysis done.

We obviously do not want embarrassing situations at our military installations. We do not want government contractors coming in and conducting criminal activities on military installations and buildings. So I think it is absolutely necessary that we do something to ensure that the contractors that we are bringing into our installations and to our buildings, that security has to be put in place. There has to be backgrounds. There has to be determined what the minimum standard is, and then, based on the exposure of those type of contractors to the facility, that needs to rise. There needs to be a gradual increase.

Mr. KUTZ. Some of these contracts were also dealing with weapons programs, major weapons programs.

Chairman COLLINS. That is what concerns me. Is there any evidence that these bad actors, and they certainly appear to be bad actors, were referred by Federal contracting officials for possible

debarment or suspension? In other words, did you come across any indications that Federal procurement officials were taking a look at the question of whether these companies should even be doing business with the Federal Government in the first place?

Mr. KUTZ. There was no evidence of that. In fact, there is a concern that they do not really know who they are dealing with here. In one of the cases that the individual basically stole the money and went to the Caribbean, the business was turned over to a relative of that individual, and the Department, I think, still thought it was doing business with the person who was gone to the Caribbean. That is where the payments were being made to.

Chairman COLLINS. It is extraordinary to me that Federal contracting officials are not looking at tax delinquencies when they are making responsibility determinations, when they are determining whether or not a company is a responsible bidder. We are supposed to have safeguards in our procurement laws to ensure that the Federal Government is only doing business with companies that demonstrate ethics and a certain level of business integrity. And I am at a loss to see how that is the case with the contracts that you investigated.

But you have found no evidence that Federal procurement officials were even looking at this evidence?

Mr. KUTZ. No.

Mr. RYAN. No.

Chairman COLLINS. In the year 2000, the GAO testified in support of legislation that would have amended the Debt Collection Improvement Act to prohibit delinquent Federal debtors, including Federal taxpayers, from being eligible to contract with Federal agencies. Mr. Kutz, could you tell me if that is still GAO's position? Would you like to see legislation that would prohibit a company that has a serious tax delinquency from being eligible to do business with the Federal Government?

Mr. KUTZ. As we noted back in 2000, it is a valid policy consideration for the Congress to look at, and it is something that—there are some implementation issues, such as data reliability; how quickly you can actually get a response from the IRS as to whether someone has tax debt. For example, if it would take 2 or 3 weeks, you would slow down the procurement process. If you could get one-day turnaround, it might be something feasible.

So at that point in time, there were serious implementation issues related to automated systems that still exist today, to some extent. But from a policy perspective, that is something that could be very well considered, like it was back then.

Chairman COLLINS. It occurs to me that companies that are failing to remit their payroll taxes can enjoy lower labor costs. And ironically, that gives these scofflaws a competitive advantage in bidding on Federal contracts. If you are a company that remits your fair share of Social Security and Medicare taxes to the Federal Government as well as the employee's share, your costs are about 15 percent higher.

If you are a company that is not remitting these payroll taxes, you are able to show lower labor costs. Do you think that is an issue as well, Mr. Kutz?

Mr. KUTZ. Absolutely, and Mr. Ryan has a case that he can mention to you. But it gives you a 15.3 percent advantage on your wage base, and almost all the 47 that we looked at are wage-based-type companies providing services. So that is a substantial difference. Plus, many of these contractors were not paying their income taxes. So, on top of the payroll taxes, the income taxes give you a substantial advantage. And I think Mr. Ryan's case is quite interesting.

Chairman COLLINS. Mr. Ryan.

Mr. RYAN. Yes, Senator, I met a retired contractor who is not part of this job; I just met a retired contractor; we were talking. And he was explaining to me that several years ago, he bid on government contracts. He paid his employees; paid his payroll taxes; and was taking care of his State responsibilities. And what he was finding was that other contractors were coming in, fly-by-nights, getting government contracts, staying in existence for a short period of time, doing away with that company, changing the name.

In one case, he said that they had magnetic signs that they put on the truck. And when the contract was done, they would take it off and put another one on. And they were able to get away, because no one ever followed up. They got a new EIN, and they just kept bidding on government contracts.

Mr. KUTZ. In 1999, we found that individuals were doing this with dozens of companies. We had some individuals that were involved in 40 or more companies that would run another into the ground; start them up; run them into the ground. And so, this is something that is an issue out there.

Chairman COLLINS. Thank you very much. Thank you, Mr. Chairman.

Senator COLEMAN. Thank you. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman. I must say our friends at the witness table offered some pretty interesting testimony. Enough to kind of wonder what is happening with the review of a contractor's ability and who they are before these contracts are issued. It sounds like it is kind of a conspiratorial thing to find these systems that permit you to go ahead, get a contract and get out of town.

And I think one of the worst violations of all is to not remit the employee withholding. It is employee money that they are stealing. They are stealing from the government, but they are also stealing from those employees, who should have those amounts credited to their Social Security and so forth.

I noticed your report said what GAO recommends—and thank you for this excellent report. Now, it says embargoed. I assume that embargo is off now that it is in the record.

Mr. KUTZ. Right.

Senator LAUTENBERG. Now, it says GAO makes recommendations to DOD for complying with statutory guidance supporting IRS efforts in collecting unpaid taxes. It was recommended to the office of OMB to develop options for prohibiting Federal contract awards to businesses and individuals that abuse the Federal tax system. DOD and IRS partially agreed. OMB did not agree that we ought to be able to punish these contractors who have showed this kind

of an attitude about their obligations to the country and to their fellow citizens.

What happened, by the way, to the guy who built the Caribbean home? Is he living there peacefully, or did we find a better place for him to live? [Laughter.]

Mr. RYAN. Well, actually, he is still there, and, as a matter of fact, one of the agents who worked on this, Kenny Hill, actually sent him an email, and he got a reply back. We told him what we wanted, and after that, he decided not to email us back anymore.

Senator LAUTENBERG. Is he out of reach?

Mr. RYAN. In the Caribbean, he is, yes.

Senator LAUTENBERG. We need an extradition treaty with that country.

Mr. KUTZ. Senator, can I make one point on one of the things that you said? You talked about the employees and whether they are made whole. I just wanted to make the point: The way the system works is that the employees are made whole——

Senator LAUTENBERG. I figured that.

Mr. KUTZ [continuing]. For Social Security and withholding taxes. And the money comes from the general fund. So the taxpayers are paying for it.

Senator LAUTENBERG. But the fund is deprived of the receipt of those taxes.

Mr. KUTZ. Right, and when we reported on this years ago, it is tens of billions of dollars over time that the Social Security fund has had to be subsidized by the general fund. So it is a substantial amount of money over time.

Senator LAUTENBERG. Was there any evidence of a conspiratorial nature among some of these questionable contractors? Was there, perhaps, a connection how to deal with the government on these things, easy pickings, as they say?

Mr. RYAN. I think of the contractors that we looked at, Senator, we did not uncover anything that would show a conspiracy, necessarily, between the contractor, the contracting officer, or the government representative. In one of the cases that my colleagues mentioned, about the gentleman who went to the Caribbean, he did have substantial contracts. He was taking the money out the back door and improving his lifestyle.

At the same time, he was subcontracting his contract to family members, friends, or people who actually left the first company and went to the second one. And in response, he wanted a kickback. He wanted to get a substantial amount of money from these subcontractors to ensure that they would have the work. He wanted the money paid under the table and sent to offshore accounts.

Mr. KUTZ. In another case, what was happening is the company was paying the owner and the owner's wife's bills for them: The mortgage, credit card bills, and car payments. And so, this money was coming out of the company. The company was using it as a deduction, probably, and these people were not reporting it as income. And they were calling it a loan, but the money was never paid back. So there were other schemes.

And, as Mr. Ryan said earlier, a lot of the companies, there was evidence they were paying their employees wages in cash, which

means that you have unreported payroll taxes under the table, basically.

Senator LAUTENBERG. It sounds like these problems are initiated at the time of contract issue, and the notion that we cannot even withhold payments to them for work that they purportedly did allows that—this sounds a little bit like a sad comedy about our inability, giving out these billions of dollars worth of contracts, that we cannot withhold money you owe us.

Mr. Ryan, I want to ask you a question: I wonder if you could update us on the progress of a report that was requested by Members of Congress last April on the Defense Department contracts that were awarded to Halliburton over the past couple of years. What has happened with it, and can we expect it to be released for Congressional review?

Mr. RYAN. I have no knowledge of that work. It is not within my investigative responsibilities.

Mr. KUTZ. GAO does have work underway in that area, but none of us are involved in that work at this point.

Senator LAUTENBERG. I see.

I was curious about whether or not some of the auditors found that—first of all, you were able to uncover this information. Why was this information not covered routinely by IRS or even DOD? There was a question asked before about DOD collecting taxes. Does DOD have that responsibility, tax collection?

Mr. KUTZ. Under the Debt Collection Improvement Act, their responsibility is to refer their payment systems to the Treasury Department for offset purposes before they make the payment, and any items that are tagged, they are supposed to withhold and remit the money back to the Treasury Department. So they do have that responsibility.

Senator LAUTENBERG. So what is it? Have you found any obstructionism from the other members of government agencies that prevented the review of these cases?

Mr. KUTZ. I am not sure I understand the question.

Senator LAUTENBERG. Well, I mean, has there been any evidence that these investigations were stopped, blocked in any way, as a result of friends in government or anything?

Mr. KUTZ. No, there is no evidence of that. But there is evidence that these companies are doing significant business with other Federal agencies, like NASA, the Department of Energy, HHS, etc. So they are doing significant business with others.

Senator LAUTENBERG. Well, the reason I asked that question, forgive me, is the Army Corps of Engineers waived an auditor's demand for information data from Halliburton and shut off an audit review because DOD's own auditing agency found that Halliburton has both failed to conduct adequate subcontracting price evaluations and had also overcharged U.S. taxpayers $61 million. This was public information, for the importation of fuel to Iraq.

Subsequently, the Army Corps waived the auditors' demands for more information and data from Halliburton, effectively shut off the audit. Is that a familiar——

Mr. KUTZ. No.

Senator LAUTENBERG [continuing]. Case to any of you?

Mr. KUTZ. We are not familiar with that.

Mr. RYAN. No.

Senator LAUTENBERG. That is why I asked the question about whether or not there was any attempt by one part of a government agency to say look, this is not really that important, and let us forget about it.

Mr. KUTZ. But let me say something else, though: With the 47 case studies we had, these are potential felonies, as I mentioned in the opening statement, as we talked about earlier. There was no evidence that any of these 47 were being pursued for prosecution under those laws that applied on failure to withhold and pay payroll taxes.

Senator LAUTENBERG. That is pretty astounding information, that they rest in comfort at the expense of the taxpayers and the country.

Senator COLEMAN. Senator Lautenberg, I would note that your time has expired.

Senator LAUTENBERG. I am sorry. Thank you.

Senator COLEMAN. Senator Fitzgerald.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. Thank you, Mr. Chairman.

Mr. Chairman, if I could have unanimous consent to submit my opening statement for the record, I would appreciate that.

Senator COLEMAN. Without objection.

[The prepared opening statement of Senator Fitzgerald follows:]

PREPARED OPENING STATEMENT OF SENATOR FITZGERALD

Good morning. I want to join my colleagues in welcoming the distinguished witnesses who are present today.

I would like to thank Chairman Coleman for holding this important hearing on Department of Defense contractors who are not paying taxes owed to the Federal Government.

The spending at the Department of Defense accounts for nearly a fifth of the Federal Government's annual budget. According to the U.S. General Accounting Office, over $183 billion was disbursed to contractors of the Department of Defense through 16 different payment systems in fiscal year 2002. At the same time, 27,1000 Department of Defense contractors owed nearly $3 billion in unpaid taxes. And it's not just the large contractors who are evading taxes, it's also the small contractors like the dentist and the caterer. The lack of controls that allowed such payments to be made without first deducting delinquent axes is astounding.

The efforts of the Department of Defense to refer contractors to the Financial Management Service (FMS) at the Department of the Treasury as required by the Debt Collection Improvement Act of 1996 are obviously inadequate. Only one payment system out of 16 separate DOD payment systems is set up to refer payment information to FMS to offset contractor payments. And in numerous cases—4,900 cases—DOD contractors provided invalid taxpayer identification numbers, which were not validated before payment was made. For one of the Federal Government's largest agencies to make billions of dollars in payments and not verify taxpayer identification numbers when the resources are right there is beyond me. What is more appalling is the fat that some of these unpaid taxes are payroll taxes deducted from employees' paychecks, but never remitted to the government.

It is the obligation of all persons, businesses and organizations in the U.S. that earn non-exempt income to pay their Federal taxes, particularly if those taxes have been withheld from an employee's wages. When hardworking Americans comply with this requirement while others blatantly fail to do so, there is an injustice and a breakdown of the system. And when there is a failure to pay taxes, it is theft—from the Federal Government and from the hardworking taxpayers in America.

The Federal tax system is based on voluntary compliance and the IRS, though fearsome in its reputation, is essentially a very large, and not very efficient, collection agency. although the Treasury's Financial Management Service runs the Treasury Offset Program, which matches IRS tax debtors with Federal payees to identify

payments that can be levied, much more needs to be done—by both the Department of Defense and Treasury.

I look forward to hearing from our witnesses from GAO today regarding their review of Department of Defense contractors' compliance with tax laws, including the scope of their investigation, their findings, and their recommendations on tightening the system. Additionally, I look forward to hearing from our witnesses from the Internal Revenue Service, Financial Management Service and the Department of Defense about their operations, the Treasury Offset Program and the referral of the DOD payment systems to Treasury.

As Members of Congress, we fail to act as stewards of taxpayer money if we allow these contractors to dodge taxes with impunity.

Again, I thank the witnesses for appearing today, and I look forward to hearing their testimony. Thank you, Mr. Chairman.

Senator FITZGERALD. And thank you, gentlemen, for being with us today.

I imagine this is far more pervasive than just the problem with the Defense Department. And I think you did a report back in April 2000 talking about how the same sort of thing is happening with government contracts from all agencies of the Federal Government.

Are we talking, in general, about contracts that are so small they are not subject to our competitive bidding or our procurement law?

Mr. KUTZ. No, they are not that small generally.

Senator FITZGERALD. They are ones that may have been competitively bid?

Mr. KUTZ. Right; most of those smaller ones would be used—the purchase card would actually be used to procure those. These were not purchase card disbursements. These were competitively-bid contracts generally.

Senator FITZGERALD. OK, competitively-bid contracts. We have a huge procurement code that walks through what you have to do for a competitive bid process, but it seems to me we are really not checking to see that those who are bidding are even true companies. You talk about fly-by-night companies that somebody maybe just opened up a week before they go in to get this government contract, and all of a sudden, they are in business. Then, when they get their payment, they take the magnetic sign off their van, and they are in some other business.

This is really pretty astonishing, the lack of controls over who is qualifying for these government contracts. Is that not an area, a fundamental threshold area, that we need to address?

Mr. KUTZ. We did not look at that systematically, but there was very little evidence that the Department's contracting officers and contract community really knew who they were dealing with, as you mentioned. Again, we would have to look at that more systematically, but there are supposed to be processes and controls in place to make sure these contractors are reputable before we do business with them, but for these 47 cases, they were not there, and they were not working.

Senator FITZGERALD. They were not there, and you saw ones who really were not legitimate businesses, is basically what you are saying.

Mr. KUTZ. Well, they were not paying their taxes in all 47 cases, and, as Mr. Ryan said, many of them were involved in these other crimes: Embezzlement, money laundering, forgery, grand theft, etc.

So there were some serious background issues with many of these contractors.

Senator FITZGERALD. So it looks like there had been no investigation, no background check at all on the part of the DOD before they did business with these entities.

Mr. KUTZ. If there was, it would have not picked—it did not pick these things up, or no one did anything about it. So again, we did not look at that process, but we saw no evidence that anyone had raised any questions.

Senator FITZGERALD. Well, it would seem to me that if we required them to do a criminal background check, required them to check to make sure their taxes were paid, required them to have been in business for a certain period of time and have a corporation in good standing—although I suppose some of these—are unincorporated sole proprietorships——

Mr. KUTZ. Correct, some of them were.

Senator FITZGERALD. But we could put some requirements in the law before they could even enter into a contract with the company, could we not?

Mr. KUTZ. Yes, we could. And I think there are some policies in place from a governmentwide perspective, but again, we did not see that they were necessarily working. I mean, these contractors could have been debarred if someone had been aware of what they were doing. So for some reason, they were not aware what they were doing, or they were aware, and they did nothing about it.

Senator FITZGERALD. There is no requirement that DOD do a criminal background check on a prospective contractor. Is that correct?

Mr. RYAN. I do not know, Senator.

Senator FITZGERALD. Is there a requirement that they check to make sure they do not have delinquent taxes?

Mr. KUTZ. No, not that I am aware of.

Mr. RYAN. No.

Senator FITZGERALD. No. Well, we could put those into the law before they could enter into a contract with companies. And it seems to me that some of these companies may be winning the competitive bidding, as a couple of the other Senators said, because they are not paying their employees' payroll taxes. They are paying their employees, perhaps, under the table and so forth. They have less overhead expense than a legitimate company that plays by the rules and funds its payroll taxes.

Were any of these 47 cases referred to prosecutors?

Mr. RYAN. We referred them back to the agency, for the agency to decide what they want to do with them. I think we developed enough evidence to indicate that the case should be reopened. I think you will have to ask the next panel as to what they decide to do with that information. We have made our full investigative files available to the agents of the IRS, and we will be glad to share the information with them and also continue to work with them.

Mr. KUTZ. We referred all 47, basically, for collection follow-up and several that Agent Ryan is talking about for criminal review.

Senator FITZGERALD. I would think some high-profile prosecutions by U.S. Attorneys around the country of these bad actors

would send a message out that might chill further criminal activity.

Well, I appreciate your being here. You do agree that this is not just a DOD problem. This is no doubt going on with perhaps all our other agencies of government.

Mr. KUTZ. It would appear so. Just these contractors alone, the 47, had a lot of business with other government agencies.

Senator FITZGERALD. So this is probably a governmentwide problem, and we are probably losing billions and billions of dollars in waste, and we are missing an easy opportunity to collect back taxes for the IRS.

Mr. KUTZ. I will note that for non-DOD agencies, the actual contractor offset of taxes has only yielded about $6 million in 2003. For DOD, it was under $1 million. So even though DOD is two-thirds of the government's contracting, and the others are a third, the other program has not been much more successful than the DOD. So something is wrong with the entire levy program for payments to contractors—$7 million a year in collections. There is something very wrong with that.

Senator FITZGERALD. Something is wrong.

Well, Mr. Chairman, thank you very much, and gentlemen, thank you for your time.

Senator COLEMAN. Thank you, Senator Fitzgerald. Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I really appreciate your conducting today's hearing and for your leadership, Mr. Chairman, in shedding light on tax evasion by DOD contractors.

Mr. Chairman, I have a statement that I would like to have placed in the record at this point.

Senator COLEMAN. Without objection.

[The prepared statement of Senator Akaka follows:]

PREPARED OPENING STATEMENT OF SENATOR AKAKA

Thank you Mr. Chairman. I appreciate your conducting today's hearing and for your leadership in shedding light on tax evasion by DoD contractors.

At a time when this country faces an unprecedented projected budget deficit of $480 billion, this year, it is wrong that 27,000 contractors owe the government $3 billion in unpaid taxes.

Americans incur a high cost as a result of the failure of government contractors to pay their taxes. The General Accounting Office report, which is the focus of today's hearing, found that well over half of the cases of abuse involved a failure to submit payroll taxes. This has resulted in a $1.2 billion funding shortfall to the U.S. Treasury, Medicare, Social Security, and federally funded State programs.

As the Ranking Member of the Governmental Affairs Financial Management Subcommittee and the Armed Services Readiness Subcommittee, I believe GAO's findings raise serious concerns at a time when my constituents are calling for investigations into overcharges for Iraqi contracts and the debarment of those contractors who are guilty of misconduct.

By law, government contractors must comply with ethical standards of conduct. Yet when contractors do break the law, they often continue to receive government contracts. A 2002 Project on Government Oversight report found that 16 of the top 43 federal contractors had been convicted of criminal violations. Only one had been suspended from receiving federal contracts.

Surprisingly, federal law does not prevent contractors with unpaid taxes from receiving contracts. The rate of tax payment delinquency among federal contractors is almost double the rate among the general public. I am disappointed that the Ad-

ministration chose to weaken ethical standards in the Federal Acquisition Regulation for contractors eligible to receive federal contracts.

GAO's findings also go to the heart of existing management challenges at DoD, which for the past 12 years have been on GAO's High Risk list. Without addressing systemic problems in DoD's financial systems, we will continue to see such abuses.

Shortcomings in DoD financial management systems are a decades-old problem. While these challenges are not exciting or easily understood, correcting them is vitally important. As we can see from the GAO report, billions of dollars are at stake. DoD's inability and unwillingness to track accurately tax levies has an impact on a variety of DoD functions and operations.

I want to know why aren't DoD and IRS working together to share relevant information and aggressively pursuing tax evading contractors?

Prior to today's hearing, DoD claimed that enabling all 20 of its pay systems to report payment information to the Treasury Offset Program (TOP) database, where it can be screened for discrepancies, presented too much of a hardship. This is unacceptable. Federal agencies are required to share this information under the Debt Collection Improvement Act of 1996.

Mr. Chairman thank you again for holding this hearing. I look forward to learning from all of our witnesses on how we can prevent these abuses in the future.

Senator AKAKA. From what I have learned, I am completely shocked at what is happening in our country, especially when we think about how much tax revenue is not being collected. At a time our country faces an unprecedented projected budget deficit of $480 billion this year, 27,000 contractors owe the government $3 billion in unpaid taxes.

As the Ranking Member of Governmental Affairs' Financial Management, the Budget, and the International Security Subcommittee and the Armed Service's Readiness and Management Support Subcommittee, and from working with Senator Fitzgerald, I believe GAO's findings raise serious concerns, especially when my constituents in Hawaii are calling for investigations into overcharges for Iraqi contracts and debarment of those contractors who are guilty of misconduct.

And hearing from the Federal side here, I also wonder about what is happening to State taxes from these contractors.

Mr. KUTZ. We can assure you that just about all 47 of them were deadbeat State taxpayers, too. We saw that in just about every case, pretty much. When you saw Federal, it was State. So all the States are affected by this, also.

Senator AKAKA. So it is a huge problem that we are facing, and I am astonished that Federal law does not prevent contractors with unpaid taxes from receiving contracts. The rate of tax payment delinquency among Federal contractors is almost double the rate among the general public. I am disappointed that the administration chose to weaken ethical standards in the Federal Acquisition Regulations for contractors eligible to receive Federal contracts.

And I have two questions, one difference that I cannot understand is that in his written statement, Deputy Under Secretary Lanzillotta states that DOD has collected $2.1 million through the levy program, your report states that DOD has only collected $332,000 through the levy program. Can you clarify the discrepancy in these numbers?

Mr. SEBASTIAN. I have a possible explanation for you. The less than $700,000 that we are referring to has to do with the 15 percent continuous levy authority. In the case of the other roughly $1.3 million that may be referred to in the Under Secretary's statement, that may be a direct one-time levy against that particular

contractor's payments, meaning it is not systematic. The IRS and DOD working in tandem would have made the levy against that particular payment, and it may not have been capped at 15 percent. But it was a one-time levy. And there may have been a few situations like that that created the additional $1.3 or $1.4 million.

Mr. KUTZ. Right. The continuous levy would mean if 20 payments were made to a contractor in a year, you would take 15 percent of each and every payment versus a one-time hit outside of this program.

Senator AKAKA. In your written statement, you stated that improving DOD's ability to aid the IRS in its levy program may require legislative changes from Congress, and after hearing the comments that are made and responses and the questions here, this question becomes very important to us. Could you elaborate on what kind of legislation you think is necessary to deal with the kinds of problems we are facing?

Mr. KUTZ. There are several that have come up here. The first one is the bar, the legislative bar, as you mentioned in your statement a couple of minutes ago of not letting contractors do business with the government that have significant or severe unpaid tax problems. And that was a bill that was produced in the House, I guess, in 1999 and 2000. And it got through the Government Reform Committee, and then, it stalled at that point in time. So, certainly, the most severe type of legislative action would be the bar. And again, there are some implementation issues with that, but conceptually, that is a policy alternative.

One other thing is sharing of information between DOD and IRS to validate the contractor information. There is some restriction. Now, this contractor database includes not only DOD contractors but other agency contractors. Right now, due to the disclosure rules, they are not able to share all of that information for validation purposes with the Internal Revenue Service to make sure we validate everyone in the contract system.

And then, Mr. Sebastian spoke earlier about possibly some legislation in the levy area.

Mr. SEBASTIAN. Right. Such as taking a look at some of the restrictions in place with regard to a contractor that comes to the IRS in an attempt to make a payment arrangement through an offer or installment agreement; currently, the levy process would suspend over the period of time in which IRS is evaluating that proposal. And if the proposal is accepted, the contractor would be paying under those arrangements.

One legislative change you could have, would be to ensure that the levy continues and may actually become a collecting mechanism for an agreed-to installment agreement or an offer in compromise. So you are guaranteed a stream of payments in the event you are dealing with a contractor who went into the arrangement knowing full-well they intended to default on the agreement.

Senator AKAKA. Mr. Chairman, it is obvious that this is a much larger problem than just in DOD, and we need to expand what we are doing to all Federal contractors and try to correct this for the benefit of our taxpayers.

Thank you very much, Mr. Chairman.

Senator COLEMAN. Thank you, Senator Akaka, and I assure you that we will continue down this path. Clearly, we have a rat's nest here, and my sense is that at least we have got folks in the system that a lot of good could happen, as it impacts not just DOD but other agencies; as it impacts local governments that depend on tax receipts; it may cut off other criminal activity. But the system has got to grab somebody, and obviously, that is not being done.

Gentlemen, I want to thank you for your testimony. Your report was exemplary; your testimony compelling. The record will be held open for another 2 weeks if my colleagues have other questions for you, but I want to thank you for your testimony today.

Mr. SEBASTIAN. Thank you.

Senator COLEMAN. I would now like to welcome our final panel of witnesses for this morning's hearing.

We have a vote posted. I believe we have 12 minutes. I will begin the hearing, and hopefully, one of my colleagues will return and continue. If that does not happen, we will simply recess for a very short period.

Our final panel, the Hon. Mark Everson, Commissioner of the Internal Revenue Service; Richard Gregg, the Commissioner of the Treasury Department's Financial Management Service; and finally, from the Department of Defense, Lawrence J. Lanzillotta, the Principal Deputy Under Secretary of Defense for the Comptroller.

Mr. Everson, it is good to see you again. As you remember, in November, you testified before this Subcommittee regarding the IRS' response to abusive tax shelters that robbed the U.S. taxpayers of an estimated $85 billion over 6 years, according to GAO's study of abusive tax shelters. In that regard, I want to acknowledge and applaud the IRS' recent legislative proposals to curb abusive tax shelters, which would raise penalties to promoters and taxpayers alike. And I would also note before your testimony, and I know you have to testify other places, but I did note this morning, I appreciated the opportunity we had to visit yesterday and your commitment to followup and root out some of the abuses and particularly the cases that have come before us. I wanted to thank you for that.

Mr. EVERSON. Thank you.

Senator COLEMAN. Mr. Lanzillotta, I also want to welcome you back and look forward to hearing how you propose to levy your contractor payments where it is warranted. I thank all of you for your attendance this afternoon, and I look forward to hearing your reaction to the recent GAO examination of DOD contractors who are abusing the Federal tax system. And I am particularly interested in learning what corrective actions you would propose to ensure that DOD contractors pay the taxes that they owe the Federal Government.

Before we begin, pursuant to Rule 6, all witnesses before this Subcommittee are required to be sworn. I would ask you to please stand and raise your right hand.

[Witnesses sworn.]

Senator COLEMAN. Thank you, gentlemen.

We will be using a timing system. You are aware of this system: One minute before the red light comes on, you will see the lights go from green to yellow. If you can, then, limit your testimony to

that period of time. Your written statement will be entered in its completeness in the record.

Commissioner Everson, we will have you go first, followed by Commissioner Gregg and finally Mr. Lanzillotta. After we have heard all of the testimony, we will turn to questions.

Commissioner Everson, you may proceed.

TESTIMONY OF HON. MARK EVERSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY

Mr. EVERSON. Mr. Chairman, Senator Fitzgerald, thank you for inviting me here today. I am particularly pleased to be here on February 12, President Lincoln's birthday. After all, he signed into law the first income tax and appointed the first Commissioner of Internal Revenue, and despite that fact, he remains one of our most popular and revered Presidents. [Laughter.]

I welcome the opportunity to testify on the General Accounting Office's study of the need for strengthened government procedures and assuring that the Department of Defense contractors meet their Federal tax obligations. I want to say at the outset that we at the IRS agree with the major conclusions of the GAO study and believe that many improvements can be made to our own efforts in this area. A number of positive steps are already underway.

Before turning to this subject, I want to say a few things about our goals at the IRS and tax collection in general. I have set three priorities for the IRS during my 5-year term as Commissioner. First, we must continue to improve service, making it easier for the taxpayer to understand and comply with the tax laws. Through focused implementation of the IRS Restructuring and Reform Act of 1998, the IRS has measurably improved service to taxpayers and practitioners. We are not backing away from this commitment to improve service.

The second area of emphasis is information technology modernization. We have made a great deal of progress in increasing e-filing and providing information to taxpayers and practitioners online and other important gains in technology. But we have struggled to update our master files and improve our financial and other infrastructure systems. We are addressing these challenges on an ongoing basis and must modernize.

The third area of focus, a core element of which is the subject of your hearing today—collections—is to strengthen the integrity of the Nation's tax system through enhanced enforcement activities. I know you are familiar with our enforcement efforts, and I remain appreciative of the Subcommittee's leadership in this area, including holding a hearing last fall on abusive tax shelters and their promotion by professional services firms.

I strongly support your call for more stringent penalties for promoters who violate the law and very much appreciate the fact that you have called for augmenting resources at the IRS. As you know, the President recently transmitted the 2005 budget request to Congress. It calls for a 5 percent overall increase for the IRS, including a 10 percent boost to our enforcement activities. The President's

[1] The prepared statement of Mr. Everson appears in the Appendix on page 82.

budget addresses a number of areas about which the Subcommittee has concerns, including enhanced collections, combatting abusive tax shelters and confronting tax abuses within the tax-exempt sector. I hope I can count on your active support for this request.

Turning to today's subject, let me reiterate what I said a moment ago: We largely agree with the GAO report. The GAO has made thoughtful observations about why the IRS has not levied taxes from many defense contractors. The GAO observed that the IRS had, "a collection philosophy of continuing to work with businesses and individuals to achieve voluntary compliance rather than taking reliable enforcement actions such as levies of Federal contractor payments."

I agree with this assessment, which I believe reflects an overhang from the 1998 Reform Act. The GAO has also said that, "due to resource constraints, the IRS has established policies that either exclude or delay referral of a significant number of cases to the levy program." I largely, but do not entirely, agree with this view. I believe we are making progress on both of these concerns. We are giving greater emphasis to enforcement, which will address some of the reticence our employees have had to use the levy tool. And, as I just noted, we are seeking more resources to boost our activities for enforcement.

This having been said, a central conflict remains between two competing public policy goals: Taxpayer rights, on the one hand, and the expectation that those who do business with the government have a clean bill of financial health, on the other. The Taxpayer Relief Act of 1997 expanded the collection authority of the government by allowing the IRS to continuously levy up to 15 percent of payments to contractors. But the IRS Restructuring and Reform Act of 1998 established new procedures which limited the prompt collection of monies due in order to protect taxpayer rights.

In addition, I would note that certain privacy protections significantly limit the IRS' ability to share taxpayer information with other agencies for collection purposes. The chart over here shows the effects of these competing priorities. As GAO has noted, in 2002, there were about a quarter of a trillion dollars of monies owed to the government. This is all money owed to the government. And as GAO also said, it stays on the books of the government for 10 years.

The pie wedges show that statutory and operational exclusions limit the amount that is available for the levy program. As examples, the statutory exclusions include the right of a taxpayer to appeal an IRS decision, which can delay the collection process for months or even years and prevents a matter from being considered for levy. This is also the case, for example, if there is already an installment agreement in place between the IRS and the taxpayer.

As for operational, or as the GAO called it, policy exclusions, the IRS has excluded from the levy portfolio certain other categories of debt: Cases involving financial hardship to the taxpayer, where the taxpayer has died, and where the taxpayer is living in a designated disaster area, to mention a few.

Responding to the GAO report and to the interests of the Subcommittee, we have already taken steps to reduce operational exclusions. Again, this is based on the 2002 audited data. As you can

see on the chart, we are making available an additional $26 billion for potential levy through adjustment of certain exclusion criteria.

These steps will take effect over the next few months, as we update the programming of our systems. We are also creating a joint task force with Treasury, Defense, and OMB to examine the contractor collection issue. By June of this year, the task force will make recommendations on short-term operational improvements, mid- and long-term operational changes and potential statutory proposals that could improve the collection of taxes from Federal contractors. The statutory limits on tax debt collection merit a public discussion about the conflict between the need for taxpayer rights versus the need to make sure that government vendors have a clean bill of financial health.

Defense contractors do not have to do business with the government. It can be argued that contractors should be held to a higher standard.

Again, I want to thank the GAO and the Subcommittee for focusing on the issue of collections from delinquent defense contractors. I am happy to take any questions.

Senator COLEMAN. Thank you, Mr. Everson. If there is anything else in your full statement, we will make sure that it is entered into the record.

Commissioner Gregg, I think what we might do here, as I am told the time is winding down on the time to vote, is I am going to recess this hearing very briefly. Senator Levin should be on his way back. But let me recess, hopefully, for not more than 10 minutes, and then, we will return with your testimony.

[Recess.]

Senator LEVIN [presiding]. The Subcommittee will be back in order, and we will call upon you, Mr. Gregg. The Chairman would like us to proceed, so please do so.

TESTIMONY OF RICHARD L. GREGG,[1] COMMISSIONER, FINANCIAL MANAGEMENT SERVICE, U.S. DEPARTMENT OF THE TREASURY

Mr. GREGG. Thank you, Senator.

Thank you for inviting me today to discuss the role of the Financial Management Service in collecting unpaid Federal taxes that are owed by DOD contractors. Treasury appreciates your focusing attention on government financial management issues.

FMS is a Treasury bureau charged with broad financial management responsibilities, including disbursing payments, collecting revenue and maintaining the government's accounts. And I welcome the opportunity today to acquaint the Subcommittee with FMS' fourth business line, which is the collection of delinquent debts owed to the government, both non-tax and tax.

The Debt Collection Improvement Act of 1996 is the principal law under which FMS collects non-tax debts owed to Federal agencies. Our collections are accomplished through two programs: The Treasury Offset Program, TOP, and cross-servicing. I will just focus on TOP today.

[1] The prepared statementof Mr. Gregg with an attachment appears in the Appendix on page 92.

TOP is our largest collection program and is directly linked to payment disbursements. Through TOP, FMS reduces the amount of individuals' or businesses' Federal payments disbursed by Treasury and other agencies to satisfy delinquent debts. Types of payments include benefit payments paid on behalf of the Social Security Administration, Office of Personnel Management retirement payments, Federal income tax refund payments and payments to businesses, vendor payments, for goods and services provided to the Federal Government.

A reduction or offset occurs if the name and taxpayer identifying number of a debtor included in the TOP database is matched against the name and the taxpayer identifying number of a Federal payment recipient. The TOP debtor information is supplied by the agencies to which the debts are owed.

The recent GAO report notes that FMS also has a key role in the collection of Federal tax debts. In partnership with FMS, the IRS collects unpaid Federal income taxes through the continuous levy of certain Federal payments disbursed by FMS. Vendor, Federal employee salary, OPM retirement, and Social Security benefit payments are among those that are levied continuously at a rate of up to 15 percent until a debt is satisfied. This is accomplished through an automated process using the TOP system. If there is a match between the IRS tax debts and FMS payment records, IRS initiates a process by which the debtor is given a minimum of 30 days to make payment arrangements, appeal the proposed levy action, or apply for a hardship determination. The levy of a payment occurs only after IRS completes its due process notification and directs FMS to levy future payments. The Continuous Levy Program was authorized under the Taxpayer Relief Act of 1997.

I spoke earlier of the link between TOP and payment disbursements. While Treasury is the primary disburser, with 85 percent of the government's disbursements, nearly 1 billion payments a year, other agencies, including DOD and the U.S. Postal Service, have payment disbursement authority as well. These agencies, which disburse payments such as salary and vendor, began matching their payments against FMS' TOP debtor database in 2002.

Individuals or businesses receiving these non-Treasury disbursed payments may also have their payments levied if they owe tax debts and would be afforded the same due process as those receiving a Treasury disbursed payment. Routinely, we work with our partner agencies on debt collection issues by providing information and making recommendations for enhanced collections. As an example, we have been working with DOD and IRS for some time on ways that are tailored to their specific needs to improve collections. In the case of DOD, the existing program is designed in such a way that their contractors may either have their payments offset, if they owe non-tax debts, or levied if they owe tax debts.

At present, payments disbursed through two of DOD's contract pay systems are being matched against the TOP data for both offset and levy purposes. I have been advised that in the coming months, DOD expects to begin matching vendor payments it disburses through its remaining systems. For our part, FMS is working closely with DOD, and we are well-prepared to assume the additional work load.

Mr. Chairman, Treasury views debt collection as an important financial management tool. Moreover, collecting money owed to the government is in close alignment with one of the governmentwide initiatives under the President's management agenda: Improved financial performance. Along these lines, you may be interested to know that the President's 2005 budget includes proposals to further improve the Federal Government's collection of delinquent debts. And one of these proposals would increase the continuous levy on Federal vendor payments from the current 15 percent to 100 percent.

Unlike many Federal payments such as salary and retirement and benefit payments, vendor payments are not recurring, and, thus, fewer opportunities exist for collection. This levy increase would not affect the administrative processes already in place that give the debtor 30 days to make payment arrangements, appeal the levy action or apply for a hardship determination.

We believe that devoting resources to debt collection is both wise and of enormous benefit to agencies in managing their budget accounts and producing accurate financial statements. As you can see from the chart attached to my statement, FMS' debt programs have resulted in the collection of more than $18 billion since 1997. Our success can be attributed, in large part, to having the expertise and the infrastructure and cooperative working relationships with agencies to collect millions of dollars of outstanding debts.

At the same time, we recognize that there are always ways to improve. For example, to help maximize the potential of the levy program, we are actively engaged with IRS in examining the feasibility of making two important improvements. First, we are discussing ways to increase the number of tax debts in TOP that can be actively collected following the completion of IRS due process notification, and, in fact, as the Commissioner pointed out, some of that has already occurred.

Under this approach, IRS may consider ways to provide due process to delinquent taxpayers before, not after, the tax debts are transmitted to TOP. Presently, payments to DOD contractors, many of which are one-time, have already been disbursed by the time the due process is completed. Modifying the due process timing would ensure that the payments being disbursed to DOD contractors who are identified as delinquent tax debtors can be levied immediately. We welcome the opportunity to work with DOD and IRS to devise procedures that address this issue.

Second, we are exploring with IRS ways to improve the accuracy of information pertaining to taxpayer identification numbers, names and addresses contained in DOD's central contractor registration database. IRS advises, however, that there may be legal impediments under current law concerning the circumstances under which TIN matching may be used by IRS, the information the IRS may disclose as a result of that matching, and to whom the information is disclosed.

If—I repeat if—these important issues can be addressed, we would anticipate increased matches of the delinquent tax debts with vendor payments to those same debtors. Increased matches would very likely result in greater collections.

Once more, I appreciate the opportunity to testify today and would be happy to answer questions.

Senator LEVIN. Thank you, Mr. Gregg. Mr. Lanzillotta.

TESTIMONY OF LAWRENCE J. LANZILLOTTA,[1] PRINCIPAL UNDER SECRETARY (COMPTROLLER), U.S. DEPARTMENT OF DEFENSE

Mr. LANZILLOTTA. Thank you, Senator.

Mr. Chairman, Members of the Subcommittee, I am pleased to be here today to discuss the Department of Defense program for offsetting payments to commercial entities that either have tax or non-tax debts owed to the Federal Government. Even though the collection of Federal debts is not a primary mission of the Department of Defense, it is an important and inherent management responsibility.

It is part of our DOD leadership's resolve to exercise strong stewardship over the taxpayers' dollars. We want to thank this Subcommittee and the General Accounting Office for focusing on how we can improve this component of our stewardship. The Department of Defense agrees with the four GAO report recommendations and has taken action to address the report findings.

Since 1991, DOD has partnered with IRS to levy offset commercial payments to collect Federal debts through a manual process involving what we call paper levies. In July 2000, IRS, in conjunction with the Financial Management Service, FMS, started the Federal Payment Levy Program. This program provides for the collection of Federal debts through continuous levy on commercial payments.

In 2001, DOD began working with FMS to participate in the program. In October 2002, DOD began providing its databases on pending commercial payments to FMS for matching against the Treasury Offset Program, TOP, database, which includes both Federal tax debt and non-tax debt. In December 2002, we began taking offsets.

The Department currently provides a commercial payments database only for its largest commercial payment system, the Mechanized Contract Administrative Service, MOCAS, system, and does this once a week. As of January 31, 2004, DOD had collected about $2.1 million through offsets. This $2.1 million collection is far below what should be achieved. Increasing this performance requires changes not only within the Department but also changes in partnerships with other agencies, to include possible legislative changes.

The primary challenge is to better identify, through automation, those DOD contractors whose payments should be offset because of their Federal debts. When DOD receives a notification that the contractor is indebted to the U.S. Government, and its payments are subject to levy, we have little trouble in executing prescribed offsets.

DOD is advancing several actions and changes to improve the Federal levy performance. We are refining our procedures for Federal levies to ensure they are streamlined and efficient as possible. We have clarified with the IRS and Treasury that the Depart-

[1] The prepared statement of Mr. Lanzillotta appears in the Appendix on page 98.

ment's central point of contact for executing levies is the Defense Finance and Accounting Service, particularly the Commercial Payment Center in Columbus, Ohio. This will enable a single office to handle levies for all DOD commercial pay systems. Instead of once-a-week, the Department will twice weekly provide its database on MOCAS to FMS and evaluate whether we can even increase the frequency.

Consistent with the GAO recommendation, the Department will continue to devote sufficient resources to implement all aspects of its formal plan to improve its levy performance. The Department is pursuing long-term changes. Some involve other agencies. We are expanding the DOD automated levy process beyond MOCAS to the rest of the Department's commercial pay systems. We have already included another pay system and will have the additional 18 pay systems that could be matched to the TOP database using the new automated system. We are currently working with Treasury to include these systems in the continuous offset program. This expanded automation should be completed no later than March 2005.

We will have 90 percent of our payments completed by August 2004, which includes all of the DFAS-owned systems, to match against the TOP database.

This action meets the GAO recommendation that DOD develop a formal plan for providing payment information to TOP for all of its commercial pay systems. This full automation is the Department's main focus for improving its levy performance.

When our input is automated, DOD has fewer problems offsetting payments for matched vendors once we receive an automated file from Treasury. However, the total dollars offset is only about 1 percent of the debts we receive from IRS. We recognize the automated process can be more effective and are working with Treasury and IRS to get the needed changes. With manual procedures, we are seldom successful because by the time we become informed of a match for a pending payment, we have disbursed the payments. Still, we are considering possible interim procedures to use until full automation is completed.

The Department of Defense relies on the information in the Central Contract Registration Database for the commercial payments provided to FMS for matching with its TOP database. This information comes from the contractors themselves. If either the name or the taxpayer identification number, the TIN, provided by the contractor differs from the name or the TIN listed on the debt record, the TOP database will not identify that contractor for an offset or levy.

We believe that increasing the accuracy of the CCR will increase the effectiveness of the TOP system's ability to identify many contractors with Federal debt. We are working with IRS and FMS on how best to validate or correct the TIN and the name of the commercial activity in the CCR database. The goal is to eliminate the CCR inaccuracies as an obstacle to better levy collections.

There are legal limitations. In seeking to achieve more levies, the Department of Defense must stay within the framework and the limitations of the Federal law and will honor taxpayers' rights. For example, certain tax-related information cannot be released even

between Federal agencies except in strict compliance with Federal law.

The Department looks forward to working with the IRS, FMS and others in considering what legislative and legal changes might help achieve more successes for this program. In closing, I assure you that the Department of Defense will support the Federal Payment Levy Program. We have a good partnership with IRS and FMS, and I am sure that we will produce substantial results. I also want to assure this Subcommittee that the Department of Defense is continuing its broader challenge of transforming all of its business and financial management processes. We have made a strong start in our historical overhaul of DOD management processes and the information systems that support them.

Once fully implemented, several years from now, our Business Management Modernization Program will consolidate and integrate our management information systems. It will enable the maximum permissible exchange of information that is key to ensuring all of our business management responsibilities.

Thank you for this opportunity to explain how the Department of Defense is working to sustain sound management and strong stewardship of its public resources. Thank you, Mr. Chairman.

Senator COLEMAN [presiding]. Thank you, Mr. Lanzillotta.

A kind of micro-focus question: Here, in terms of the number of DOD payment systems, my notes indicate that Thomas Bloom, former Director of the Defense Finance and Accounting Service, told GAO auditors there were 16 DOD payment systems, and I think the report was based on that. The Director of Commercial Pay Systems told the investigative staff of the Permanent Subcommittee that there were 18 DOD payment systems, and I believe your testimony today talks about 20 DOD payment systems.

Could you please tell me the correct number of DOD payment systems?

Mr. LANZILLOTTA. Mr. Chairman, in this area, there are 20 systems. Six are owned internally by DFAS; 14 are owned by other organizations such as the military services.

Senator COLEMAN. OK. In listening to your testimony, it is clear that the solution to a lot of the problems lies in expanded automation. You have got to automate your systems; get them up to capacity. Apparently, we are talking about 90 percent of the work will be done by 2004, but March 2005 is when you expect to have things in place?

Mr. LANZILLOTTA. In August 2004, we expect to have 90 percent of the dollar volume automated. It will take us until March 2005 to get that last 10 percent. But those last 10 percent represent numerous systems that are small and are more challenging.

Senator COLEMAN. Can you help me understand or the Subcommittee understand what happened? From 1996 to 1997, when the Financial Management Service system was put in place; Taxpayer Offset Program, all of that, up until today, you have got a long period of time. I understand that collections under the system did not really, in any kind of significant way, take place until 2002–2003. What happened in the interim?

Mr. LANZILLOTTA. As I mentioned in my statement earlier, we have always done manual processes. But when we process 12 mil-

lion vouchers a year, these manual processes, because of the deliberative process, were not terribly effective. It was not until July 2000 that FMS and IRS gave us the ability to use automation. We were working as part of the development of those systems to ensure that we would be able to transmit data with FMS.

In 2001, we started our own contractor debt system, which allowed us to pull from the MOCAS system the information that FMS would need. In 2002, it took us from 2001 to 2002 to perfect our system, run test data and test files, to where we could certify to the system that it was accurate and that we would not be making offsets or doing things that later we would regret.

Senator COLEMAN. One of the keys to accuracy is having correct taxpayer identification numbers. Can you tell me what your plan is to ensure that you get correct taxpayer identification numbers prior to being paid?

Mr. LANZILLOTTA. Right now, we are working with both FMS and IRS and hope to resolve this in the task force that was announced.

In the Department of Defense currently, the TIN number is provided by the vendor on a voluntary basis. He just writes in the number that he has. We have no way to validate it until we get a readback from FMS as to what that is. There are 270,000 contractors currently in the database. It only works effectively if we can do a bump and know where our mistakes are. Individual queries are somewhat time consuming.

Senator COLEMAN. You say it is voluntary. Is there anything that would preclude you from requiring——

Mr. LANZILLOTTA. I stand corrected, Mr. Chairman. It is not voluntary. In the case of service contracts, it is required by law.

Senator COLEMAN. Services, but not goods, it is not required by law?

Mr. LANZILLOTTA. There are some cases where the TIN numbers are not required by the vendor to put in.

Senator COLEMAN. Is there anything that would preclude you from requiring, as a condition of getting a contract, in all contract cases, the submission of a TIN number?

Mr. LANZILLOTTA. You know, this is kind of a question outside my expertise. It requires a procurement official. But a lot of these payments are what we call miscellaneous payments. They are payments to the credit cards, airlines, utilities, some agreements that we have, tariff agreements, where we just do things—they provide a service, and we just pay them, and a contract does not exist.

Our goal would be to get TIN numbers for as much as we possibly could, because that is the key for us to be able to identify where the offset should be taken.

Senator COLEMAN. One of the penalties for not providing taxpayer identification numbers is backup withholding, I believe about 28 percent. Do you know if you have implemented that?

Mr. LANZILLOTTA. No, Mr. Chairman, we have not, but we will.

Our problem that we are running into is when a vendor provides us a TIN, we do not know that it is a bad TIN until we bump it up against a payment, against the FMS. We do not know ahead of time. So we are having trouble ensuring that he has provided a valid TIN, because we have to make absolutely sure that when we hold up 28 percent of the payment that it is legally correct.

Senator COLEMAN. I would strongly urge that you focus on what you need to do to make sure that you can evaluate whether somebody has a valid TIN, taxpayer identification number; and then, at that point in time, you can use the backup withholding. And when you said you will, when will you begin to use backup withholding?

Mr. LANZILLOTTA. We have immediately told DFAS to make a plan for people who have not provided a TIN in areas where the law requires a TIN to implement the 28 percent. It will take us—I do not know exactly how much time—to work out with FMS and IRS the validation of the TINs, so we will know ahead of time that the TIN is wrong, and we can withhold the 28 percent.

Senator COLEMAN. I turn to the commissioners, perhaps to supplement the response there. Can you give us a better sense of what kinds of things have to be done so that we can ensure that you have that kind of very basic information of a taxpayer identification number?

Mr. EVERSON. I guess the one point I would emphasize is what I said before more generally that there are two conflicting sets of interests here. Generally, in this area, the protection of the taxpayer rights in terms of the procedures for due process that came in through RRA 1998 and some that we follow that we are reviewing, as we have already said, in terms of cleaning up some of these operational constraints. That is one set of conflicts with prompt collection.

The other does relate to the absolute protection of taxpayer information, and there is a part of the Internal Revenue Code, that really protects information. Now, there is a carve-out here where we can share information on services, as Larry was just indicating. The carve-out relates to active contracts. This database is broader than that. It includes the registration of those who would wish to do business with the government, and that is not a carve-out that qualifies—the broader population does not qualify for the data sharing, nor does, as was indicated, goods that are purchased.

So there is a whole series of issues here regarding taxpayer information that we need to get to, and I know some have suggested maybe people could waive their protections there, and then, we could address it that way. I think we need to focus on these issues over the next few months and figure out what the best way to jump on this problem so that we can automate the solution.

As Larry said, and I agree, unless we automate it, we are not going to get anywhere. It is too cumbersome if it is all done by manpower.

Senator COLEMAN. Commissioner Gregg, anything to add?

Mr. GREGG. Yes, I think that the basic issue is if we could take a slice of the CCR and look at those that are active, but then, it gets down to—it is one thing for us to be able to identify that a TIN does not match, but what is necessary—and maybe legislation is necessary to give IRS the authority to provide the correct information to DOD, because it does not help very much if we just tell them that sorry, no match, and we cannot give them the information that is a valid TIN for that particular vendor. So that is something that I think IRS is looking at, but perhaps legislation is required. I am not sure.

Senator COLEMAN. Please let us know if you think you need that authority, because certainly, we would be inclined to move in that direction.

We are going to have a second round, but before my round is over, just to Commissioner Everson, in the 47 cases that were identified in the GAO report, can you tell us what your plans are with the folks involved in those cases?

Mr. EVERSON. Certainly, I think you know, and Senator Levin knows, we worked very closely with this Subcommittee, on the followup of the hearings that you had in November, and I very much appreciate the materials that you have provided to us in connections with those matters that you were looking at.

It is going to be the same thing here. We are going to take these 47 cases that happen to come from GAO. Our normal procedure would be that our business unit that handles these matters would look at them as a screen and then send potential cases into the Criminal Investigations Division, where they might take the case, investigate them.

I am going to shortcut that process and ask our CI people to look at each and every one of these 47 cases to see what they think, in case they would conclude that they ought to look at some of them that maybe the business unit would not have looked at.

Senator COLEMAN. Your CI people means criminal investigators?

Mr. EVERSON. Criminal investigators, 1,811 law enforcement officials.

Senator COLEMAN. Thank you very much, Commissioner. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman, and thank you all for your testimony.

The first question has to do with whether we should require that the Department of Defense contractors be paid up on their taxes or, at a minimum, be paid up on an installment agreement so that they not be on default on either their taxes or on an installment agreement. What is the Department of Defense's position on that? In other words, in order to get a new contract, you are not going to get a contract if you are in default on your taxes.

Mr. LANZILLOTTA. In concept, Senator, I do not believe the Department would oppose that at all and would welcome the opportunity to have some legislative authority, because as it was mentioned before, it is not against the law to owe back taxes and still have a contract with the Federal Government.

Senator LEVIN. It is not a matter of being against the law. The question is whether we ought to be giving a contract to people, paying them money when they owe us money. It is not a matter of whether it is a crime or illegal. It is a matter of just pure business common sense. No business would operate that way, and we are always told we should try to be more businesslike in our operations.

So why would the Department of Defense, if we are owed money from a contractor on taxes, they are delinquent on taxes, or they are delinquent on an installment agreement, why would we be giving that contractor another contract?

Mr. LANZILLOTTA. I completely agree with the concept, Senator, that we should require full payment or give us the ability to get

full payment. But we will need some legislative authority to do that.

Senator LEVIN. Will you recommend it?

Mr. LANZILLOTTA. In concept, I certainly support it.

Senator LEVIN. Would you let the Subcommittee know whether you would recommend it, that the Department ask the Secretary as to whether or not he and the Department would support it? I understand OMB opposes it. Do you know if that is true?

Mr. LANZILLOTTA. Well, it happened in 2000, and so, everybody who was involved with that is not here to ask as to what were their reasons. I would have to get the provision and take it back and look at it. But in concept, we are looking at ourselves, and we looked at our database whether we could have a certification on the database as to whether somebody had paid their back taxes and make them certify, during registration, that they were not in arrears.

We were told that legally, that is challenging to put that certification in there, that we did not have that authority, and then, if we did, in some cases, it would still be meaningless, because we would not have a way to back it up to see if they were lying to us or not. I think we need to look at it.

Senator LEVIN. But false representation to get a contract is a pretty serious business under law. If you make a misrepresentation about a fact in order to get a Federal contract, you have got problems. And so, it is a real deterrent. It is a real weapon here to try to collect taxes.

But rather than pursue it further, if you would get the Department's position on that issue, it would be helpful to us, because I think some of us, at least, want to seriously consider that kind of a requirement.

Obviously, people can owe back taxes. A lot of times, that is going to be true. But if there is not an agreement to pay back taxes which is being complied with, if a contractor does not even have that, it seems to me that we should be mighty reluctant to give that contractor any additional contracts, unless there is some national security reason to do it. If that is the only contractor who is providing us with a substance that we cannot get anywhere else, I guess we have got to take our licks on that one. But other than that, I think we should be a lot more commonsensical about handing out taxpayer dollars to contractors who owe the IRS money.

Mr. LANZILLOTTA. I will turn this over to Commissioner Everson. The Department does not know or does not have a list of vendors who owe back taxes. We only know when we submit a vendor payment against the database at that time.

Senator LEVIN. You can require that the person represent that they do not owe back taxes before they get a contract.

Mr. LANZILLOTTA. A certification-type process.

Senator LEVIN. A certification process, yes.

And just give us your position on a certification process. Commissioner Everson.

Mr. EVERSON. Yes, thank you, Senator. I think this comes back to what I said is a conflict of two legitimate public policy interests. One is taxpayer rights, on the one hand, and the other is the desire of the government to have its vendors have a clean bill of financial

health. We do have to be careful here, because there are instances where there are legitimate disputes between companies or individuals and the government. And they do take time to get resolved.

So I do not think that I would be in a position to advocate that one side of this trumps the other, if you will. We need to improve, clearly, the sharing of information. We need to look at that so that judgment can be brought to bear into this discussion. But I would be reluctant to encourage a one-sided solution. It has got to be a balanced solution.

As I indicated in the statement, we have agreed, this group plus OMB, has agreed to look at this, and I had a meeting with OMB on this subject earlier this week, and as they indicated, in the information that potential vendors bring to the government to be considered for a contract, information beyond that which is normally required between two contracting parties in the private sector is requested and then considered.

I do believe that the administration can look at whether, in its procurement policies, additional changes can be made in that regard. But again, this involves more than just the procedural rights of taxpayers. You also get into privacy considerations, and there will need to be discussion as to whether statutory modifications are appropriate to have information sharing.

Senator LEVIN. I do not see that there is any privacy issue in requiring that a potential contractor certify that he or she does not owe any withholding taxes. That is a certification issue.

Mr. EVERSON. That is a procurement issue, that is exactly right.

Senator LEVIN. That is not a privacy issue.

Mr. EVERSON. But if you want to ping the IRS database to see whether that is correct or not, that is a different issue.

Senator LEVIN. That may be a different issue.

Mr. EVERSON. Right.

Senator LEVIN. But just requiring the certification, now 25,000 of the 27,000——

Mr. EVERSON. Right.

Senator LEVIN [continuing]. Cases are withholding issues. Those are usually not disputed issues. That is money which was——

Mr. EVERSON. Just trying to be clear here.

Senator LEVIN. No, I can understand that there can be legitimate disputes. I can understand that. And we have got major defense contractors who have very legitimate disputes over contract issues, including whether taxes are owed.

Mr. EVERSON. Yes.

Senator LEVIN. We can protect that legitimate right. But when 90 percent of your cases deal with withholding taxes, over which there is no dispute at all, it seems to me just requiring a certification which would subject somebody who falsely certifies it to a criminal action could provide a real deterrent, a real collection device for back taxes.

When the 30-day levy notice is finally sent, when is the money actually withheld? Is it at the same time that notice is sent, or is it the end of the 30 days?

Mr. EVERSON. I would defer to my colleague.

Mr. GREGG. Yes, it depends on the type of payment. If it is a recurring payment for a non-levy——

Senator LEVIN. The first one on a levy, when notice of a levy goes out.

Mr. GREGG. And that depends on—what I said in my statement is that sometimes, because of the sending out the notice, the due process notice, we miss that first payment, because we get the information from DOD, and at that time, the payment may have to go out the door in 10 or 15 days, and by the time the due process notice goes out, the payment is out the door. So what we do is have our files ready for the subsequent payment.

Senator LEVIN. But you do not wait for the 30 days.

Mr. GREGG. No, we do not hold, or DOD does not hold payments up because of——

Senator LEVIN. Until after the 30-day period is up.

Mr. GREGG. No.

Senator LEVIN. Mr. Lanzillotta.

Mr. LANZILLOTTA. The due process has to take place before I can make a payment offset.

Senator LEVIN. Are payments made during that 30-day process?

Mr. LANZILLOTTA. If FMS or the IRS has not completed their process, and a payment is due, a payment is made, yes.

Senator LEVIN. Well, my question is you are sent a notice, a 30-day notice, a so-called due process notice, that a levy is going to attach. My question is will payments be made during that 30-day period?

Mr. LANZILLOTTA. Yes.

Senator LEVIN. OK. So you have a situation here where this is the fourth step in a process, right? Frequently, there has been a year's wait while somebody is in a queue.

Mr. EVERSON. But as you indicated, Senator, this chart here—I want to respond to a point you made earlier. You asked if some of this is in response to the Subcommittee's interest or the GAO's interest; very much so. We have already taken some actions here to improve just what you are talking about. If you look over on the left, this pink box, it has got what we call—I have characterized it as operational exclusions. GAO said policy. Below that squiggly line are areas where we have already looked, and we are making changes. This queue issue is one of them.

And we are going to do more to clean this up.

Senator LEVIN. That is good news in terms of this queue, because that one seems fairly—I mean, I am glad you have cleaned that one up. It is pretty obvious that it needed to be cleaned up, and I commend you for it.

My last question in this round, then, would be do you have officers, in the IRS, that are there full-time revenue officers that work in the Tax Levy Program?

Mr. EVERSON. That is a good question. We have revenue officers, of course, but you are asking about the levy program for Federal contractors, per se, I think is the substance of what you are asking.

Senator LEVIN. Right. That is correct.

Mr. EVERSON. Yes, it is entirely automated is the answer, Senator. So I have seen your proposal on this, and all five of the points that you have made, I think that this task force that we have suggested we are going to put together ought to look at that, because expertise attaches to all kinds of elements of our responsibility, and

collections, as you know, as we have discussed, we have drawn down our revenue officers by over 25 percent due to resource constraints in the last 6 or 7 years. We are bringing that back up. The kind of thing we do need to consider is the expertise of revenue officers as we go forward, and we will in this task force.

Senator LEVIN. I want to commend you for not just considering that but for fighting for resources for tax collection. We have got to turn this around. We cannot have these many uncollected taxes out there that just go by default because we do not have the resources to go after folks. There are a lot of areas where we need to go after them, and I appreciate your leadership and seeking the resources to do that.

Mr. EVERSON. Thank you.

Senator COLEMAN. Thank you, Senator Levin.

Just to follow up on that comment, I share the concerns of Senator Levin, and I appreciate in our conversations, Commissioner, your intent to focus those resources, focus them on folks who are making a lot of money and should be paying their fair share, and they are not. And I think that the focus piece is also an important piece that the average taxpayer needs to understand and appreciate.

Commissioner, Senator Levin in his questioning had raised the issue of a certification process, a taxpayer contractor certifying that they are not in violation of any taxpaying obligation. Do you know if any other agencies have a certification process?

Mr. EVERSON. It is really a procurement question, Senator, and I am not sure that I know the answer to that. And again, from our point of view, it is not a consideration unless you cure this issue of the data sharing because of privacy. Then, it could play for us.

Senator COLEMAN. And certainly, the Department of Defense is the 800-pound gorilla when it comes to contracting. Such a substantial percentage of Federal contracts are within that Department. But the testimony from earlier witnesses gave us the very clear understanding that these problems exist in other agencies.

For Mr. Gregg, I would turn to you and raise the resource issue. For instance, just in these cases, we are talking about 27,100 tax-delinquent contractors identified by the GAO, with the potential of there being many more throughout the Federal Government. Does the FMS have the resources to levy all contractor payments?

Mr. GREGG. Yes, we do, Senator. We have a very highly automated system, and we are basically prepared to handle about anything—we have huge amounts of debt already in our database and resources, not that I say they are unlimited, but they are enough to handle this.

Senator COLEMAN. That is very encouraging, Commissioner.

At the present time, I believe, the Defense Finance and Accounting Service is sending one computer tape a week, and I think, Mr. Lanzillotta, you said that you were trying to increase that, to mechanize your MOCAS system payments, sending a tape once a week. Was the intent to increase, sending that tape twice a week?

Mr. LANZILLOTTA. Yes, Mr. Chairman, what we are looking at now is what is the cycle time that we have right now on a tape, and we are going to go to two tapes a week with the hope of doing

a continuous offset, where all the new contracts or new vouchers would just constantly be sent to FMS.

Senator COLEMAN. And I guess, then, the same question to you, Commissioner: Is that a resource question? Are you prepared to begin accepting and processing more MOCAS tapes?

Mr. GREGG. Yes, we are.

Senator COLEMAN. OK; that is very helpful.

I take it if taxpayer identification numbers in the Central Contractor Registry are validated, that will increase your ability to make matches for levy purposes?

Mr. GREGG. If there is a way for IRS to validate and provide accurate information back to DOD, if there is a problem with one of the TINs, then, yes. And I think that is something that this task force can look at, to see how much flexibility they have there.

Senator COLEMAN. OK; the last question I am going to have is the Department of Defense has its one major disbursement system now going through the FMS process, but apparently a large number of other systems are not. Is there anything that the IRS can do, working with the Defense Department to accelerate the process of getting these systems referred to the FMS?

Mr. LANZILLOTTA. Mr. Chairman, we are accelerating the process. And this is a DOD thing that we have to do. By August, we hope to have 90 percent of our volume, no later than August, 90 percent of our volume through the FMS system. The last systems, the remaining 10 percent, they represent a lot of smaller systems that we are just going to have to work on to ensure that no later than March 2005, we will have 100 percent of our vouchers being able to go through the FMS.

Senator COLEMAN. Commissioner, perhaps on another occasion, we can have a broader discussion of the conflicting values issue that you raised, two important values: Taxpayer rights, and you have the value of trying to make sure that collections are done properly.

Mr. EVERSON. Yes.

Senator COLEMAN. Because taxpayers are impacted when collections are not collected properly, and I can see that here. But when payments are not made to Social Security, and to Medicare, taxpayers are paying for that.

Mr. EVERSON. Yes, absolutely. I could not agree with you more. It is a very important subject. We need to run a balanced system that gives adequate consideration to both of those considerations.

Senator COLEMAN. And as all of you gentlemen, I am sure, can tell by the reaction of my colleagues to this GAO report, there are a lot of concerns about the present state of affairs, a lot of concerns; certainly with DOD but beyond DOD, within the Federal Government. And I think it is quite obvious that we expect that those concerns will be addressed, that they be addressed expeditiously and that we do what we can to raise the level of confidence in the average taxpayer that they are paying their fair share, and they are not alone.

So, with that, Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman.

On this balance issue, I totally agree with you. One of the first things that I got involved in when I came to Washington, was a taxpayers' bill of rights.

Mr. EVERSON. Yes.

Senator LEVIN. As a matter of fact, that taxpayers' bill of rights came out of this Governmental Affairs Committee. Senator Pryor was involved; a number of other people were involved. It was a bipartisan effort, and it was very important, because there are abuses not just by taxpayers but by the IRS.

Mr. EVERSON. Yes.

Senator LEVIN. We do not want abuses on either side. But this issue, it seems to me and I think all of us, is an issue where we are handing out money. I mean, the Chairman is really focused on this aspect of it, and he is so right. I do not think this is the same thing as having a normal tax dispute about how much money does a taxpayer owe the government.

We are handing out money to taxpayers. Ninety percent of the delinquent taxpayers here are people who have not paid their withholding, which I think is a crime.

Mr. EVERSON. I agree with that entirely. The only cautionary note I am suggesting is that if you make things automatic, there are always exceptions, and I believe, however, the sharing of information that allows people to exercise judgment, that is where you get to a good answer.

Senator LEVIN. I agree. You can get into areas where there are going to be disputes, but where you have got 25,000 of the 27,000 are withholding issues——

Mr. EVERSON. Yes, that is pretty clear cut.

Senator LEVIN. Now, on the due process issue, if you send out a delinquency notice to somebody, that you are delinquent, can the IRS not give notice in that delinquency notice that you can be levied, in fact, any payment from the government to you can be levied for this delinquency unless you come in and work out something? Can't the levy due process notice be right in the delinquency notice?

Mr. EVERSON. There are a series of steps that are in the laws from RRA 1998, and then, there are some other procedural things that the IRS does. And if you look at the whole time line—I considered doing a blow-up of this chart but declined to do it.

Senator LEVIN. You took pity on us.

Mr. EVERSON. Because you still could not see it. [Laughter.]

The whole process and the dozen or more steps runs up to 2½ years. Someone who has a potential problem of $5,000 at the end goes all the way through the process, and has sustained penalties and interest, might owe $30,000 but not until 2½ years later.

Someone can keep this moving if they want to. Some of this is at our discretion. I am not suggesting it is all in RRA 1998. And we have got to look at that. But some of the notices that we will send are actually very effective, because they do not require a great deal of investment of manpower, and they draw a certain response. So with the shortage of the revenue agents that we have had that we have all discussed, there has been more reliance on a barebones, automated system here.

We need to attack that. As I have indicated, we have over 1,000 collection personnel who will come in if the Congress provides the monies we have asked for. This can help us, and perhaps as we look at these procedures, we can, as we are doing here, improve our times. And then, we will also look at legislative remedies. I do believe the Congress is open to considering whether there need to be some modifications. I am not suggesting throwing out RRA 1998. I do not want to be misinterpreted at all on that. But perhaps there are some modifications in order. One was mentioned earlier about frivolous offers to settle something, where you say I will settle a $1 million debt with $1. That can keep the process alive and provide rights. That is not a good thing, obviously.

So we have got to look at both internal procedures and, I suggest, perhaps, statutory changes.

Senator LEVIN. So you will be giving us recommendations for statutory changes?

Mr. EVERSON. What we have agreed is that the three organizations represented here and OMB are going to take a look at this whole set of issues, both what is out there operationally; which largely might be in my shop; might be at DOD; could be in FMS, although I doubt—I mean, they are really sort of—largely a conduit here, a processor; we are going to look at that, and we will look and see what statutory considerations or processes might be warranted.

Senator LEVIN. What kind of time line is there for that review?

Mr. EVERSON. We will do something by June. I think that gives us 3 or 4 months to look at it.

Senator LEVIN. That is great.

Mr. Lanzillotta, why are you delivering data to FMS only twice a week? Why not every day?

Mr. LANZILLOTTA. Senator, that is the goal, but what we have to make sure we do is when we pay a voucher, we send it over to FMS. They have to process it and come back and tell us where the offset should take place.

Senator LEVIN. But is this not all automated?

Mr. LANZILLOTTA. It still takes about a day for us to send a file over to FMS; for them to bump the file and send it back to us.

Senator LEVIN. I know that, but can the list not be sent over automatically every day instead of twice a week?

Mr. LANZILLOTTA. We are trying to get to that point where we——

Senator LEVIN. What is the problem, if it is automated, in getting to that point?

Mr. LANZILLOTTA. Our systems. We have to redo the system a little bit, modify the system. Because what we do not want to do is get caught up where we have a transaction in transit somewhere, and we make a payment or fail to make a payment or collect twice or not collect at all.

Senator LEVIN. Final question, then, would be whether or not you can share with us the DOD contractor list that you have imposed tax levies on?

Mr. LANZILLOTTA. Senator, I can give you the same reference my fiscal lawyers gave me that says no.

Senator LEVIN. And that is because of a privacy concern?

Mr. LANZILLOTTA. That is because their interpretation of the statute says that we cannot release that information. I understand that there is some differing of opinion.

Senator LEVIN. The question is this: Under Section 6103 of the Tax Code, you are not allowed access to confidential taxpayer information?

Mr. LANZILLOTTA. Senator——

Senator LEVIN. You have it. You have a list of contractors that are in default and that have been levied upon. So if you got that list, why can we not have that list?

Mr. LANZILLOTTA. Senator, I am just going to have to——

Senator LEVIN. Can you get us the legal opinion from your shop that says that you cannot share it with us? That is, would you get your lawyers to send a letter to the Subcommittee here explaining why it is that you can have it, despite Section 6103, but we cannot? That is the question. I am not asking you for the answer today.

Mr. LANZILLOTTA. Certainly, Senator.

Senator LEVIN. Would you get that from your lawyer to the Subcommittee? [1]

Thank you, Mr. Chairman.

Senator COLEMAN. Thank you very much, Senator Levin.

Gentlemen, thank you for your testimony; again, to the GAO, thank you for your work.

This hearing will be closed. The record, however, will be left open for 14 days.

[Whereupon, at 12:15 p.m., the Subcommittee adjourned.]

[1] See Exhibit No. 7 (question No. 1) which appears in the Appendix on page 192.

APPENDIX

United States General Accounting Office

GAO

Testimony

Before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 9:30 a.m. EST
Thursday, February 12, 2004

FINANCIAL MANAGEMENT

Some DOD Contractors Abuse the Federal Tax System with Little Consequence

Statement of

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GAO-04-414T

February 12, 2004

GAO
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Highlights

Highlights of GAO-04-414T, a testimony before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

FINANCIAL MANAGEMENT

Some DOD Contractors Abuse the Federal Tax System with Little Consequence

Why GAO Did This Study

GAO addressed issues related to three high-risk areas including the Department of Defense (DOD) and the Internal Revenue Service (IRS) financial management and IRS collection of unpaid taxes. This testimony provides a perspective on (1) the magnitude of unpaid federal taxes owed by DOD contractors, (2) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, (3) whether DOD and IRS have effective processes and controls in place to use the Treasury Offset Program (TOP) in collecting unpaid federal taxes from DOD contractors, and (4) whether DOD contractors with unpaid taxes are prohibited by law from receiving federal contracts.

In a companion report issued today, GAO made recommendations to DOD for complying with statutory guidance and supporting IRS efforts in collecting unpaid taxes, to IRS for improving the effectiveness of collection activities, and to the Office of Management and Budget (OMB) to develop options for prohibiting awards to contractors that abuse the tax system. DOD and IRS partially agreed; OMB did not agree. DOD and OMB also did not agree with GAO's matters for congressional consideration that DOD report on its collections through TOP, and OMB report on policy options developed for contractors that abuse the tax system. GAO reiterated support for its recommendations as well as its suggestions to Congress.

www.gao.gov/cgi-bin/getrpt?GAO-04-414T

To view the full product, click on the link above. For more information, contact Gregory D. Kutz at (202) 512-9095 or kutzg@gao.gov, or Steven J. Sebastian at (202) 512-3406.

What GAO Found

DOD and IRS records showed that over 27,000 contractors owed about $3 billion in unpaid taxes as of September 30, 2002. DOD has not fully implemented provisions of the Debt Collection Improvement Act of 1996 that would assist IRS in levying up to 15 percent of each contract payment to offset a DOD contractor's federal tax debt. We estimate that DOD could have collected at least $100 million in fiscal year 2002 had it and IRS fully utilized the levy process authorized by the Taxpayer Relief Act of 1997. As of September 2003, DOD had collected only about $687,000 in part because DOD provides contractor payment information from only 1 of its 16 payment systems to TOP. In response to our draft report, DOD developed a schedule to provide payment information to TOP for all of its additional payment systems by March 2005.

Furthermore, we found abusive or potentially criminal activity related to the federal tax system through our audit and investigation of 47 DOD contractor case studies. The 47 contractors provided a variety of goods and services, including building maintenance, catering, dentistry, funeral services, and parts or support for weapons and other sensitive military programs. The businesses in these case studies owed primarily payroll taxes with some dating back to the early 1990s. These payroll taxes included amounts withheld from employee wages for Social Security, Medicare, and individual income taxes. However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund the business.

For example, owners of two businesses each borrowed nearly $1 million from their companies and, at about the same time, did not remit millions of dollars in payroll taxes. One owner bought a boat, several cars, and a home outside the United States. The other paid over $1 million for a furnished home. Both contractors received DOD payments during fiscal year 2002, but one went out of business in 2003. The business, however, transferred its employees to a relative's company (also with unpaid taxes) and recently received payments on a previous contract.

IRS's continuing challenges in collecting unpaid federal taxes also contributed to the problem. In several case studies, IRS was not pursuing DOD contractors due to resource and workload management constraints. For other cases, control breakdowns resulted in IRS freezing collection activity for reasons that were no longer applicable. Federal law does not prohibit contractors with unpaid federal taxes from receiving federal contracts. OMB is responsible for providing overall direction to governmentwide procurement policies, regulations, and procedures, and is in the best position to develop policy options for prohibiting federal contracts to contractors that abuse the tax system.

Mr. Chairman, Members of the Subcommittee, and Representative Schakowsky:

Thank you for the opportunity to discuss payments to Department of Defense (DOD) contractors that abuse the federal tax system. Our related report,[1] released today and developed at the request of this Subcommittee and Representative Schakowsky, addresses issues related to three high-risk areas: DOD and Internal Revenue Service (IRS) financial management and IRS collection of unpaid taxes. Since 1990, we have periodically reported on federal programs and operations that are high risk due to their greater vulnerabilities to fraud, waste, and abuse. As a result of the fraud and abuse identified in our series of testimonies and reports on DOD's purchase card program, you requested more comprehensive audits and investigations of controls over payments to DOD contractors.

DOD and IRS face a variety of high-risk challenges. Of the 26 areas on our governmentwide "high risk" list, 6 are DOD program areas, and the department shares responsibility for 3 other high-risk areas that are governmentwide in scope. Financial management, 1 of the 6 DOD program high-risk areas, has weaknesses, including nonintegrated and proliferating financial management systems, and fundamental flaws in the overall control environment. As we have documented in numerous reports, DOD's financial management problems leave it highly vulnerable to fraud, waste, and abuse. IRS high-risk areas include financial management weaknesses and difficulties in collecting unpaid taxes. Both areas continue to expose the federal government to significant losses of tax revenue and disproportionately increase the burden on compliant taxpayers to fund government activities.

Today, we will summarize our work on DOD payments to contractors that abuse the federal tax system. Our testimony will provide a perspective on (1) the magnitude of unpaid federal taxes owed by DOD contractors, (2) whether DOD and IRS have effective processes and controls in place to use the Treasury Offset Program (TOP) and Federal Payment Levy Program (FPLP) in collecting unpaid federal taxes from DOD contractors, (3) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, and (4) whether DOD

[1] U.S. General Accounting Office, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (Washington, D.C.: Feb. 12, 2004).

contractors with unpaid federal taxes are prohibited by law from receiving federal contracts.

Summary

The federal government will continue to miss opportunities to collect on hundreds of millions of dollars in unpaid federal taxes owed by DOD contractors until DOD begins to fulfill its responsibilities under the Debt Collection Improvement Act of 1996 (DCIA) by fully assisting IRS in its attempts to levy DOD contractor payments, and IRS fully utilizes its authority under FPLP. Based on DOD and IRS records, over 27,000 contractors registered in DOD's automated registration system had nearly $3 billion in unpaid federal taxes as of September 30, 2002. DOD contractors receiving fiscal year 2002 payments from five of the largest Defense Finance and Accounting Service (DFAS) contract and vendor payment systems owed at least $1.7 billion of this nearly $3 billion.

As the largest purchaser of goods and services in the federal government, DOD payments to contractors totaled about $183 billion in fiscal year 2002. We estimate that DOD, which functions as its own disbursing agent, could have offset payments and collected at least $100 million in unpaid taxes in fiscal year 2002 if it had fully assisted IRS in effectively levying contractor payments. However, in the 6 years since passage of the Taxpayer Relief Act of 1997,[2] DOD has collected only about $687,000. DOD recently implemented a TOP payment reporting process for its contract payment system, which disbursed over $86 billion to contractors in fiscal year 2002. However, DOD did not have formal plans or a schedule at the completion of our work for reporting payment information from its 15 vendor payment systems, which disbursed another $97 billion to contractors in fiscal year 2002. In response to our draft report, DOD developed a schedule to provide payment information to TOP for all of its additional payment systems by March 2005. DOD did not have an organizational structure in place to implement a TOP reporting process at the remaining payment systems.

IRS faces a number of high-risk challenges. Due to resource and workload management constraints, IRS established policies that either exclude or delay putting a significant number of cases into the levy program. In addition to policy constraints, inaccurate or outdated information in IRS

[2] The act enhanced IRS's ability to collect unpaid federal taxes by authorizing IRS to continuously levy up to 15 percent of certain federal payments made to businesses and individuals.

systems prevent cases from entering the levy program. Our review of IRS collection efforts against DOD contractors selected for audit and investigation indicated that IRS attempts to work with the businesses and individuals to achieve voluntary compliance, pursuing enforcement actions such as levies of federal contract payments later rather than earlier in the collection process. For many of our case study contractors, this resulted in businesses and individuals continuing to receive federal contract payments without making any payments on their unpaid federal taxes.

We also found numerous instances of abusive or potentially criminal activity related to the federal tax system during our audit and investigation of 47 DOD contractor case studies. The 34 case studies involving businesses[3] with employees had primarily unpaid payroll taxes, some dating to the early 1990s and some for as many as 62 tax periods.[4] These payroll taxes included amounts withheld from employees for Social Security, Medicare, and individual income taxes. However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund their businesses. The other 13 case studies involved individuals who had unpaid income taxes dating as far back as the 1980s. Several contractors in our study provided parts or services supporting weapons and other sensitive military programs.

Federal law does not prohibit a contractor with unpaid federal taxes from receiving contracts from the federal government. DOD contract awards of nearly $165 billion represented nearly two-thirds of the federal government's contracting activity during fiscal year 2002. The criteria calling for federal agencies to do business only with responsible contractors do not require contracting officers to consider a contractor's tax noncompliance, unless the contractor has been suspended or debarred

[3] A tax identification number (TIN) is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number (EIN) assigned by IRS serves as the TIN. For individuals, the Social Security number (SSN) assigned by the Social Security Administration serves as the TIN. Contractors register their TINs in the CCR database in either the TIN/EIN field or the SSN field. In our report, a contractor completing the TIN/EIN field is referred to as a business, while a contractor completing the SSN field is referred to as an individual.

[4] A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is 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.

for tax evasion as explained later in our statement. Presently, the federal government has no coordinated process for identifying and determining the businesses and individuals that abuse the federal tax system and for conveying that information to contracting officers for use before awarding contracts.

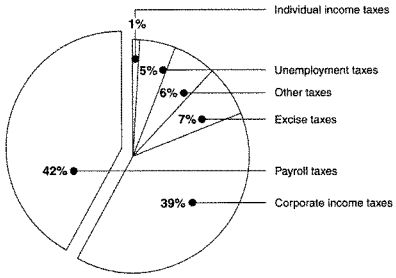
As discussed in the report released today, we made recommendations to DOD for complying with DCIA and supporting IRS efforts under the Taxpayer Relief Act of 1997 in collecting unpaid taxes, to IRS for improving the effectiveness of collection activities, and to the Office of Management and Budget (OMB) to develop options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system. DOD and IRS partially agreed, and OMB did not agree with our recommendations. DOD and OMB also did not agree with our matters for congressional consideration that DOD report on its collections through the TOP, and OMB report on policy options developed and actions taken against contractors that abuse the federal tax system. We reiterated support for our recommendations as well as our suggestions to Congress.

DOD Contractors Owe Billions in Unpaid Federal Taxes

The nearly $3 billion in unpaid federal taxes owed by over 27,000 contractors registered in DOD's Central Contractor Registration system (CCR) represented almost 14 percent of the registered contractors as of February 2003. In addition, DOD contractors receiving fiscal year 2002 payments from five of the largest DFAS contract and vendor payment systems represented at least $1.7 billion of the nearly $3 billion in unpaid federal taxes shown on IRS records. Data reliability issues with respect to DOD and IRS records prevented us from identifying an exact amount of unpaid federal taxes. Consequently, the total amount of unpaid federal taxes owed by DOD contractors is not known.

The type of unpaid taxes owed by these DOD contractors varied and consisted of payroll, corporate income, excise, unemployment, individual income, and other types of taxes. Unpaid payroll taxes include amounts that a business withholds from an employee's wages for federal income taxes, Social Security, Medicare, and the related matching contributions of the employer for Social Security and Medicare. As shown in figure 1, about 42 percent of the total tax amount owed by DOD contractors was for unpaid payroll taxes.

Figure 1: DOD Contractor Unpaid Taxes by Tax Type



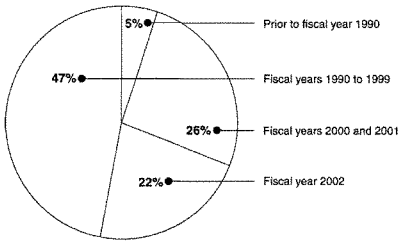
Source: GAO analysis of DOD and IRS records.

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 hold these amounts "in trust" for the federal government until the employer makes a federal tax deposit in that amount. 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 Federal Insurance Contribution Act contributions for Social Security and Medicare. Individuals within the business (e.g., corporate officers) may be held personally liable for the withheld amounts not forwarded and assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP). Failure to remit payroll taxes can also be a criminal felony offense punishable by imprisonment of more than a year, while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense punishable by imprisonment of up to a year.

The law imposes no penalties upon an employee 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 a previous report.[5] Over time, the amount of this subsidy is significant. As of September 1998, the estimated cumulative amount of unpaid taxes and associated interest for which the Social Security and Medicare trust funds were subsidized by the general fund was approximately $38 billion.

A substantial amount of the unpaid federal taxes shown in IRS records as owed by DOD contractors had been outstanding for several years. As reflected in figure 2, 78 percent of the nearly $3 billion in unpaid taxes was over a year old as of September 30, 2002, and 52 percent of the unpaid taxes was for tax periods prior to September 30, 1999.

Figure 2: DOD Contractor Unpaid Taxes by Fiscal Year



Source: GAO analysis of DOD and IRS records.

[5] U.S. General Accounting Office, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AIMD/GGD-99-211 (Washington, D.C.: Aug. 2, 1999).

Our previous work[6] has shown that 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 tax debt, which, over time, can dwarf the original tax obligation.

DOD and IRS Are Not Collecting Millions in Unpaid Federal Taxes from Contractors

Until DOD establishes processes to provide information from all payment systems to TOP, the federal government will continue missing opportunities to collect hundreds of millions of dollars in tax debt owed by DOD contractors. Additionally, IRS's current implementation strategy appears to make the levy program one of the last collection tools IRS uses. Changing the IRS collection program to (1) remove the policies that work to unnecessarily exclude cases from entering the levy program and (2) promote the use of the levy program to make it one of the first collection tools could allow IRS—and the government—to reap the advantages of the program earlier in the collection process.

DOD Is Not Fully Assisting in the Collection of Unpaid Taxes Owed by Its Contractors

We estimate that DOD, which functions as its own disbursing agent, could have offset payments and collected at least $100 million in unpaid taxes in fiscal year 2002 if it and IRS had worked together to effectively levy contractor payments. However, in the 6 years since the passage of the Taxpayer Relief Act of 1997, DOD has collected only about $687,000. DOD collections to date relate to DFAS payment reporting associated with implementation of the TOP process in December 2002 for its contract payment system,[7] which disbursed over $86 billion to DOD contractors in fiscal year 2002.

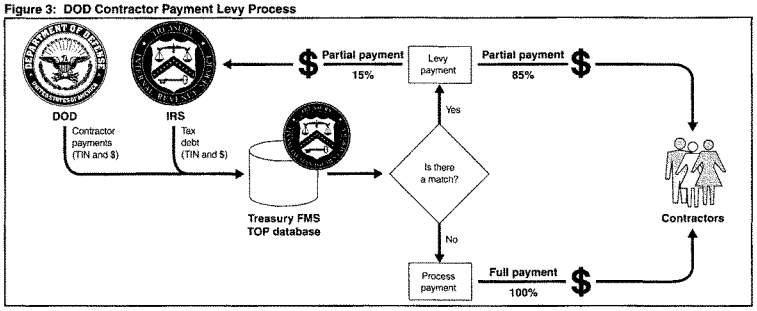
[6] U.S. General Accounting Office, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000); *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, GAO/AIMD-99-12 (Washington, D.C.: Oct. 29, 1998); and GAO/AIMD/GGD-99-211.

[7] Mechanization of Contract Administration Services (MOCAS).

Although it has been more than 7 years since the passage of DCIA,[8] DOD has not fully assisted IRS in using its continuous levy authority for the collection of unpaid taxes by providing Treasury's Financial Management Service (FMS) with all DFAS payment information. IRS's continuous levy authority authorizes the agency to collect federal tax debts of businesses and individuals that receive federal payments by levying up to 15 percent of each payment until the debt is paid. Under TOP, FMS matches a database of debtors (including those with federal tax debt) to certain federal payments (including payments to DOD contractors). When a match occurs, the payment is intercepted, the levied amount is sent to IRS, and the balance of the payment is sent to the debtor. All disbursing agencies are to compare their payment records with the TOP database. Since DOD has its own disbursing authority, once DFAS is notified by FMS of the amount to be levied, DOD should deduct this amount from the contractor payment before it is made to the payee and forward the levied amount to the Department of the Treasury as described in figure 3.

[8] Congress passed DCIA to maximize the collection of delinquent nontax debts owed to federal agencies. Under the regulations implementing DCIA, disbursing agencies, including DOD and others that independently disburse rather than having it done on their behalf by FMS, are required to compare their payment records with the TOP database. If a match occurs, the disbursing agency must offset the payment, thereby reducing or eliminating the nontax debt.

Figure 3: DOD Contractor Payment Levy Process



Source: GAO.

The TOP database includes federal tax and nontax debt, state tax debt, and child support debt. By fully participating in the TOP process, DOD will also aid in the collection of other debts, such as child support and federal nontax debt (e.g., student loans).

At the completion of our work, DOD had no formal plans or schedule to begin providing payment information from any of its 15 vendor payment systems to FMS for comparison with the TOP database. These 15 decentralized payment systems disbursed almost $97 billion to DOD contractors from 22 different payment locations in fiscal year 2002. In response to our draft report, DOD developed a schedule to provide payment information to TOP for all of its additional payment systems by March 2005. As we have previously reported, DOD's business systems environment is stovepiped and not well integrated.[9] DOD recently reported that its current business operations were supported by approximately 2,300 systems in operation or under development, and requested approximately

[9] U.S. General Accounting Office, *DOD Business Systems Modernization: Continued Investment in Key Accounting Systems Needs to Be Justified*, GAO-03-465 (Washington, D.C.: Mar. 28, 2003); *DOD Business Systems Modernization: Important Progress Made to Develop Business Enterprise Architecture, but Much Work Remains*, GAO-03-1018 (Washington, D.C.: Sept. 19, 2003).

$18 billion in fiscal year 2003 for the operation, maintenance, and modernization of DOD business systems. In addition, DFAS did not have an organizational structure in place to implement the TOP payment reporting process. DOD recently communicated a timetable for implementing TOP reporting for its vendor payment systems with completion targeted for March 2005.

IRS Policies Exclude Cases from the Levy Program

IRS's continuing challenges in pursuing and collecting unpaid taxes also hinder the government's ability to take full advantage of the levy program. For example, due to resource constraints, IRS has established policies that either exclude or delay referral of a significant number of cases to the program. Also, the IRS review process for taxpayer requests, such as installment agreements or certain offers in compromise which IRS is legally required to consider, often takes many months, during which time IRS excludes these cases from the levy program. In addition, inaccurate or outdated information in IRS systems prevents cases from entering the levy program. Our audit and investigation of 47 case studies also showed IRS continuing to work with businesses and individuals to achieve voluntary compliance, and taking enforcement actions such as levies of federal contractor payments later in the collection process. We recently recommended that IRS study the feasibility of submitting all eligible unpaid federal tax accounts to FMS on an ongoing basis for matching against federal payment records under the levy program, and use information from any matches to assist IRS in determining the most efficient method of collecting unpaid taxes, including whether to use the levy program.[10] The study was not completed at the time of our audit. In earlier reviews,[11] we estimated IRS could use the levy program to potentially recover hundreds of millions of dollars in tax debt.

Although the levy program could provide a highly effective and efficient method of collecting unpaid taxes from contractors that receive federal payments, IRS policies restrict the number of cases that enter the program and the point in the collection process they enter the program. For each of

[10] U.S. General Accounting Office, *Tax Administration: Federal Payment Levy Program Measure, Performance, and Equity Can Be Improved*, GAO-03-356 (Washington, D.C.: Mar. 6, 2003).

[11] U.S. General Accounting Office, *Tax Administration: IRS' Levy of Federal Payments Could Generate Millions of Dollars*, GAO/GGD-00-65 (Washington, D.C.: Apr. 7, 2000), GAO-03-356, and GAO-01-711.

the collection phases listed below, IRS policy either excludes or severely delays putting cases into the levy program.

- **Phase 1:** Notify taxpayer of unpaid taxes, including a demand for payment letter.
- **Phase 2:** Place the case into the Automated Collection System (ACS) process. The ACS process consists primarily of telephone calls to the taxpayer to arrange for payment.
- **Phase 3:** Move the case into a queue of cases awaiting assignment to a field collection revenue officer.
- **Phase 4:** Assign the case to field collections where a revenue officer attempts face-to-face contact and collection.

As of September 30, 2002, IRS listed $81 billion of cases in these four phases: 17 percent were in notice status, 17 percent were in ACS, 26 percent were in field collection, and 40 percent were in the queue awaiting assignment to the field. At the same time these four phases take place, sometimes over the course of years, DOD contractors with unpaid taxes continue to receive billions of dollars in contract payments. IRS excludes cases in the notification phase from the levy program to ensure proper notification rules are followed. However, as we previously reported, once proper notification has been completed, IRS continues to delay or exclude from the levy program those accounts placed in the other three phases.[12] IRS policy is to exclude accounts in the ACS phase primarily because officials believed they lack the resources to issue levy notices and respond to the potential increase in telephone calls from taxpayers responding to the notices. Additionally, IRS excludes the majority of cases in the queue phase (awaiting assignment to field collection) from the levy program for 1 year. Only after cases await assignment for over a year does IRS allow them to enter the levy program. Finally, IRS excludes most accounts from the levy program once they are assigned to field collection because revenue officers said that the levy action could interfere with their successfully contacting taxpayers and resolving the unpaid taxes.

These policy decisions, which may be justified in some cases, result in IRS excluding millions of cases from potential levy. IRS officials that work on

[12] GAO-03-356.

ACS and field collection inventories can manually unblock individual cases they are working in order to put them in the levy program. However, by excluding cases in the ACS and field collection phases, IRS records indicate it excluded as much as $34 billion of cases from the levy program as of September 30, 2002. In January 2003, IRS unblocked and made available for levy those accounts identified as receiving federal salary or annuity payments. However, other accounts remain blocked from the levy program. IRS stated that it intended to unblock a portion of the remaining accounts sometime in 2005. Additionally, $32 billion of cases are in the queue, and thus under existing policy would be excluded from the levy program for the first year each case is in that phase. IRS policies, along with its inability to more actively pursue collections, both of which IRS has in the past attributed to resource constraints, combine to prevent many cases from entering the levy program. Since IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally limited to 10 years from the date of the assessment, these long delays greatly decrease the potential for IRS to collect the unpaid taxes.

We identified specific examples of IRS not actively pursuing collection in our review of 47 selected cases involving DOD contractors. In one case, IRS cited resource and workload management considerations. IRS is not currently seeking collection of about $14.9 billion of unpaid taxes citing these considerations–about 5 percent of its overall inventory of unpaid assessments as of September 30, 2002. In another case, IRS cited financial hardship where the taxpayer was unable to pay. This puts collection activities on hold until the taxpayer's adjusted gross income (per subsequent tax return filings) exceeds a certain threshold. Some cases repeatedly entered the queue awaiting assignment to a field collection revenue officer and remained there for long periods.

IRS Delays in Processing and Inaccurate Records Exclude Cases from the Levy Program

In addition to excluding cases for various operational and policy reasons as described above, IRS excludes cases from the levy program for particular taxpayer events such as bankruptcy, litigation, or financial hardship, as well as when taxpayers apply for an installment agreement or an offer in compromise. When one of these events take place, IRS enters a code in its automated system that excludes the case from entering the levy program. Although these actions are appropriate, IRS may lose opportunities to collect through the levy program if the processing of agreements is not timely or prompt action is not taken to cancel the exclusion when the event, such as a dismissed bankruptcy petition, is concluded.

Delays in processing taxpayer documents and errors in taxpayer records are long-standing problems at IRS and can harm both government interests and the taxpayer. Our review of cases involving DOD contractors with unpaid federal taxes indicates that problems persist in the timeliness of processing taxpayer applications and in the accuracy of IRS records. For example, we identified a number of cases in which the processing of DOD contractor applications for an offer in compromise or an installment agreement was delayed for long periods, thus blocking the cases from the levy program and potentially reducing government collections. We also found that inaccurate coding at times prevented both IRS collection action and cases from entering the levy program. For example, if these blocking codes 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.

IRS Subordinates Use of the Levy Program to Other Collection Efforts

Although the nation's tax system is built upon voluntary compliance, when businesses and individuals fail to pay voluntarily, the government has a number of enforcement tools to compel compliance or elicit payment. Our review of DOD contractors with unpaid federal taxes indicates that although the levy program could be an effective, reliable collection tool, IRS is not using the program as a primary tool for collecting unpaid taxes from federal contractors. For the cases we audited and investigated, IRS subordinated the use of the levy program in favor of negotiating voluntary tax compliance with the DOD contractors, which often resulted in minimal or no actual collections.

DOD Contractors Involved in Abusive or Potentially Criminal Activity Related to the Federal Tax System

We selected for case study 47 businesses and individuals that had unpaid taxes and were receiving DOD contractor payments in fiscal year 2002. For all 47 cases that we audited and investigated, we found abusive or potentially criminal activity related to the federal tax system. Thirty-four of these case studies involved businesses with employees that had unpaid payroll taxes dating as far back as the early 1990s, some for as many as 62 tax periods. However, rather than fulfill their role as "trustees" of this money and forward it to IRS, these DOD contractors diverted the money for other purposes. The other 13 case studies involved individuals that had unpaid income taxes dating as far back as the 1980s. We are referring the 47 cases detailed in our related report to IRS for evaluation and additional collection action or criminal investigation.

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

Our audit and investigation of the 34 case study business contractors showed substantial abuse or potential criminal activity as all had unpaid payroll taxes and all diverted funds for personal or business use. In table 1, and on the following pages, we highlight 13 of these businesses and estimate the amounts that could have been collected through the levy program based on fiscal year 2002 DOD payments. For these 13 cases, the businesses owed unpaid taxes for a range of 6 to 30 quarters (tax periods). Eleven of these cases involved businesses that had unpaid taxes in excess of 10 tax periods, and 5 of these were in excess of 20 tax periods. The amount of unpaid taxes associated with these 13 cases ranged from about $150,000 to nearly $10 million; 7 businesses owed in excess of $1 million. In these 13 cases, we saw some cases where IRS filed tax liens on property and bank accounts of the businesses, and a few cases where IRS collected minor amounts through the levying of non-DOD federal payments. We also saw 1 case in which the business applied for an offer in compromise, which IRS rejected on the grounds that the business had the financial resources to pay the outstanding taxes in their entirety, and 2 cases in which the businesses entered into, and subsequently defaulted on, installment agreements to pay the outstanding taxes. In 5 of the 13 cases, IRS assessed the owners or business officers with TFRPs, yet no collections were received from these penalty assessments.

Table 1: DOD Contractors with Unpaid Federal Taxes—Business

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
1	*Base support and custodial services:* provides dining, trash removal, security, cleaning, and recycling programs on military bases	Nearly $10 million	$527,000	$3.5 million	State tax authorities levied the business bank account. The owner borrowed nearly $1 million from the business. The owner bought a boat, several cars, and a home outside the United States. The business was dissolved in 2003 and transferred its employees to a relative's business, where it submitted invoices and received payments from DOD on a previous contract through August 2003.
2	*Engineering research services:* conducts studies for DOD	Over $1 million	$58,000	$390,000	The owner paid $1 million to purchase a house and furnishings in the mid-1990s. At around the same time, the owner borrowed nearly $1 million from the business, and the business stopped paying its taxes in full. DOD awarded the business contracts totaling over $600,000.
3	*Aircraft-related goods:* manufactures structural parts for DOD aircraft	Nearly $2 million	$50,000	$336,000	The business received over 30 DOD contracts from 1997 through 2002 totaling nearly $2 million.
4	*Research services:* provides research for DOD	Over $700,000	$13,000	$86,000	DOD awarded the business a contract in 2002 for nearly $800,000. Owner has over $1 million in loans related to cars, real estate, and recreational activities, and owner also has a high-performance airplane.
5	*Janitorial services:* provides custodial services at a DOD facility	Over $3 million	$108,000	$719,000	The business did not make tax payments after early 2001, and it made only partial payments prior to that dating back to the mid-1990s. The business also did not file corporate tax returns for 8 years.
6	*Private security services:* provides security guards at military bases	Nearly $6 million	$3,000	$21,000	One of the business's officers, who owns a large boat, paid off a recreation-related loan in 1999. The business paid taxes while in bankruptcy, but largely stopped paying after emerging from bankruptcy.
7	*Furniture sales and construction services:* sells and installs office furniture at military installations	Over $150,000	$6,000	$38,000	The owners used the business to pay personal expenses, such as house mortgage and credit cards. One owner is a retired military officer.
8	*Custodial services:* provides janitorial and housekeeping services at military installations	Over $800,000	$219,000	$1.5 million	The business received numerous DOD contracts from 1998 through 2001 totaling nearly $12 million. The business is linked to potential check fraud.

(Continued From Previous Page)

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
9	*Construction services:* provides housing management services, including maintenance, repairs, and renovations, on military bases	Over $1 million	$357,000	$2.4 million	The business owes DOD tens of thousands of dollars for an overpayment in early 2000.
10	*Base support services:* provides landscaping and snow removal at a military base	Nearly $1 million	$33,000	$217,000	The business was awarded contracts from 1999 through 2000 worth over $1 million. The business owes taxes dating back to the early 1990s.
11	*Construction services:* provides repairs to aircraft hangars at a military base	Over $700,000	$422,000	$2.8 million	
12	*Medical personnel services:* provides nursing, pharmacy, physical therapy, and other skilled medical personnel in DOD facilities	Nearly $6 million	$698,000	$4.7 million	Several federal and state tax liens have been placed against the owner.
13	*Aircraft-related goods:* manufactures aircraft components for several DOD and civilian programs	Over $400,000	$29,000	$194,000	The business was awarded numerous DOD contracts in a recent 4-year period totaling over $300,000.

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

Notes: Dollar amounts are rounded. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole proprietorship).

[a]Unpaid tax amount as of September 30, 2002.

[b]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[c]DOD payments from MOCAS, One Bill Pay, Integrated Accounts Payable System (IAPS), Computerized Accounts Payable System (CAPS) Clipper, and CAPS Windows automated systems identified by GAO.

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

- **Case # 1** - This base support contractor provided services such as trash removal, building cleaning, and security at U.S. military bases. The

business had revenues of over $40 million in 1 year, with over 25 percent of this coming from federal agencies. This business's outstanding tax obligations consisted of unpaid payroll taxes. In addition, the contractor defaulted on an IRS installment agreement. IRS assessed a TFRP against the owner. The business reported that it paid the owner a six figure income and that the owner had borrowed nearly $1 million from the business. The business also made a down payment for the owner's boat and bought several cars and a home outside the country. The owner allegedly has now relocated his cars and boat outside the United States. This contractor went out of business in 2003 after state tax authorities seized its bank account. The business transferred its employees to a relative's business, which also had unpaid federal taxes, and submitted invoices and received payments from DOD on a previous contract through August 2003.

- **Case # 2** - This engineering research contractor received nearly $400,000 from DOD during 2002. At the time of our audit, the contractor had not remitted its payroll tax withholdings to the federal government since the late 1990s. In 1996, the owner bought a home and furnishings worth approximately $1 million and borrowed nearly $1 million from the business. The owner told our investigators that the payroll tax funds were used for other business purposes.

- **Case # 3** - This aircraft parts manufacturer did not pay payroll withholding and unemployment taxes for 19 of 20 periods through the mid- to late 1990s. IRS assessed a TFRP against several corporate officers, and placed the business in the FPLP in 2000. This business claims that its payroll taxes were not paid because the business had not received DOD contract payments; however, DOD records show that the business received over $300,000 from DOD during 2002.

- **Case # 5** - This janitorial services contractor reported revenues of over $3 million and had received over $700,000 from DOD in a recent year. The tax problems of this business date back to the mid-1990s. At the time of our audit, the business had both unpaid payroll and unemployment taxes of nearly $3 million. In addition, the business did not file its corporate tax returns for 8 years. IRS assessed a TFRP against the principal officer of the business in early 2002. This contractor employed two officers who had been previously assessed TFRPs related to another business.

- **Case # 7** - This furniture business reported gross revenues of over $200,000 and was paid nearly $40,000 by DOD in a recent year. The business had accumulated unpaid federal taxes of over $100,000 at the time of our audit, primarily from unpaid employee payroll taxes. The business also did not file tax returns for several years, even after repeated notices from IRS. The owners made an offer to pay IRS a portion of the unpaid taxes through an offer in compromise, but IRS rejected the offer because it concluded that the business and its owners had the resources to pay the entire amount. At the time of our audit, IRS was considering assessing a TFRP against the owners to make them personally liable for the taxes the business owed. The owners used the business to pay their personal expenses, such as their home mortgage, utilities, and credit cards. The owners said they considered these payments a loan from the business. Under this arrangement, the owners were not reporting this company benefit as income so they were not paying income taxes, and the business was reporting inflated expenses.

- **Case # 9** - This family-owned and operated building contractor provided a variety of products and services to DOD, and DOD provided a substantial portion of the contractor's revenues. At the time of our review, the business had unpaid payroll taxes dating back several years. In addition to failing to remit the payroll taxes it withheld from employees, the business had a history of filing tax returns late, sometimes only after repeated IRS contact. Additionally, DOD made an overpayment to the contractor for tens of thousands of dollars. Subsequently, DOD paid the contractor over $2 million without offsetting the earlier overpayment.

- **Case # 10** - This base support services contractor has close to $1 million in unpaid payroll and unemployment taxes dating back to the early 1990s, and the business has paid less than 50 percent of the taxes it owed. IRS assessed a TFRP against one of the corporate officers. This contractor received over $200,000 from DOD during 2002.

Examples of Abuse of the Federal Tax System by Individuals

Individuals are responsible for the payment of income taxes, and our audit and investigation of 13 individuals showed significant abuse of the federal tax system similar to what we found with our DOD business case studies. In table 2, and on the following pages, we highlight four of the individual case studies. In all four cases, the individuals had unpaid income taxes. In one of the four cases, the individual operated a business as a sole proprietorship with employees and had unpaid payroll taxes. Taxes owed

by the individuals ranged from four to nine tax periods, which equated to years. Each individual owed in excess of $100,000 in unpaid income taxes, with one owing in excess of $200,000. In two of the four cases, the individuals had entered into, and subsequently defaulted on, at least one installment agreement to pay off the tax debt.

Table 2: DOD Contractors with Unpaid Federal Taxes—Individual

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
14	*Vehicle repair services:* provides repair and painting for military vehicles	Over $100,000	$22,000	$147,000	The business was investigated for paying employee wages in cash. Despite a substantial tax liability, the owner recently purchased a home valued at over $1 million as well as a luxury sports car. The owner also owes a federal agency for child support.
15	*Dentist:* provides dental services at military facility	Over $100,000	$12,000	$78,000	DOD recently increased the individual's contract by over $80,000. The dentist's credit history included several credit card accounts that were identified for collection action.
16	*Dentist:* provides dental services at military facility	Over $200,000	$11,000	$76,000	DOD awarded the individual a multiyear contract for over $400,000. This individual paid income tax for only 1 year since 1993. The individual previously had a business that owes over $100,000 in unpaid payroll and unemployment taxes going back to the early 1990s.
17	*Training services:* conducts management and leadership courses	Over $100,000	$2,000	$12,000	This individual has not paid income taxes for 5 years.

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

Notes: Dollar amounts are rounded. Nature of unpaid taxes for individuals was primarily due to unpaid income taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole proprietorship). For cases selected as individuals, we reviewed both the owner and related business information, if it could be identified.

[a]Unpaid tax amount as of September 30, 2002.

[b]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[c]DOD payments from MOCAS, One Bill Pay, IAPS, and CAPS automated systems identified by GAO.

The following provides illustrative detailed information on these four cases.

- **Case # 14** - This individual's business repaired and painted military vehicles. The owner failed to pay personal income taxes and did not send employee payroll tax withholdings to IRS. The owner owed over $500,000 in unpaid federal business and individual taxes. Additionally, the TOP database showed the owner had unpaid child support. IRS levied the owner's bank accounts and placed liens against the owner's real property and business assets. The business received over $100,000 in payments from DOD in a recent year, and the contractor's current DOD contracts are valued at over $60 million. In addition, the business was investigated for paying employee wages in cash. Despite the large tax liability, the owner purchased a home valued at over $1 million and a luxury sports car.

- **Case # 15** - This individual, who is an independent contractor and works as a dentist at a military installation, had a long history of not paying income taxes. The individual did not file several tax returns and did not pay taxes in other periods when a return was filed. The individual entered into an installment agreement with IRS but defaulted on the agreement. This individual received $78,000 from DOD during a recent year, and DOD recently increased the individual's contract by over $80,000.

- **Case # 16** - This individual is another independent contractor who also works as a dentist on a military installation. DOD paid this individual over $200,000 in recent years, and recently signed a multiyear contract worth over $400,000. At the time of our review, this individual had paid income taxes for only 1 year since the early 1990s and had accumulated unpaid taxes of several hundred thousand dollars. In addition, the individual's prior business practice owes over $100,000 in payroll and unemployment taxes for multiple periods going back to the early 1990s.

- **Case # 17** - DOD paid this individual nearly $90,000 for presenting motivational speeches on management and leadership. This individual has failed to file tax returns since the late 1990s and had unpaid income taxes for a 5-year period from the early to mid-1990s. The total amount of unpaid taxes owed by this individual is not known because of the individual's failure to file income tax returns for a number of years. IRS placed this individual in the levy program in late 2000; however, DOD

payments to this individual were not levied because DFAS payment information was not reported to TOP as required.

See our related report[13] for details on the other 30 DOD contractor case studies.

Contractors with Unpaid Taxes Are Not Prohibited by Law from Receiving Contracts from the Federal Government

Federal law does not prohibit a contractor with unpaid federal taxes from receiving contracts from the federal government. Existing mechanisms for doing business only with responsible contractors do not prevent businesses and individuals with unpaid federal taxes from receiving contracts. Further, the government has no coordinated process for identifying and determining the businesses and individuals with unpaid taxes that should be prevented from receiving contracts and for conveying that information to contracting officers before awarding contracts.

In previous work, we supported the concept of barring delinquent taxpayers from receiving federal contracts, loans and loan guarantees, and insurance. In March 1992, we testified on the difficulties involved in using tax compliance as a prerequisite for awarding federal contracts.[14] In May 2000, we testified in support of H.R. 4181 (106th Congress), which would have amended DCIA to prohibit delinquent federal debtors, including delinquent taxpayers, from being eligible to contract with federal agencies.[15] Safeguards in the bill would have enabled the federal government to procure goods or services it needed from delinquent taxpayers for designated disaster relief or national security. Our testimony also pointed out implementation issues, such as the need to first ensure that IRS systems provide timely and accurate data on the status of taxpayer accounts. However, this legislative proposal was not adopted and there is no existing statutory bar on delinquent taxpayers receiving federal contracts.

[13] GAO-04-95.

[14] U.S. General Accounting Office, *Tax Administration: Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season*, GAO/T-GGD-92-23 (Washington, D.C.: Mar. 17, 1992).

[15] U.S. General Accounting Office, *Debt Collection: Barring Delinquent Taxpayers From Receiving Federal Contracts and Loan Assistance*, GAO/T-GGD/AIMD-00-167 (Washington, D.C.: May 9, 2000).

Federal agencies are required by law to award contracts to responsible sources.[16] This statutory requirement is implemented in the FAR, which requires that government purchases be made from, and government contracts awarded to, responsible contractors only.[17] To effectuate this policy, the government has established a debarment and suspension process and established certain criteria for contracting officers to consider in determining a prospective contractor's responsibility. Contractors debarred, suspended, or proposed for debarment are excluded from receiving contracts and agencies are prohibited from soliciting offers from, awarding contracts to, or consenting to subcontracts with these contractors, unless compelling reasons exist. Prior to award, contracting officers are required to check a governmentwide list of parties that have been debarred, suspended, or declared ineligible for government contracts,[18] as well as to review a prospective contractor's certification[19] on debarment, suspension, and other responsibility matters. Among the causes for debarment and suspension is tax evasion.[20] In determining whether a prospective contractor is responsible, contracting officers are also required to determine that the contractor meets several specified standards, including "a satisfactory record of integrity and business ethics." Except for a brief period during 2000 through 2001, contracting officers have not been required to consider compliance with federal tax laws in making responsibility determinations.[21]

[16] 10 U.S.C. § 2305 (b) and 41 U.S.C. § 253b (2000).

[17] 48 C.F.R. § 9.103 (a).

[18] Contractors included on the list as having been declared ineligible on the basis of statutory or regulatory procedures are excluded from receiving contracts under the conditions and for the period set forth in the statute or regulation. Agencies are prohibited from soliciting offers from, awarding contracts to, or consenting to subcontracts with these contractors under these conditions and for that period.

[19] Such certification is required only for contracts exceeding the simplified acquisition threshold.

[20] The government may suspend a contractor suspected of tax evasion, upon adequate evidence, and debar a contractor for a conviction or civil judgment for commission of tax evasion. Further, prospective contractors are required to certify in their bids or proposals whether they or their principals, within the preceding 3 years, were convicted or had civil judgments rendered against them for commission of tax evasion, and whether they or their principals are presently indicted or otherwise criminally or civilly charged with commission of tax evasion.

Neither the current debarment and suspension process nor the requirements for considering contractor responsibility effectively prevent the award of government contracts to businesses and individuals that abuse the tax system. Since most businesses and individuals with unpaid taxes are not charged with tax evasion, and fewer still convicted, these contractors would not necessarily be subject to the debarment and suspension process. None of the contractors described in this report were charged with tax evasion for the abuses of the tax system we identified.

A prospective contractor's tax noncompliance, other than tax evasion, is not considered by the federal government before deciding whether to award a contract to a business or individual. Further, no coordinated and independent mechanism exists for contracting officers to obtain accurate information on contractors that abuse the tax system. Such information is not obtainable from IRS because of a statutory restriction on disclosure of taxpayer information.[22] As we found in November 2002,[23] unless reported by prospective contractors themselves, contracting officers face significant difficulties obtaining or verifying tax compliance information on prospective contractors.

[21] In December 2000, a controversial revision to the FAR was issued that required contracting officers to consider a prospective contractor's compliance with several areas of law, including tax, in determining a satisfactory record of integrity and business ethics. This revision was revoked in December 2001 after having been effectively suspended for many federal agencies earlier in 2001.

[22] 26 U.S.C. § 6103 (2000).

[23] U.S. General Accounting Office, *Government Contracting: Adjudicated Violations of Certain Laws by Federal Contractors*, GAO-03-163 (Washington, D.C.: Nov. 15, 2002).

Moreover, even if a contracting officer could obtain tax compliance information on prospective contractors, a determination of a prospective contractor's responsibility under the FAR when a contractor abused the tax system is still subject to a contracting officer's individual judgment. Thus, a business or individual with unpaid taxes could be determined to be responsible depending on the facts and circumstances of the case. Since the responsibility determination is largely committed to the contracting officer's discretion and depends on the contracting situation involved, there is the risk that different determinations could be reached on the basis of the same tax compliance information. On the other hand, if a prospective contractor's tax noncompliance results in mechanical determinations of nonresponsibility, de facto debarment could result. Further, a determination that a prospective contractor is not responsible under the FAR could be challenged.[24]

Because individual responsibility determinations can be affected by a number of variables, any implementation of a policy designed to consider tax compliance in the contract award process may be more suitably addressed on a governmentwide basis. The formulation and implementation of such a policy may most appropriately be the role of OMB's Office of Federal Procurement Policy. The Administrator of Federal Procurement Policy provides overall direction for governmentwide procurement policies, regulations, and procedures. In this regard, OMB's Office of Federal Procurement Policy is in the best position to develop and pursue policy options for prohibiting federal contract awards to businesses and individuals that abuse the tax system.

Concluding Comments

Thousands of DOD contractors that failed in their responsibility to pay taxes continue to get federal contracts. Allowing these contractors to do substantial business with the federal government while not paying their federal taxes creates an unfair competitive advantage for these businesses and individuals at the expense of the vast majority of DOD contractors that do pay their taxes. DOD's failure to fully comply with DCIA and IRS's continuing challenges in collecting unpaid taxes have contributed to this

[24] For example, if the prospective contractor is a small business, the nonresponsibility determination would be reviewed by the Small Business Administration, which could issue a Certificate of Competency stating that the prospective contractor is responsible for the purpose of receiving and performing a specific government contract. A determination of nonresponsibility could also be protested through the bid protest process.

unacceptable situation, and have resulted in the federal government missing the opportunity to collect hundreds of millions of dollars in unpaid taxes from DOD contractors. Working closely with IRS and Treasury, DOD needs to take immediate action to comply with DCIA and thus assist in effectively implementing IRS's legislative authority to levy contract payments for unpaid federal taxes. Also, IRS needs to better leverage its ability to levy DOD contractor payments, moving quickly to use this important collection tool. Beyond DOD, the federal government needs a coordinated process for dealing with contractors that abuse the federal tax system, including taking actions to prevent these businesses and individuals from receiving federal contracts.

Our related report on these issues released today includes nine recommendations to DOD, IRS, and OMB. Our DOD recommendations address the need to comply with the DCIA by supporting IRS efforts under the Taxpayer Relief Act of 1997 to collect unpaid federal taxes. Our IRS recommendations address improving the effectiveness of IRS collection activities through earlier use of the Federal Payment Levy Program and changing or eliminating policies that prevent businesses and individuals with federal contracts from entering the levy program. Our OMB recommendation addresses developing and pursuing policy options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system. In written comments on a draft of our report, DOD and IRS officials partially agreed with our recommendations. OMB officials did not agree with our recommendation to develop policy options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system.

Our report also suggests that Congress consider requiring DOD to periodically report to Congress on progress in providing its payment information to TOP for each of its contract and vendor payment systems, including details of the resulting collections by system and in total for all contract and vendor payment systems during the reporting period. In addition, our report suggests that Congress consider requiring that OMB report to Congress on progress in developing and pursuing options for prohibiting federal government contract awards to businesses and individuals that abuse the federal tax system, including periodic reporting of actions taken. DOD and OMB did not agree with our matters for congressional consideration.

We continue to believe all of our recommendations and matters for congressional consideration constitute valid and necessary courses of

action, especially in light of the identified weaknesses and the slow progress of DOD to fully implement the offset provisions of the DCIA since its passage more than 7 years ago.

Mr. Chairman, Members of the Subcommittee, and Ms. Schakowsky, this concludes our prepared statement. We would be pleased to answer any questions you may have.

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PRINTED ON RECYCLED PAPER

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

INTRODUCTION AND SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

What will this extra $300 million do?

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

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

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

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

COLLECTING TAXES FROM DELINQUENT CONTRACTORS

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

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

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

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

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

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

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

FEDERAL PAYMENT LEVY PROGRAM

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

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

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

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

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

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

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

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

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

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

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

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

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

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

FILING AND PAYMENT COMPLIANCE (F&PC) MODERNIZATION

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

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

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

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

COLLECTION CHALLENGES AND EARLY PREVENTION

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

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

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

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

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

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

TAXPAYER PROTECTION AFFECTING ACCOUNTS ELIGIBLE FOR FPLP

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

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

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

- Section 6330 generally prohibits the use of any levy (including continuous levies by FMS as part of the FPLP) unless the IRS has notified the taxpayer of his or her right to a Collection Due Process (CDP) hearing. If the taxpayer requests a CDP hearing, then the proposed levy cannot proceed until the resolution of that hearing, which may involve judicial review. The IRS must give taxpayers an opportunity to respond to the CDP notice, and suspends levy action during this period, even if the taxpayer ultimately does not request a CDP hearing.

- Section 6331(k) generally prohibits levy action when a taxpayer has proposed to compromise a tax liability or seeks to enter into an installment agreement. A taxpayer may appeal the rejection of an offer in compromise or proposed installment agreement to the IRS Office of Appeals, and the prohibition on levy continues while this appeal is pending.

- Section 6331(i) prohibits the making of levies during the period that a taxpayer's refund suit for a divisible tax (such as employment taxes) is pending in federal district court. Thus, if such a suit were pending with respect to employment taxes relating to a particular employee and a particular tax period , the IRS generally could not commence a levy to collect from that employer. In some cases, the IRS will be prohibited from collecting unpaid

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

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

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

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

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

CONCLUSION

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

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

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

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

Statement of Commissioner Richard L. Gregg
Financial Management Service – U.S. Department of the Treasury
Before the Permanent Subcommittee on Investigations
Senate Committee on Governmental Affairs
February 12, 2004
Collecting Federal Tax Debts Owed by Department of Defense Contractors

Mr. Chairman, Senator Levin, and Members of the Subcommittee:

Thank you for inviting me to discuss the role of the Financial Management Service (FMS) in collecting unpaid federal taxes that are owed by Department of Defense (DOD) contractors. Treasury appreciates your focusing attention on government financial management issues.

FMS is the Treasury bureau charged with broad financial management responsibilities – including disbursing payments, collecting revenue, and maintaining the government's accounts. I welcome the opportunity today to acquaint the Committee with FMS' fourth business line – the collection of delinquent debts owed to the government, both non-tax and tax.

The Debt Collection Improvement Act of 1996 is the principal law under which FMS collects non-tax debts owed to federal agencies. Our collections are accomplished through two programs – the Treasury Offset Program (TOP) and the Cross-Servicing Program. TOP is our largest collection program and is directly linked to payment disbursements. Through TOP, FMS reduces the amounts of individuals' or businesses' federal payments disbursed by Treasury and other agencies to satisfy delinquent debts. Types of payments include benefit payments paid on behalf of the Social Security

Administration, Office of Personnel Management (OPM) retirement payments, federal income tax refund payments, and payments to businesses (vendor payments) for goods and services provided to the federal government. A reduction, or "offset", occurs if the name and taxpayer identifying number of a debtor included in the TOP database is matched against the name and taxpayer identifying number of a federal payment recipient. The TOP debtor information is supplied by the agencies to which the debts are owed. Under the Cross-Servicing Program, delinquent debts that are referred to FMS by federal agencies are collected using a variety of means. This includes offsetting payments through TOP, sending demand letters to debtors, garnishing wages administratively, and contracting for the services of private collection agencies.

The recent General Accounting Office report notes that FMS also has a key role in the collection of federal tax debts. In partnership with FMS, the Internal Revenue Service (IRS) collects unpaid federal income taxes through the continuous levy of certain federal payments disbursed by FMS. Vendor, federal employee salary, OPM retirement, and Social Security benefit payments are among those that are levied continuously at a rate of up to 15 percent until a debt is satisfied. This is accomplished through an automated process using the TOP system. If there is a match between IRS tax debts and FMS payment records, IRS initiates a process whereby the debtor is given a minimum of 30 days to make payment arrangements, appeal the proposed levy action, or apply for a hardship determination. The levy of a payment occurs only after IRS completes its due-process notifications and directs FMS to levy future payments. The continuous levy program is authorized under the Taxpayer Relief Act of 1997.

I spoke earlier of the link between TOP and payment disbursements. While Treasury is the primary disburser (85 percent or nearly one billion payments annually with an associated dollar value of more than $1.5 trillion) – other agencies, including DOD and the U.S. Postal Service, have payment disbursement authority, either by statute or by delegation. These agencies, which disburse payments such as salary and vendor, began matching their payments against FMS' TOP debtor database in 2002. Individuals or businesses receiving these non-Treasury disbursed payments may also have their payments levied if they owe tax debts, and would be afforded the same due process as those receiving a Treasury disbursed payment. Routinely, we work with our partner agencies on debt collection issues by providing information and making recommendations for enhancing collections. As an example, we have been working with DOD and IRS for some time on ways that are tailored to their specific needs to improve collections. In the case of DOD, the existing program is designed in such a way that their contractors may either have their payments offset if they owe non-tax debts or levied if they owe tax debts. At present, payments disbursed through two of DOD's contract pay systems are being matched against TOP data for both offset and levy purposes. I have been advised that, in the coming months, DOD expects to begin matching vendor payments it disburses through its remaining systems. For our part, FMS is working closely with DOD and we are well prepared to assume the additional workload.

Mr. Chairman, Treasury views debt collection as an important financial management tool. Moreover, collecting money owed to the government is in close alignment with one

of the government-wide initiatives under the President's Management Agenda – improved financial performance. Along these lines, you may be interested to know that the President's 2005 budget includes proposals to further improve the federal government's collection of delinquent debts. One of these proposals would increase the continuous levy on federal vendor payments from the current 15 percent to 100 percent. Unlike many federal payments such as salary, retirement, and benefit payments, vendor payments are not recurring payments and thus present fewer opportunities for collection. This levy increase would not affect the administrative processes already in place that give the debtor 30 days to make payment arrangements, appeal the levy action, or apply for a hardship determination.

We believe that devoting resources to debt collection is both wise and of enormous benefit to agencies in managing their budget accounts and producing accurate financial statements. As you can see in the chart attached to my statement, FMS' debt programs have resulted in the collection of more than $18 billion since 1997. Our success can be attributed, in large part, to having the expertise, infrastructure and cooperative working relations required to collect the millions of outstanding debts. At the same time, we recognize that there are always opportunities to improve and refine our programs. For example, to help maximize the potential of the levy program, we are actively engaged with IRS in examining the feasibility of making two significant improvements. First, we are discussing ways to increase the number of tax debts in TOP that can be actively collected following the completion of IRS due process notifications. Under this approach, IRS may consider ways to provide due process to delinquent taxpayers before,

not after, the tax debts are transmitted to TOP. Presently, payments to DOD contractors, many of which are one-time payments, have already been disbursed by the time the due process is completed. Modifying the due process timing would ensure that the payments being disbursed to DOD contractors who are identified as delinquent tax debtors can be levied immediately. We welcome the opportunity to work with DOD and the IRS to devise procedures that address this issue. Second, we are exploring with IRS ways to improve the accuracy of the information pertaining to taxpayer identification numbers (TINs), names, and addresses contained in DOD's central contractor registration database. IRS advises, however, that there may be legal impediments under current law concerning the circumstances under which TIN matching may be used by the IRS, the information the IRS may disclose as a result of TIN matching, and to whom the information may be disclosed. If these important issues can be addressed, we would anticipate increased matches of delinquent tax debts with vendor payments to those same debtors. Increased matches would likely result in increased levy collections through TOP.

Once more, I appreciate the opportunity to discuss FMS' work in the debt collection arena. I would be happy to answer any questions.

Debt Collection Performance Summary

Collections through Treasury Offset Program	Collections in Fiscal Year 2003	Collections Since 1997
Tax Refunds – Child Support	$1.42 billion	$9.3 billion
Tax Refunds – Non-Tax Debts	$1.02 billion	$7.2 billion
Tax Refunds – State Income Tax	$152 million	$383 million
Administrative Offsets of Other Payments (SSA, OPM, vendor, salary)	$88.3 million	$247 million
Tax Levy	$89.2 million	$185.7 million
➢ Office of Personnel Management Annuity	$6.1 million	$18.7 million
➢ Social Security Administration Benefits	$74.5 million	$133.3 million
➢ Federal Salaries	$1.6 million	$3.2 million
➢ Vendor Payments	$6.4 million	$29.6 million
➢ DOD Vendor Payments	$.68 million	$.9 million
Advanced Refund Credit Payments		$465 million
Child Tax Credit Payments	$207 million	$207 million
Total for TOP	$2.99 billion	$17.98 billion
Collections through Cross-Servicing		
	$108 Million	$316 million
TOTAL COLLECTIONS	$3.1 billion	$18.3 billion

Statement of Larry J. Lanzillotta
Principal Deputy Under Secretary of Defense (Comptroller) and
Deputy Under Secretary of Defense for Management Reform
Before the Senate Committee on Governmental Affairs
Permanent Subcommittee on Investigations
12 February 2004

Mr. Chairman and members of the Committee, I am pleased to be here to discuss the Department of Defense (DoD) program for offsetting payments to commercial entities that have either tax or non-tax debts owed to the federal government.

Even though the collection of federal debts is not a primary mission of the Department of Defense, it is an important and inherent management responsibility. It is part of our DoD leadership's resolve to exercise strong stewardship of the taxpayer dollars appropriated to us. We want to thank this committee and the General Accounting Office (GAO) for focusing on how we can improve this component of our stewardship. The Department of Defense agrees with the four GAO report recommendations and is taking action to address the report's findings.

Status of DoD Levy Program

Since 1991 DoD has been partnering with the IRS to levy, i.e. offset commercial payments to collect federal debts through a manual process involving what we call paper levies. In July 2000, the IRS, in conjunction with the Financial Management Service (FMS), started the Federal Payment Levy Program (FPLP). This program provides for the collection of federal debts through continuous levy on commercial payments. In 2001, DoD began working with the FMS to participate in the program.

In October 2002, DoD began providing its database on pending commercial payments to FMS for matching against the Treasury Offset Program (TOP) database, which includes both federal tax debt and non-tax debt. In December 2002, we began taking offsets.

The Department currently provides a commercial payments database only for its largest commercial pay system, the Mechanization of Contract Administration Services (MOCAS) system, and does this once a week. (The Department of Defense uses the term "commercial pay systems" to encompass both contractor pay systems and vendor pay systems.)

As of January 31, 2004, DoD had collected about $2.1 million through offsets. This $2.1 million collection is far below what should be achievable. Increasing this performance

requires changes not only within the Department but also changes in partnership with other agencies -- to include possible legislative changes.

The primary challenge is to better identify, through automation, those DoD contractors whose payments should be offset because of their federal debts. When DoD receives notification that a contractor is indebted to the U.S. government and its payments are subject to levy, we have little trouble executing the prescribed offset.

Short-Term DoD Actions and Changes

DoD is advancing several actions and changes to improve its federal levy performance.

Procedures. We are refining our procedures for federal levies to ensure they are as streamlined and efficient as possible.

Central point of contact. We have clarified with the IRS and Treasury that the Department's central point of contact for executing levies is the Defense Finance and Accounting Service (DFAS) - specifically its Contract Payment Center in Columbus, Ohio. This will enable a single office to handle levies for all DoD commercial pay systems.

More frequent TOP checks. Instead of once a week, the Department will twice weekly provide its database to FMS and evaluate whether an even greater frequency has merit.

Resources. Consistent with the GAO's recommendation, the Department will continue to devote sufficient resources to implement all aspects of its formal plan to improve its levy performance.

Long-Term Changes and Issues

The Department is pursuing several long-term changes, some involving other agencies.

Further automation. We are expanding our DoD automated levy process beyond MOCAS to the rest of the Department's commercial pay systems. We have an additional 19 commercial pay systems that could be matched to the TOP database using the new automated system. We are currently working with the Treasury to include these systems in the continuous offset program. This expanded automation should be completed by March,

2005. This action meets the GAO recommendation that DoD develop a formal plan for providing payment information to the TOP for all its commercial pay systems.

This full automation is the Department's main focus for improving its levy performance. When our input is automated, DoD has very few problems offsetting payments for matched vendors once we receive an automated file from Treasury. However, the total dollars offset is only about one percent of the debts we receive from IRS. We recognize the automated process needs improvement.

With manual procedures, we seldom are successful because by the time we become informed of a match for a pending payment, we have had to disburse the payment. Still, we are considering possible interim procedures to use until full automation is completed.

TINs and contractor names. The Department of Defense relies on information in Central Contractor Registration (CCR) for the commercial payments database provided to the FMS for matching with its TOP database. This information comes from contractors themselves. If either the name or the Taxpayer Identification Number (TIN) provided by the contractor differs from the name or TIN listed on the debt record, the TOP database will not identify that contractor for an offset or levy. We believe that inaccuracies in the CCR cause the TOP system to fail to identify many contractors with federal debts.

We are working with the IRS and FMS on how best to validate or correct the TIN and name of the commercial entities in the CCR. The goal is to eliminate CCR inaccuracy as an obstacle to better levy collections.

Legal limitations. In seeking to achieve more levies, the Department of Defense must stay within the framework and limitations of federal law. For example, certain tax-related information cannot be released, even between federal agencies, except in strict compliance with federal law. Federal officials can be subject to prosecution and civil liabilities for unauthorized disclosure of protected information.

Legislative/legal changes. The Department looks forward to working with the IRS, FMS, and others in considering what legislative or legal changes might help us achieve more levies.

Closing

In closing, I assure you that the Department of Defense will support the continuous federal levy program. We have a good partnership with the IRS and FMS, and I am sure that that will produce substantial results.

I also want to assure this committee that the Department of Defense is continuing its broader challenge of transforming all its business and financial processes. We have made a strong start in our historic overhaul of DoD management processes and the information

systems that support them. Once fully implemented several years from now, our Business Management Modernization Program will consolidate and integrate our management and information systems. It will enable the maximum permissible exchange of information that is key to ensuring all our business management responsibilities.

Thank you for this opportunity to explain how the Department of Defense is working to sustain sound management and strong stewardship of its public resources.

United States General Accounting Office

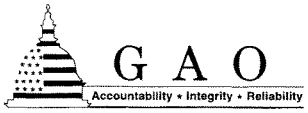
GAO

Report to Congressional Requesters

February 2004

FINANCIAL MANAGEMENT

Some DOD Contractors Abuse the Federal Tax System with Little Consequence



GAO-04-95

Permanent Subcommittee on Investigations
EXHIBIT #1

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-04-95, a report to congressional requesters

Why GAO Did This Study

GAO was asked to determine (1) the magnitude of unpaid federal taxes owed by Department of Defense (DOD) contractors, (2) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, (3) whether DOD and the Internal Revenue Service (IRS) have effective processes and controls in place to use the Treasury Offset Program (TOP) in collecting unpaid federal taxes from DOD contractors, and (4) whether DOD contractors with unpaid federal taxes are prohibited by law from receiving contracts from the federal government.

What GAO Recommends

GAO makes recommendations to DOD for complying with statutory guidance and supporting IRS efforts in collecting unpaid taxes, to IRS for improving the effectiveness of collection activities, and to the Office of Management and Budget (OMB) to develop options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system. DOD and IRS partially agreed; OMB did not agree. DOD and OMB also did not agree with GAO's matters for congressional consideration that DOD report on its collections through TOP and OMB report on policy options developed and actions taken against contractors that abuse the federal tax system. GAO reiterated support for its recommendations as well as for its suggestions to Congress.

www.gao.gov/cgi-bin/getrpt?GAO-04-95

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gregory D. Kutz at (202) 512-9095 or kutzg@gao.gov, or Steven J. Sebastian at (202) 512-3406.

February 2004

FINANCIAL MANAGEMENT

Some DOD Contractors Abuse the Federal Tax System with Little Consequence

What GAO Found

DOD and IRS records showed that over 27,000 contractors owed about $3 billion in unpaid taxes as of September 30, 2002. DOD has not fully implemented provisions of the Debt Collection Improvement Act of 1996 that would assist IRS in levying up to 15 percent of each contract payment to offset a DOD contractor's federal tax debt. We estimate that DOD could have collected at least $100 million in fiscal year 2002 had it and IRS fully utilized the levy process authorized by the Taxpayer Relief Act of 1997. As of September 2003, DOD had collected only about $687,000 in part because DOD provides contractor payment information from only 1 of its 16 payment systems to TOP. DOD had no formal plans at the completion of our work to provide payment information from its other 15 payment systems to TOP.

Furthermore, we found abusive or potentially criminal activity related to the federal tax system through our audit and investigation of 47 DOD contractors. The 47 contractors provided a variety of goods and services, including parts or support for weapons and other sensitive military programs. The businesses in these case studies owed primarily payroll taxes with some dating back to the early 1990s. These payroll taxes included amounts withheld from employee wages for Social Security, Medicare, and individual income taxes. However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund the business.

For example, owners of two businesses each borrowed nearly $1 million from their companies and, at about the same time, did not remit millions of dollars in payroll taxes. One owner bought a boat, several cars, and a home outside the United States. The other paid over $1 million for a furnished home. Both contractors received DOD payments during fiscal year 2002, but one went out of business in 2003. The business, however, transferred its employees to a relative's company (also with unpaid taxes) and recently received DOD payments on a previous contract.

IRS's continuing challenges in collecting unpaid federal taxes also contributed to the problem. In several case studies, IRS was not pursuing DOD contractors due to resource and workload management constraints. For other cases, control breakdowns resulted in IRS freezing collection activity for reasons that were no longer applicable. Federal law does not prohibit contractors with unpaid federal taxes from receiving federal contracts. OMB is responsible for providing overall direction to governmentwide procurement policies, regulations, and procedures, and is in the best position to develop policy options for prohibiting federal government contract awards to businesses and individuals that abuse the tax system.

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Abbreviations

ACS	Automated Collection System
CAPS	Computerized Accounts Payable System
CCR	Central Contractor Registration
DCIA	Debt Collection Improvement Act of 1996
DCMA	Defense Contract Management Agency
DFAS	Defense Finance and Accounting Service
DLIS	Defense Logistics Information Service
DOD	Department of Defense
DOE	Department of Energy
EIN	employer identification number
FAR	Federal Acquisition Regulation
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FPLP	Federal Payment Levy Program
GSA	General Services Administration
IAPS	Integrated Accounts Payable System
IRS	Internal Revenue Service
MOCAS	Mechanization of Contract Administration Services
NASA	National Aeronautics and Space Administration
OMB	Office of Management and Budget
OSI	Office of Special Investigations
SSA	Social Security Administration
SSN	Social Security number
TFRP	trust fund recovery penalty
TIN	tax identification number
TOP	Treasury Offset Program

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United States General Accounting Office
Washington, D.C. 20548

February 12, 2004

The Honorable Norm Coleman
Chairman
The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate

The Honorable Janice D. Schakowsky
House of Representatives

In fiscal year 2002, the Department of Defense (DOD) awarded contracts totaling nearly $165 billion. This is nearly two-thirds of the federal government's contracting activity. Since 1990, we have periodically reported on federal programs and operations that are high risk due to their greater vulnerabilities to fraud, waste, and abuse. Lasting solutions to high-risk problems offer the potential to save billions of dollars, dramatically improve service to the American public, strengthen public confidence and trust in the performance and accountability of our national government, and ensure the ability of the government to deliver on its promises.

DOD and the Internal Revenue Service (IRS) face a variety of high-risk challenges. Of the 26 areas on our governmentwide "high risk" list, 6 are DOD program areas, and the department shares responsibility for 3 other high-risk areas that are governmentwide in scope. Financial management, 1 of the 6 DOD high-risk program areas, has weaknesses, including the lack of effective and efficient asset management and accountability, unreliable estimates of environmental and disposal liabilities, lack of accurate budget and cost information, nonintegrated and proliferating financial management systems, and fundamental flaws in the overall control environment. As we have documented in numerous reports, DOD's financial management problems leave it highly vulnerable to fraud, waste, and abuse. IRS high-risk areas include financial management weaknesses and difficulties in collecting unpaid taxes. Both areas continue to expose the federal government to significant losses of tax revenue and disproportionately increase the burden on compliant taxpayers to fund government activities. This report addresses issues related to three high-risk areas: DOD and IRS financial management and IRS collection of unpaid taxes.

For the last several years, Congress and others have expressed concern that declines in IRS compliance and collections programs are eroding taxpayer confidence in the fairness of our federal tax system. As of September 30, 2002, IRS had confirmed unpaid taxes, including interest and penalties, totaling $249 billion nationwide,[1] of which nearly $49 billion represented unpaid payroll taxes.

As you requested, this report addresses (1) the magnitude of unpaid federal taxes owed by DOD contractors, (2) whether DOD and IRS have effective processes and controls in place to use the Treasury Offset Program (TOP)[2] and Federal Payment Levy Program (FPLP)[3] in collecting unpaid federal taxes from DOD contractors, (3) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, and (4) whether DOD contractors with unpaid federal taxes are prohibited by law from receiving federal contracts.

Our work was performed from March 2003 through September 2003 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. Details on our scope and methodology are included in appendix I. The results of 17 of the 47 case studies we audited and investigated are shown in tables 2 and 3. The results of the other 30 case studies are included in appendix II.

[1] U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury*, GAO-03-109 (Washington, D.C.: January 2003).

[2] Treasury established TOP as part of implementing its responsibilities under the Debt Collection Improvement Act of 1996. Treasury created TOP to centralize the process by which certain federal payments are withheld or reduced to collect delinquent nontax debts owed to federal agencies.

[3] A provision in the Taxpayer Relief Act of 1997 authorized IRS to continuously levy up to 15 percent of certain federal payments made to delinquent taxpayers. IRS established its continuous levy program, now referred to as FPLP, to collect federal tax debt. In this report, we refer to FPLP as the levy program. Levy is the legal process by which IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

Results in Brief

Some DOD contractors abuse the federal tax system with little consequence.[4] DOD and IRS records showed that about 27,100 contractors registered in DOD's Central Contractor Registration (CCR) system had nearly $3 billion in unpaid federal taxes as of September 30, 2002, of which 78 percent was over a year old. Of these contractors, over 25,600 were businesses[5] that primarily owed unpaid payroll taxes. These taxes include amounts that a business withholds from an employee's wages for federal income taxes, Social Security, Medicare, and the related matching contributions of the employer for Social Security and Medicare. The other approximately 1,500 contractors were primarily individuals who owed but had not paid income taxes on their business profits or individual income.

We estimate that DOD, which functions as its own disbursing agent, could have offset payments and collected at least $100 million in unpaid taxes in fiscal year 2002 if it had fully assisted IRS in effectively levying contractor payments. In the 6 years since passage of the Taxpayer Relief Act of 1997, DOD has collected only about $687,000. DOD collections to date relate to its recently implemented TOP payment reporting process for its contract payment system, which, according to DOD records, disbursed over $86 billion to contractors in fiscal year 2002. DOD did not, however, have formal plans or a schedule at the completion of our work for reporting payment information to TOP for its 15 vendor payment systems, which disbursed another $97 billion to contractors in fiscal year 2002. DOD officials contend it would be difficult to implement a TOP reporting process for vendor payments because the systems are decentralized in 22 different payment locations. In addition, DOD did not have an organizational structure in place to implement a TOP reporting process. Unless DOD establishes processes to assist IRS in identifying payments

[4] In this report, a DOD contractor abused the federal tax system when payroll taxes withheld from employee wages were not remitted to IRS for 1 year or more. 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.

[5] A tax identification number (TIN) is a unique nine-digit identifier assigned to each business and individual that files a tax return. For businesses, the employer identification number (EIN) assigned by IRS serves as the TIN. For individuals, the Social Security number (SSN) assigned by the Social Security Administration (SSA) serves as the TIN. Contractors register their TINs in the CCR database in either the TIN/EIN field or the SSN field. In our report, a contractor completing the TIN/EIN field is referred to as a business, while a contractor completing the SSN field is referred to as an individual.

from DOD systems that IRS could levy for unpaid federal taxes, the federal government will miss opportunities to collect hundreds of millions of dollars in unpaid taxes owed by DOD contractors.

IRS faces a number of high-risk challenges. Due to resource and workload management constraints, IRS established policies that either exclude or delay putting a significant number of cases into the levy program. In addition to policy constraints, inaccurate or outdated information in IRS systems prevent cases from entering the levy program. Our review of IRS collection efforts against DOD contractors selected for audit and investigation indicated that IRS attempts to work with the businesses and individuals to achieve voluntary compliance, pursuing enforcement actions such as levies of federal contract payments later rather than earlier in the collection process. For many of our case study contractors, this resulted in businesses and individuals continuing to receive federal contract payments without making any payments on their unpaid federal taxes.

We also found numerous instances of abusive or potentially criminal[6] activity related to the federal tax system during our audit and investigation of 47 DOD contractor case studies. The 34 case studies involving businesses with employees had primarily unpaid payroll taxes, some dating to the early 1990s and some for as many as 62 tax periods.[7] However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund their businesses. The other 13 case studies involved individuals who had unpaid income taxes dating as far back as the 1980s. These 47 DOD contractors provided a wide variety of goods and services, including building maintenance, construction, consulting, catering, dentistry, and funeral services. Several of these contractors provided parts or services supporting weapons and other sensitive military programs.

[6] 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). Some potential crimes under the Internal Revenue Code constitute fraud because of the presence of intent to defraud, intentional misrepresentation or deception, or other required legal elements.

[7] A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is 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.

Federal law does not prohibit a contractor with unpaid federal taxes from receiving contracts from the federal government. At this juncture, the criteria calling for federal agencies to do business only with responsible contractors do not require contracting officers to consider a contractor's tax noncompliance, unless the contractor has been suspended or debarred for tax evasion. Further, the federal government has no coordinated process for identifying and determining the businesses and individuals that abuse the federal tax system and for conveying that information to contracting officers for use before awarding contracts. The Office of Federal Procurement Policy in the Office of Management and Budget (OMB) is responsible for providing overall direction to governmentwide procurement policies, regulations, and procedures and may be in the best position to facilitate discussions between DOD, IRS, and other affected agencies. Options could include designating such tax abuse as a cause for governmentwide debarment and suspension or, if allowed by statute, authorizing IRS to declare such businesses and individuals ineligible for government contracts.

We are making recommendations to DOD to immediately provide its contractor payment information to TOP and to IRS to use the levy program as one of the first steps in the collection process. We are making a recommendation to OMB to develop and pursue policy options for prohibiting contract awards to contractors that abuse the federal tax system, including any necessary legislation. We also suggest that Congress consider requiring DOD to periodically report to Congress on its progress in implementing the Debt Collection Improvement Act of 1996 (DCIA) and providing its payment information for each of its contract and vendor payment systems to TOP, including details of actual collections by system and in total for all contract and vendor payment systems during the reporting period. In addition, Congress may wish to require that OMB report to Congress on progress in developing and pursuing options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system, including periodic reporting of actions taken against contractors.

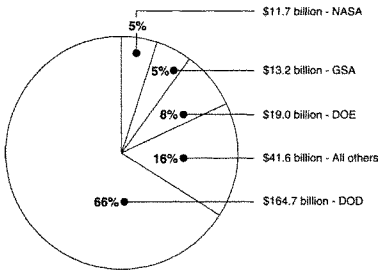
DOD and IRS partially agreed with our recommendations while OMB did not agree. In addition, DOD and OMB disagreed with our matters for congressional consideration. DOD did not agree that a requirement is necessary for DOD to report to Congress on its progress in implementing the DCIA. We believe that such reporting to Congress is necessary to facilitate oversight since DOD, until recently, had taken little action to implement the offset provisions of DCIA since its passage more than 7

years ago. We continue to believe that Congress may wish to consider such oversight as the federal government is missing opportunities to collect hundreds of millions of dollars in unpaid taxes owed by DOD contractors. In oral comments, OMB questioned the need for developing or pursuing additional mechanisms to prohibit federal contract awards to "tax abusers." OMB's comments provide us no basis to change our recommendation. We believe that OMB should assume a leadership role in ensuring that contractors that abuse the tax system are prohibited from receiving federal contracts. See the "Agency Comments and Our Evaluation" section of this report for a more detailed discussion of agency comments. We have reprinted the DOD and IRS written comments in appendixes III and IV.

Background

As the largest purchaser of goods and services in the federal government, DOD awarded contracts valued at nearly $165 billion in fiscal year 2002. Within the federal government, DOD represented about two-thirds of the federal contract spending reported in fiscal year 2002, as shown in figure 1. Spending at the next three largest federal agencies, the Department of Energy (DOE), the General Services Administration (GSA), and the National Aeronautics and Space Administration (NASA), represented only about half of the remaining 34 percent of federal contract awards during the same period.

Figure 1: Fiscal Year 2002 Federal Contract Award Amounts by Agency



Source: Federal Procurement Data Center.

In 1998, DOD established the CCR database as the primary repository for contractor information shared with other agencies. With minor exceptions, contractors are required to register in the CCR database prior to award of a DOD contract. In addition to a one-time registration process, contractors are required to keep all registered information current, and must confirm the registered information is accurate and complete annually. The CCR database contains a wide variety of contractor information including contractor name, address, points of contact, electronic payment information, and tax identification number (TIN). As of June 2003, the CCR database contained almost 224,000 active contractor registrations. DOD; NASA; the Departments of the Treasury, Transportation, and the Interior; as well as the Office of Personnel Management currently use CCR to register contractors. According to CCR officials, while some contractors engage in business with more than one agency (e.g., DOD and NASA), prospective and current DOD contractors represented the majority of CCR registrations. On October 1, 2003, a final rule change to the Federal Acquisition Regulation (FAR) was announced[8] that generally requires all federal contractors to register in the CCR database.

[8] Federal Acquisition Regulation; Central Contractor Registration, 68 *Fed. Reg.* 56,669 (2003) (to be codified at 48 C.F.R. pts. 1, 2, 4, 13, 32, and 52).

Unlike most federal agencies that rely on the Department of the Treasury's Financial Management Service (FMS) for issuing payments, DOD has its own disbursing authority. The Defense Finance and Accounting Service (DFAS) has overall payment responsibility for goods and services purchased by DOD. As part of a reorganization in April 2001, DFAS separated its commercial payment services into two areas—contract pay and vendor pay. Contract pay handles invoices for formal, long-term contracts that are typically administered by the Defense Contract Management Agency (DCMA). These contracts tend to cover complex, multiyear purchases with high-dollar values, such as major weapon systems. The single DOD automated system[9] used in contract pay disbursed over $86 billion to contractors in fiscal year 2002. While somewhat of a misnomer, vendor pay[10] is handled by 15 DOD payment and disbursing systems operating in 22 DFAS offices, and cumulatively disbursed another $97 billion to contractors during fiscal year 2002.

Overhauling DOD's financial management represents a major challenge that goes far beyond financial accounting to the very fiber of the department's range of business operations and management culture. Of the 26 areas on our governmentwide "high-risk" list, 6 are DOD program areas, and the department shares responsibility for 3 other high-risk areas that are governmentwide in scope. Financial management, one of the 6 DOD program areas, has weaknesses, including the lack of effective and efficient asset management and accountability, unreliable estimates of environmental and disposal liabilities, lack of accurate budget and cost information, nonintegrated and proliferating financial management systems, and fundamental flaws in the overall control environment. As we have documented in numerous reports, DOD's financial management problems leave it highly vulnerable to fraud, waste, and abuse.

In our high-risk list, IRS also shares responsibility for three areas that are governmentwide in scope, as well as two IRS program areas pertinent to this report: IRS financial management and collection of unpaid taxes. In both of these areas, weaknesses continue to expose the federal government to significant losses of tax revenue, and compliant taxpayers bear the increased burden of financing the government's activities. IRS

[9] Mechanization of Contract Administration Services.

[10] The vendor pay systems include payments for contracts not administered by DCMA, plus miscellaneous noncontractual payments such as utilities.

attempts to identify businesses and individuals that do not pay the taxes they owe through its various enforcement programs. However, inadequate financial and operational information has rendered IRS unable to develop reliable cost-based performance information for its tax collection and enforcement programs, and to judge whether the agency is appropriately allocating available resources among competing management priorities. As of September 2002, IRS had an inventory of known unpaid taxes,[11] including interest and penalties, totaling $249 billion, of which $112 billion has some collection potential and thus is at risk.[12]

Our recent testimonies and reports have highlighted large and pervasive declines in IRS compliance and collection programs. These programs generally experienced larger workloads, smaller staffing, and fewer numbers of cases closed per employee from 1996 through 2001. By the end of fiscal year 2001, IRS was deferring collection action for about one of three tax delinquencies assigned to the collection programs. In a September 2002 report to the IRS Oversight Board, former IRS Commissioner Rossotti said that IRS has been facing a growing compliance workload at the same time that resources were declining. He said the result is a "huge gap" between the number of taxpayers that are not filing, not reporting, or not paying what they owe and IRS's capacity to deal with them.

In addition, we reported in 1999 that nearly 2 million businesses owed about $49 billion in payroll taxes, which was about 22 percent of the total outstanding balance of IRS unpaid tax assessments.[13] As of September 30, 2002, the amount of unpaid payroll taxes remained about the same (nearly $49 billion). In our 1999 report, we noted that according to IRS records, IRS had assessed $15 billion in penalties against approximately 185,000 individuals found to be willful and responsible for the nonpayment of payroll taxes withheld from employees. We reported that much of this

[11] As of September 2003, IRS had an inventory of known unpaid taxes totaling $246 billion of which $120 billion has some collection potential but only $20 billion of which is considered currently collectible. This inventory includes unpaid taxes that IRS is attempting to collect and unpaid taxes that IRS knows are due but for which it has decided not to pursue collection. Total unpaid taxes also include an unknown amount of unpaid taxes that IRS has not identified and are therefore not in the IRS inventory.

[12] GAO-03-109.

[13] U.S. General Accounting Office, *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed*, GAO/AIMD/GGD-99-211 (Washington, D.C.: Aug. 2, 1999).

amount was not being collected, and that businesses and individuals owing payroll taxes received significant federal benefits and other federal payments.

The Taxpayer Relief Act of 1997[14] enhanced IRS's ability to collect unpaid federal taxes by authorizing IRS to continuously levy up to 15 percent of certain federal payments made to businesses and individuals. The continuous levy program, now referred to as FPLP, was implemented in July 2000. This program provides an automated process for serving tax levies and collecting unpaid taxes through Treasury's FMS and its TOP process.

[14] Taxpayer Relief Act of 1997 § 1024, 26 U.S.C. § 6331(h) (2000).

Treasury established the TOP as part of implementing the DCIA.[15] Congress passed DCIA to maximize the collection of delinquent nontax debts owed to federal agencies. TOP centralizes the process by which certain federal payments are withheld or reduced to collect delinquent debts, and as part of that program, FMS has a centralized database of debts that DCIA requires federal agencies to refer to FMS.[16] Under the regulations implementing DCIA, disbursing agencies, including DOD and others that independently disburse rather than having it done on their behalf by FMS, are required to compare their payment records with the TOP database.[17] If a match occurs, the disbursing agency must offset the payment, thereby reducing or eliminating the nontax debt.

FMS assists IRS in implementing FPLP through a feature of the TOP process, thus enabling IRS to electronically serve a tax levy. 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. For payments disbursed directly by other federal agencies, such as DOD, FMS identifies the amount to be levied from the disbursing agency's payment information and notifies the disbursing agency to deduct the levy amount before payment is made.[18]

As a practical matter, FMS cannot honor a tax levy through TOP unless the disbursing agency has fulfilled its DCIA responsibilities to compare payment records with the TOP database.[19] When a disbursing agency provides FMS with payment information for comparison with the TOP database, FMS has an opportunity to notify the disbursing agency of an IRS levy. To the extent disbursing agencies are not providing payment information to TOP, the implementation of FPLP is hindered.

[15] Pub. L. No. 104-134, 110 Stat. 1321 (1996).

[16] 31 U.S.C. § 3716(c)(6) (2000).

[17] 31 C.F.R. § 285.5 (c)(2) (2003).

[18] U.S. General Accounting Office, *Tax Administration: Millions of Dollars Could Be Collected If IRS Levied More Federal Payments*, GAO-01-711 (Washington, D.C.: July 20, 2001).

[19] 31 U.S.C. § 3716(c)(1)(A) (2000) and 31 C.F.R. § 285.5(c)(2) (2003).

DCIA also requires agencies to refer certain debt to Treasury for centralized collection.[20] FMS reported that the debt referrals to TOP totaled more than $186 billion as of September 2002. Of this amount, $81 billion were federal tax debt, $71 billion were child support debt, $3 billion were state tax debt, and $31 billion were federal nontax debt (e.g., student loans).

Under the levy process, IRS supplies FMS with an electronic file containing unpaid tax information for inclusion in the TOP database. FMS compares the TIN and name on federal payment records with the TIN and name on unpaid tax records provided by IRS. When FMS identifies a business or individual with unpaid taxes that is scheduled to receive a federal payment, it informs IRS, which issues a notice of intent to levy to the delinquent taxpayer (unless the notice was previously sent).[21] Once a notice of impending levy is received, the delinquent taxpayer has several options for action and a minimum of 30 days to respond.[22] The options are as follows:

- The taxpayer may disagree with IRS's assessment and collection of tax liability, and appeal the action by requesting a hearing with the IRS Office of Appeals. Generally, IRS must suspend any levy actions while the hearing and related appeals are pending.
- The taxpayer may elect to pay the debt in full.
- The taxpayer may negotiate with IRS to establish an alternative payment arrangement, such as an installment agreement or an offer in compromise.[23] IRS is precluded from continuing with a levy action while it considers a taxpayer's proposed installment agreement or offer in compromise.

[20] 31 U.S.C. § 3711(g)(1) (2000).

[21] IRS must give the taxpayer written notice 30 days before initiating a levy or seizure action. 26 U.S.C. § 6330(a) (2000).

[22] Before receiving a notice of intent to levy, a taxpayer typically receives several balance due notices as part of the IRS standard notification process.

[23] Installment agreements allow the full payment of the debt in smaller, more manageable amounts. An offer in compromise approved by IRS allows a delinquent taxpayer to settle unpaid debt for less than the full amount due.

- The taxpayer may apply to IRS for a hardship determination, for which a business or individual demonstrates to IRS that making any payment would result in a significant financial hardship. In such cases, IRS may agree to delay collection action until the taxpayer's financial condition improves.

If the delinquent taxpayer does not respond to the levy notice, IRS will instruct FMS to proceed with the continuous levy and reduce all scheduled payments by up to 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. Since the inception of the levy program in July 2000, IRS has used it to collect $76 million in tax debt, including over $60 million in tax debt during fiscal year 2002, by directly levying federal payments. In earlier reviews,[24] we estimated that IRS could use the levy program to potentially recover hundreds of millions of dollars in tax debt.

DOD Contractors Owe Billions in Unpaid Federal Taxes

The federal government pays billions of dollars to DOD contractors that abuse the federal tax system. Further, as of September 2002, businesses and individuals registered in DOD's CCR database owed nearly $3 billion in unpaid federal taxes. Data reliability issues with respect to DOD and IRS records prevented us from identifying an exact amount. Consequently, the total amount of unpaid federal taxes owed by DOD contractors is not known.

Magnitude of Unpaid Federal Taxes Owed by DOD Contractors

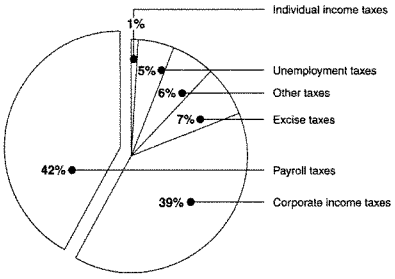
DOD and IRS records showed that the nearly $3 billion in unpaid federal taxes is owed by about 27,100 contractors registered in CCR. This represents almost 14 percent of the contractors registered as of February 2003. Of this number, over 25,600 were businesses that primarily had unpaid payroll taxes.[25] Many also had unpaid federal unemployment taxes. The other approximately 1,500 contractors were primarily individuals who did not pay income taxes on their business profits or individual income.

[24] U.S. General Accounting Office, *Tax Administration: Federal Payment Levy Program Measure, Performance, and Equity Can Be Improved*, GAO-03-356 (Washington, D.C.: Mar. 6, 2003); *Tax Administration: IRS' Levy of Federal Payments Could Generate Millions of Dollars*, GAO/GGD-00-65 (Washington, D.C.: Apr. 7, 2000); and GAO-01-711.

[25] Payroll taxes consist of income and employment taxes (i.e., Federal Insurance Contribution Act (FICA) contributions—Social Security and Medicare) withheld from an employee's wages, as well as the employer's matching FICA contributions.

The amount of unpaid taxes for DOD contractors registered in CCR ranged from a small amount owed by an individual for a single tax period to millions of dollars owed by a business over more than 60 tax periods. The type of unpaid taxes owed by these contractors varied and consisted of payroll, corporate income, excise, unemployment, individual income, and other types of taxes. In the case of unpaid payroll taxes, an employer withheld federal taxes from an employee's wages, but did not send the withheld payroll taxes or the employer's required matching amount to IRS. As shown in figure 2, about 42 percent of the total tax amount owed by DOD contractors was for unpaid payroll taxes.

Figure 2: DOD Contractor Unpaid Taxes by Tax Type



Source: GAO analysis of DOD and IRS records.

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 hold these amounts "in trust" for the federal government until the employer makes a federal tax deposit in that amount.[26] 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 Federal Insurance Contribution Act (FICA) contributions. Individuals within the business (e.g., corporate officers) may be held personally liable for the withheld amounts not forwarded and assessed a civil monetary penalty known as a trust fund recovery penalty (TFRP).[27] Failure to remit payroll taxes can also be a criminal felony offense[28] punishable by imprisonment of more than a year, while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense[29] punishable by imprisonment of up to a year. The law imposes no penalties upon an employee 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 a previous report.[30] Over time, the amount of this subsidy is significant. As of September 1998, the last date on which information was readily available, the estimated cumulative amount of unpaid taxes and associated interest for which the Social Security and Medicare trust funds were subsidized by the general fund was approximately $38 billion.[31]

Based on our case study analysis, we found that contractors with unpaid federal taxes provide a wide range of goods and services to DOD, including

[26] 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) (2000).

[27] 26 U.S.C. § 6672 (2000).

[28] 26 U.S.C. § 7202 (2000).

[29] 26 U.S.C. § 7215 (2000).

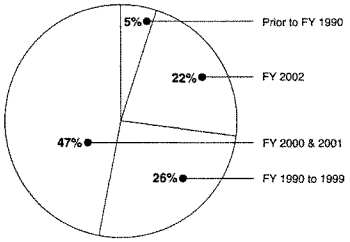
[30] GAO/AIMD/GGD-99-211.

[31] The estimate includes both FICA and Self-Employment Contribution Act taxes, but does not include federal income tax withholdings. Accrued interest is included in this amount because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to the rates used to develop IRS's interest accruals.

building maintenance, catering, construction, consulting, custodial, dentistry, music, and funeral services. Several of these contractors provided parts or services related to aircraft components for several DOD and civilian programs.

A substantial amount of the unpaid federal taxes shown in IRS records as owed by DOD contractors had been outstanding for several years. As reflected in figure 3, 78 percent of the nearly $3 billion in unpaid taxes was over a year old as of September 30, 2002, and 52 percent of the unpaid taxes was for tax periods prior to September 30, 1999.

Figure 3: DOD Contractor Unpaid Taxes by Fiscal Year



Source: GAO analysis of DOD and IRS records.

Our previous work[32] has shown that 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 tax debt, which, over time, can dwarf the original tax obligation.

[32] U.S. General Accounting Office, *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 GAO/AIMD/GGD-99-211.

DOD Contractor Unpaid Taxes Are Likely Understated

Although the nearly $3 billion in unpaid federal taxes owed by DOD contractors as of September 30, 2002, is a significant amount, it may not reflect the true amount of unpaid taxes owed by these businesses and individuals. Data integrity issues with DOD's contractor database and the nature of IRS's taxpayer account database prevented us from identifying the true extent of DOD contractor unpaid taxes.

For example, we found that some contractors providing goods and services to DOD could not be identified. We analyzed the TINs reported by contractors in the CCR database. A TIN field[33] is completed during a CCR registration, and contractors are responsible for the TIN's accuracy. During our review, we found that the CCR database included nearly 4,900 employer identification numbers (EIN) that did not match the IRS Master Files.[34] Our examination also identified some invalid TINs[35] that were either all the same digit (e.g., 999999999) or an unusual series of digits (e.g., 123456789). Invalid TINs in the CCR database prevented us from determining if the contractor had unpaid taxes.[36] We recently recommended to IRS and OMB that options to routinely validate all TINs in the CCR be considered, and use of contractor and TIN information from CCR be required for tax reporting by all federal agencies.[37]

As previously mentioned, some contractors that received DOD payments were not registered in CCR. Our analysis of fiscal year 2002 disbursements totaling almost $20 billion through one DFAS vendor payment system[38]

[33] Contractors register their TINs in the CCR database into either the TIN/EIN field (business) or the SSN field (individual).

[34] IRS Master Files are data files that contain tax return filing histories for businesses and individuals.

[35] In this report, an invalid TIN refers to a missing TIN, a TIN with more or less than nine numeric characters, a TIN that includes an alpha character, or a TIN that does not match or cannot be found in IRS or SSA records.

[36] We referred this matter to our Office of Special Investigations because we were concerned that some contractors may be registering in CCR with invalid TINs to avoid federal taxes or debt collection.

[37] U.S. General Accounting Office, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*, GAO-04-74 (Washington, D.C.: Dec. 5, 2003).

[38] One Bill Pay, formerly known as Standard Accounting and Reporting System.

identified payments totaling about $1 billion with a TIN that did not match a contractor TIN in the CCR database. We also identified contractor payments totaling over $4 billion that lacked TINs in the same DFAS system. Missing TINs in the DOD payment record prevented us from determining if the payees were contractors with unpaid taxes. DOD financial management regulations require that after reasonable efforts to obtain the TIN have been unsuccessful, federal income tax at 31 percent should be withheld and the balance of the payment forwarded to the payee.

Another factor that contributes to understating the amount of unpaid federal taxes owed by DOD contractors is that the IRS taxpayer account 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. During our review, we identified instances in which a DOD contractor failed to file tax returns for a particular tax period and, therefore, was listed in IRS records as having no unpaid taxes. Consequently, the true extent of unpaid taxes for these businesses and individuals is not known.

It is important to note that timing issues could result in some DOD contractors that we identified with unpaid taxes having already paid the amounts due. For example, some very recent amounts that appear as unpaid taxes through a matching of DOD and IRS records may involve matters that are routinely resolved between the taxpayer and IRS, with the taxes paid, abated, or both[39] within a short period. Also, it should be noted that some assessments developed by IRS through third party information may be overstated due to a lack of taxpayer information (e.g., deductions). Similarly, as we have previously reported,[40] IRS records contain errors that affect the accuracy of taxpayer account information, and lead to both lost opportunities to collect outstanding taxes and a burden on taxpayers because IRS continues to pursue amounts from taxpayers that are no longer owed. Consequently, some of the nearly $3 billion may not reflect true unpaid taxes, although we cannot quantify this amount. Nonetheless,

[39] 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).

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

we believe the nearly $3 billion represents a reasonable yet conservative estimate of unpaid federal taxes owed by DOD contractors.

DOD and IRS Are Not Collecting Millions in Unpaid Federal Taxes from Contractors

We estimate that DOD, which functions as its own disbursing agent, could have levied payments and collected at least $100 million in unpaid taxes in fiscal year 2002 if it and IRS had worked together to effectively levy contractor payments. However, in the 6 years since the passage of the Taxpayer Relief Act of 1997, DOD has collected only about $687,000. DOD collections to date relate to DFAS payment reporting associated with implementation of the TOP process in December 2002 for its Mechanization of Contract Administration Services (MOCAS) contract payment system, which disbursed over $86 billion to DOD contractors in fiscal year 2002. DFAS had no plans or schedule at the completion of our review to report payment information to TOP for any of its 15 vendor payment systems, which disbursed another $97 billion to DOD contractors in fiscal year 2002.

IRS's continuing challenges in pursuing and collecting unpaid taxes also hinder the government's ability to take full advantage of the levy program. For example, due to resource constraints, IRS has established policies that either exclude or delay referral of a significant number of cases to the program. The IRS review process for taxpayer requests, such as installment agreements or certain offers in compromise, which IRS is legally required to consider, often takes many months, during which time IRS excludes these cases from the levy program. In addition, inaccurate or outdated information in IRS systems prevents cases from entering the levy program. Our audit and investigation of 47 DOD contractor case studies, discussed in detail later in this report, also show IRS continuing to work with businesses and individuals to achieve voluntary compliance and taking enforcement actions, such as levies of federal contractor payments, later in the collection process.

From a governmentwide perspective, making payments to federal contractors without requiring the businesses or individuals to meet their tax obligations through methods such as levying payments to collect unpaid taxes is not a sound business practice. Until DOD begins to fulfill its responsibilities under DCIA by fully assisting IRS in its attempts to levy contractor payments and IRS fully utilizes its authority under the Taxpayer Relief Act of 1997, the federal government will continue to miss opportunities to collect on hundreds of millions of dollars in unpaid federal taxes owed by DOD contractors.

DOD Is Not Fully Assisting in the Collection of Unpaid Taxes Owed by Its Contractors

Although it has been more than 7 years since the passage of DCIA, DOD has not fully assisted IRS in using its continuous levy authority for the collection of unpaid taxes by providing FMS with all DFAS payment information. IRS's continuous levy authority authorizes the agency to collect federal tax debts of businesses and individuals that receive federal payments by levying up to 15 percent of each payment until the debt is paid. Under TOP, FMS matches a database of debtors (including those with federal tax debt) to certain federal payments (including payments to DOD contractors). When a match occurs, the payment is intercepted, the levied amount is sent to IRS, and the balance of the payment is sent to the debtor. The TOP database includes federal tax and nontax debt, state tax debt, and child support debt. All disbursing agencies are to compare their payment records with the TOP database.[41] Since DOD has its own disbursing authority, once DFAS is notified by FMS of the amount to be levied, it should deduct this amount from the contractor payment before it is made to the payee and forward the levied amount to the Department of the Treasury. By fully participating in the TOP process, DOD will also aid in the collection of other debts, such as child support and federal nontax debt (e.g., student loans).

At the completion of our work, DOD had no formal plans or schedule to begin providing payment information from any of its 15 vendor payment systems to FMS for comparison with the TOP database. These 15 payment systems disbursed almost $97 billion to DOD contractors in fiscal year 2002. DFAS officials contend that it would be difficult to provide this payment information to TOP because the systems are decentralized and nonintegrated in 22 different payment locations. As we have previously reported, DOD's business systems environment is stovepiped and not well integrated. DOD recently reported that its current business operations were supported by approximately 2,300 systems in operation or under development, and requested approximately $18 billion in fiscal year 2003 for the operation, maintenance, and modernization of its business systems.[42] In addition, DFAS did not have an organizational structure in place to implement the TOP payment reporting process. DOD recently

[41] 31 C.F.R. § 285.5(c)(2) (2003).

[42] U.S. General Accounting Office, *DOD Business Systems Modernization: Continued Investment in Key Accounting Systems Needs to Be Justified*, GAO-03-465 (Washington, D.C.: Mar. 28, 2003) and *DOD Business Systems Modernization: Important Progress Made to Develop Business Enterprise Architecture, but Much Work Remains*, GAO-03-1018 (Washington, D.C.: Sept. 19, 2003).

communicated a timetable for implementing TOP reporting for its vendor payment systems with completion targeted for March 2005. Until DOD establishes processes to provide information from all payment systems to TOP, the federal government will continue missing opportunities to collect hundreds of millions of dollars in unpaid taxes owed by DOD contractors.

Although DFAS recently began providing payment information to TOP from its largest payment system, total collections to date have been minimal. In December 2002, DFAS began providing FMS with payment information for its MOCAS contract payment system, which disbursed over $86 billion to contractors in fiscal year 2002. According to IRS, from December 2002 through September 2003, DOD collected about $687,000 in unpaid taxes from contractor payments.[43] However, our analysis of IRS records for DOD contractors receiving fiscal year 2002 payments from MOCAS showed that these contractors owed about $750 million in unpaid federal taxes as of September 30, 2002.

As mentioned previously, IRS records showed that over 27,100 contractors in DOD's CCR database owed nearly $3 billion in unpaid federal taxes as of September 30, 2002. We reviewed payment transactions in five of the largest DOD disbursement systems covering about 72 percent of the fiscal year 2002 disbursements, or almost $131 billion, from DFAS contract and vendor payment systems. Contractors paid through these five DOD automated systems represented at least $1.7 billion of the nearly $3 billion in unpaid federal taxes shown on IRS records. We estimate that DOD could have offset contractor payments to collect at least $100 million of this

[43] Although over $1 million was levied during this period, FMS refunded $353,500 to the contractors due to a processing error. FMS levied the DOD payments prior to IRS issuing a levy to FMS and prior to the statutory pre-levy notification letter to the taxpayer. Consequently, FMS was required to refund some collections. DFAS implemented the levy process near the beginning of our review; therefore, we did not test controls over the process.

amount in fiscal year 2002 if DOD had been fulfilling its responsibilities under DCIA to compare its payment records with the TOP database.[44]

IRS Policies Exclude Cases from the Levy Program

Although the levy program could provide a highly effective and efficient method of collecting unpaid taxes from contractors that receive federal payments, IRS policies restrict the number of cases that enter the program and the point in the collection process they enter the program. For each of the collection phases listed below, IRS policy either excludes or severely delays putting cases into the levy program.[45]

- **Phase 1:** Notify taxpayer of unpaid taxes, including a demand for payment letter.
- **Phase 2:** Place the case into the Automated Collection System (ACS) process. The ACS process consists primarily of telephone calls to the taxpayer to arrange for payment.
- **Phase 3:** Move the case into a queue of cases awaiting assignment to a field collection revenue officer.
- **Phase 4:** Assign the case to field collections where a revenue officer attempts face-to-face contact and collection.

[44] We estimated this potential collection amount using the assumptions that all unpaid federal taxes were referred to Treasury FMS for inclusion in the TOP database, and all fiscal year 2002 DFAS payment information was provided to FMS for matching against the TOP database. The collection amount was calculated on 15 percent of the payment amount up to the amount of unpaid taxes. Our analysis did not account for any exclusion allowed by the levy program, such as cases where the contractor had entered bankruptcy, made alternative arrangements to pay, or demonstrated to IRS that making payments on the outstanding tax debt would result in a financial hardship. However, although federal agencies are required to obtain contractor TINs by 31 U.S.C. § 7701(c)(1), many DOD contractor payment transactions do not include TINs; therefore, the total amount of unpaid federal taxes owed by contractors and potential collections through FPLP is not known.

[45] Although cases may move through the phases sequentially, it is not necessary that they do so. Cases begin in the notice phase, but they move back and forth between various phases and may, for example, enter the queue or Automated Collection System phases repeatedly. There are also other status phases into which a case might enter that are not presented here.

As of September 30, 2002, IRS listed $81 billion of cases in these four phases: 17 percent were in notice status, 17 percent were in ACS, 26 percent were in field collection, and 40 percent were in the queue awaiting assignment to the field. At the same time these four phases take place, sometimes over the course of years, DOD contractors with unpaid taxes continue to receive billions of dollars in contract payments. IRS excludes cases in the notification phase from the levy program to ensure proper notification rules are followed. However, as we previously reported, once proper notification has been completed, IRS continues to delay or exclude from the levy program those accounts placed in the other three phases.[46] IRS policy is to exclude accounts in the ACS phase primarily because officials believed they lack the resources to issue levy notices and respond to the potential increase in telephone calls from taxpayers responding to the notices. Additionally, IRS excludes the majority of cases in the queue phase (awaiting assignment to field collection) from the levy program for 1 year. Only after cases await assignment for over a year does IRS allow them to enter the levy program.[47] Finally, IRS excludes most accounts from the levy program once they are assigned to field collection because revenue officers said that the levy action could interfere with their successfully contacting taxpayers and resolving the unpaid taxes.

These policy decisions, which may be justified in some cases, result in IRS excluding millions of cases from potential levy. IRS officials who work on ACS and field collection inventories can manually unblock individual cases they are working in order to put them in the levy program. However, by excluding cases in the ACS and field collection phases, IRS records indicate it excluded as much as $34 billion of cases from the levy program as of September 30, 2002. In January 2003, IRS unblocked and made available for levy those accounts identified as receiving federal salary or annuity payments. However, other accounts remain blocked from the levy program. IRS stated that it intended to unblock a portion of the remaining accounts sometime in 2005. Additionally, $32 billion of cases are in the queue, and thus under existing policy, would be excluded from the levy

[46] GAO-03-356.

[47] IRS sends tax debt notifications at least once each year. When IRS initiated the levy program, it blocked all cases entering the queue for 1 year to ensure that at least one notice would be sent before the case entered the levy program. IRS officials stated that they intend to change this policy in early 2004.

program for the first year each case is in that phase. IRS policies along with its inability to more actively pursue collections, both of which IRS has in the past attributed to resource constraints, combine to prevent many cases from entering the levy program. Since IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the assessment, these long delays greatly decrease the potential for IRS to collect the unpaid taxes.[48]

We identified specific examples of IRS not actively pursuing collection in our audit and investigation of 47 selected cases involving DOD contractors. For example, IRS used a special code within its automated systems to block collection action for almost 10 months for one DOD contractor that owed nearly $260,000 in unpaid taxes. Specifically, IRS closed collection actions against this case (using an administrative transaction code it refers to as 530-39) citing resource and workload management considerations. IRS is not currently seeking collection of about $14.9 billion of unpaid taxes because of this administrative code—about 5 percent of its overall inventory of unpaid assessments as of September 30, 2002. Once IRS reversed the special code, it placed the contractor into its queue of cases awaiting assignment for collection action. The contractor remained in the queue, awaiting assignment, from October 2001 through the time of our review in May 2003—19 months. DOD paid this contractor over $110,000 in fiscal year 2002, missing opportunities to collect as much as $17,000 through the 15 percent levy.

For another DOD contractor, IRS coded the individual within its automated systems in 1999 as having financial hardship and therefore unable to pay. This code put collection activities on hold until the individual's adjusted gross income (per subsequent tax return filings) exceeded a certain threshold. At the same time, IRS entered a code to prevent further collection actions because of its own resource constraints. IRS automated systems are designed to automatically reverse the financial hardship code when the adjusted gross income exceeds a certain threshold. That reversal would put the contractor back into the IRS collection system. However, before that occurred, the contractor stopped filing tax returns in 1997 and the IRS resource constraint code had the unintended effect of IRS not

[48] The 10-year period can be extended or suspended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS's records for decades.

attempting to obtain the unfiled tax returns. This combination of codes effectively stopped collection action from taking place for this contractor and created a catch–22 situation since one code prevents IRS from pursuing the individual until a filed tax return reports higher income and the other code prevents IRS from pursuing the individual to obtain non-filed tax forms. DOD paid this individual nearly $220,000 in 2002 and almost $700,000 since 1999. If an effective 15 percent levy had been in place, the government could have collected over $30,000 of the unpaid taxes in 2002. Because of the individual's failure to file, the true amount of unpaid taxes is not known, but could be significantly greater than the over $160,000 currently reflected in IRS records.

Some cases repeatedly enter the queue awaiting assignment to a field collection revenue officer and remain there for long periods. For example, one DOD contractor had gone between ACS and the queue awaiting assignment since 1998. This individual's case entered the queue three times but was never assigned. As of May 2003, this case spent almost 3 and a half years in the queue. Moving a case in and out of the queue affects its eligibility for the levy program. For another contractor involving over $100,000 in unpaid taxes, IRS put the case into ACS in July 2000. As noted previously, IRS routinely blocks ACS cases from entering the levy program. Nine months later, in April 2001, IRS moved this case from ACS into the queue to await assignment to a revenue officer. Again, in accordance with IRS policy, IRS excludes cases in the queue from entering the levy program for 1 year. After 1 year, the case was referred to the levy program, so this case took about 21 months from the time it initially went to ACS until it was moved into the levy program. The contractor received over $350,000 in federal payments from 1999 to 2002, and current payments would not be subject to the 15 percent levy because DOD is not reporting information from the vendor payment system to TOP.

IRS Delays in Processing and Inaccurate Records Exclude Cases from the Levy Program

In addition to excluding cases for various operational and policy reasons as described above, IRS excludes cases from the levy program for particular taxpayer events, such as bankruptcy, litigation, or financial hardship, as well as when taxpayers apply for an installment agreement or an offer in compromise. When one of these events takes place, IRS enters a code in its automated system that excludes the case from entering the levy program. Although these actions are appropriate, IRS may lose opportunities to collect through the levy program if the processing of agreements is not timely or prompt action is not taken to cancel the exclusion when the event, such as a dismissed bankruptcy petition, is concluded.

Delays in processing taxpayer documents and errors in taxpayer records are long-standing problems at IRS and can harm both government interests and the taxpayer. In 2002, the IRS Taxpayer Advocate Service[49] reported that over 65 percent of all offers in compromise take longer than 6 months to process. Similarly, in our audits of IRS financial statements, we reported on delays in processing offers in compromise. In those audits, we identified delays in processing that were outside IRS's control (such as taxpayer failure to provide appropriate documentation to support the offer), as well as delays caused by IRS inactivity.[50] These findings are consistent with an earlier IRS internal audit report that found, in a majority of cases sampled, that IRS had periods of inactivity that lasted 60 days or more.[51] Similarly, past audits have identified instances in which inaccurate records allowed tax refunds to be released to citizens who owe taxes and other cases in which IRS erroneously assessed millions of dollars due to inaccurate records.[52] Our audit of cases involving DOD contractors with unpaid federal taxes indicates that problems persist in the timeliness of processing taxpayer applications and in the accuracy of IRS records.

In our review of DOD contractors with unpaid federal taxes, we identified a number of cases in which the processing of DOD contractor applications for an offer in compromise or an installment agreement was delayed for long periods, thus blocking the cases from the levy program and potentially reducing government collections. For example, in one case, a DOD contractor with nearly $400,000 in unpaid federal taxes applied for an offer in compromise in mid-1999, but IRS did not reject the offer until July 2000—over a year later. In this same case, the individual filed for an installment agreement in March 1999, but it took IRS over 2 years—until mid-2001—to reject the proposed agreement. During this period, the individual's account was blocked from potential levying. From 1999 to 2001, DOD paid this individual over $200,000 in contract payments. Had

[49] The Taxpayer Advocate Service is an IRS program that provides an independent system to ensure that tax problems that have not been resolved through normal channels are promptly and fairly handled.

[50] U.S. General Accounting Office, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000).

[51] Review of the Offers in Compromise Program (Reference No. 091603, Dec. 7, 1998), performed by what is now the Office of the Treasury Inspector General for Tax Administration.

[52] GAO-01-42.

DOD been reporting its payments to TOP during this period and had IRS not blocked the account for a potential levy, a 15 percent levy of these payments could have generated over $30,000 in collections for the government.

In another example, there was both a long delay by IRS in deciding whether to accept a DOD contractor's proposed installment agreement as well as a failure to properly reverse the codes once a decision was made. The case had a levy block due to a proposed installment agreement submitted by the business in mid-2000. As mentioned above, under IRS regulations, once a code is entered into the system indicating that a taxpayer has applied for or is currently under an offer in compromise or installment agreement, the case is automatically blocked from the levy program. IRS rejected the installment agreement offer after a year. However, IRS had not properly reversed the code in its systems that indicated an installment agreement application was pending, as of our review in May 2003. Consequently, this account with over $60,000 in unpaid taxes was inappropriately excluded from the levy program for 2 years. Meanwhile, this business received nearly $30,000 in payments from DOD while the statutory period in which IRS had to collect the unpaid taxes continued to run.

We found that inaccurate coding at times prevented both IRS collection action and cases from entering the levy program. Because the coding within a taxpayer's account determines whether the account will enter the levy program, effective management of these codes is critical. If these blocking codes 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.

For example, as of May 2003, one DOD contractor had been assigned to field collection since the spring of 1996. However, the case entered bankruptcy, thus blocking it from the levy program and preventing all collection action on the case. Although the bankruptcy was settled in 1998, the case was never released for collection action. IRS had incorrectly entered a reversal code, causing the case to remain in bankruptcy status and therefore blocking it from the levy program. On the basis of our review, IRS was attempting to reverse the bankruptcy code and begin collection action against the case. Similarly, in another case, a DOD contractor entered into an installment agreement with IRS in the spring of 1999, at which time IRS posted the appropriate code to block other collection activities. The individual defaulted on the agreement, after

making three payments, in 1999. However, IRS did not post the code required to cancel the installment agreement, leaving the individual's account blocked from collection activities, such as the levy program. If the correct code had been posted, IRS systems would have automatically put the individual in the levy program in late 2000 when IRS implemented the program.

IRS Subordinates Use of the Levy Program to Other Collection Efforts

Although the nation's tax system is built upon voluntary compliance, when businesses and individuals fail to pay voluntarily, the government has a number of enforcement tools to compel compliance or elicit payment. Our review of DOD contractors with unpaid federal taxes indicates that although the levy program could be an effective, reliable collection tool, IRS is not using the program as a primary tool for collecting unpaid taxes from federal contractors. For the cases we audited, IRS subordinated the use of the levy program in favor of negotiating voluntary tax compliance with the business or individual.

We recently recommended that IRS study the feasibility of submitting all eligible unpaid federal tax accounts to FMS on an ongoing basis for matching against federal payment records under the levy program, and use information from any matches to assist IRS in determining the most efficient method of collecting unpaid taxes, including whether to use the levy program. Although IRS raised concerns that increasing the use of the levy program would increase workload for its staff and would entail excessively high computer programming costs, it agreed to study the feasibility of such an arrangement.[53] The study was not completed at the time of our review.

For the DOD contractors we audited and investigated, IRS attempts to gain voluntary compliance often resulted in minimal or no actual collections. For example, one case involved a sole proprietorship that had gross revenue of over $40 million in 2001, about 10 percent of which came from DOD contract payments. Although this business worked primarily for federal agencies, it failed to remit payroll and unemployment taxes and had accumulated unpaid federal taxes of nearly $10 million. Even with the mounting tax debt, revenue officers continued working to get the business to make payments, including executing an installment agreement, on which

[53] GAO-03-356.

the business defaulted. After defaulting, IRS did not put the case into the levy program. In November 2002, the revenue officer put a 1-year collection hold on the business to see if it could restructure, cut costs, and become profitable so that it could enter into another installment agreement to voluntarily pay the tax debt. Throughout this period, the business rarely paid its taxes on time or in full (essentially additional payroll taxes), yet the business continued to operate and increase the amount of unpaid federal taxes owed. In this case, IRS did not levy the business's assets because it thought a levy would cause the business to fail. However, the state in which the business operated seized funds from the business's bank account in early 2003 to partially settle the business's state tax debt. This caused the business to cease operations in early 2003, leaving IRS with a potentially uncollectible debt of nearly $10 million.

As another example, shortly after one business in our selection of DOD contractors defaulted on an installment agreement, it requested and received another installment agreement. The business promised to make current tax payments. However, after only a few months the business was not paying its current tax liabilities (essentially additional payroll taxes) and had fallen behind on the installment agreement. Even without the business accumulating more debt, the installment agreement required the business to make monthly payments for 13 years. Given the business's history of default, failure to pay its current tax debt, and default on the current agreement, indications were the business would not fulfill this obligation. However, instead of canceling this long-term payment plan and preventing the business from accumulating additional debt due to its failure to remit current quarterly payroll taxes, IRS reinstated the installment agreement and declined to put a lien on the business's properties. The business again defaulted on the installment agreement less than 2 months after initiation, and at the time of our review, IRS was negotiating with the business for yet another installment agreement.

Challenges for IRS Collections

The nation's tax system is rooted in the doctrine of its citizens voluntarily complying with the tax laws. IRS has a difficult task in maintaining a balance between this key doctrine and effectively fulfilling its role as the nation's tax collector. The philosophical thrust of this doctrine can, however, negatively affect IRS's ability to collect what is legitimately owed to the government. If IRS fails or is limited in its ability to act quickly and aggressively against businesses and individuals that repeatedly fail to pay the taxes they owe, it runs the risk of not fulfilling its mission. IRS also risks further weakening voluntary compliance as declines in enforcement

programs may erode taxpayer confidence in the fairness of our federal tax system and may create the perception that there is little risk in noncompliance. The potential revenue losses and the threat to voluntary compliance make the collection of unpaid taxes a high-risk area. Congress and others have been concerned that declines in IRS enforcement programs are eroding taxpayer confidence in the fairness of our tax system.

Prompt collection is important because, as discussed earlier, IRS generally has a finite period under which to seek collection for unpaid taxes. Generally, there is a 10-year statutory collection period beyond which IRS is prohibited from attempting to collect. Unless the collection period is extended, IRS removes unpaid taxes that exceed this statutory period from its records. Even if a case is not actively worked for extended periods, the collection period continues to move toward expiration, reducing IRS's opportunity to collect the amount due.

The levy program could help IRS take prompt enforcement action and operate more efficiently. In addition, from a governmentwide perspective, paying billions of dollars to DOD contractors that at the same time have substantial unpaid taxes is not a sound business practice. Withholding up to 15 percent of these payments is an effective collection method and is authorized by law. Additionally, the levy program can assist other collection activities. For example, in one case the levy helped IRS collect against a DOD contractor it was unable to locate. The IRS revenue officers tried without success for 5 years to contact this business owner. However, after placing a lien on the owner's assets and putting the case into FPLP, which began to levy payments from the business's contract with another federal agency, the contractor was ready to cooperate with IRS.

As the above case indicates, the levy program can have a far greater impact on the tax program than just the dollars levied. We reported in the past that businesses and individuals are more likely to pay voluntarily when faced with a notice of intent to levy.[54] Our audit of DOD contractors also found this to be true. For example, IRS issued a levy notice to one DOD contractor in the spring of 2003. After complaining that the levy would force it into bankruptcy, the contractor agreed to begin making voluntary installment payments. IRS accepted this offer and therefore did not levy. At the time of our review in May 2003, IRS had received two payments from

[54] GAO-03-356.

the contractor to begin paying the liability from its earliest tax period. In addition, the business paid two tax deposits for current (2003) periods of over $160,000. This sequence of events indicates that, as we reported previously, the threat of IRS levy action often brings about tax payments and greater taxpayer compliance and fairness to those that do pay their taxes.

In a previous report, we estimated that after receiving a notice of intent to levy, about 29 percent of taxpayers take action that enables IRS to remove them from the active inventory of unpaid taxes or move them to an inactive status. Specifically, we estimated that subsequent to receiving a levy notice, about 19 percent of the taxpayers resolved their liability and were removed from the active inventory, while about 10 percent obtained determinations of financial hardship.[55] By reclassifying some active accounts to an inactive status and removing others, the levy program helps IRS prioritize its inventory of unpaid taxes more efficiently and enables IRS to focus more of its resources on unpaid accounts that have more collection potential.

As described above, the advantages of the levy program to IRS in assisting its collection efforts are clear given its claims of resource constraints. However, IRS's current implementation strategy appears to make the levy program one of the last collection tools IRS uses. Changing the program to (1) remove the policies that work to unnecessarily exclude cases from entering the levy program and (2) promote the use of the levy program to make it one of the first collection tools could allow IRS—and the government—to reap the advantages of the program earlier in the collection process.

[55] GAO-03-356.

DOD Contractors Involved in Abusive or Potentially Criminal Activity Related to the Federal Tax System

To determine whether there are instances of abusive or potentially criminal activity by DOD contractors related to the federal tax system, we selected 47 case study businesses and individuals that had unpaid taxes and were receiving DOD contractor payments in fiscal year 2002. We excluded cases that IRS categorized as "compliance assessment,"[56] business cases with total unpaid taxes under $10,000, and individual cases with total unpaid taxes under $5,000. Our selection was based upon a business or individual having a large number of unpaid tax periods, owing large tax debt, and receiving DOD contractor payments. For more information on our criteria for the selection of the 47 case studies, see appendix I.

For all 47 cases that we audited and investigated, we found abusive or potentially criminal activity related to the federal tax system. Thirty-four of these case studies involved businesses with employees who had unpaid payroll taxes dating as far back as the early 1990s, some for as many as 62 tax periods. However, rather than fulfill their role as "trustees" of this money and forward it to IRS, these DOD contractors diverted the money for other purposes. To reiterate, the diversion of payroll taxes for personal or business use is potentially criminal activity. The other 13 case studies involved individuals that had unpaid income taxes dating as far back as the 1980s. We are referring the 47 cases detailed in this report to IRS for evaluation and additional collection action or criminal investigation.

Nature of Business for Case Study Contractors

DOD is a large and complex organization with a budget of about $400 billion and operations across the world. Because DOD contracts for a large variety of goods and services, it is not surprising that we found DOD contractors that have unpaid taxes from a large number of industries. Table 1 shows a breakdown for our 47 contractor case studies by the type of goods and services provided to DOD.

[56] For financial reporting, IRS classifies its unpaid tax debts as either (1) federal taxes receivable (taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling), (2) compliance assessments (where neither the taxpayer nor the court has affirmed that the amounts are owed), or (3) write-offs (which are unpaid assessments that IRS does not expect to collect because of factors such as taxpayer death, bankruptcy, or insolvency).

Table 1: Types of Goods and Services Provided by DOD Contractors in Case Studies

Type of business	Number
Maintenance/construction services	8
Custodial services	4
Aircraft-related goods supplier	4
Research services	3
Consulting services	3
Music services	2
Dentist	2
Training services	2
Information technology personnel services	2
Other[a]	17
Total	**47**

Source: GAO analysis of DOD and public records.

[a]Includes goods and services such as uniform manufacturing, courier services, medical personnel services, funeral services, weapon parts, and computer equipment.

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

As discussed previously, businesses with employees are required by law to collect, account for, and transfer income and employment taxes to IRS, which the employer withholds from an employee's wages. IRS refers to these withheld payroll taxes as trust fund taxes because the employer holds the employee's money "in trust" until the employer makes a federal tax deposit in that amount. Businesses that fail to remit payroll taxes to the federal government are liable for the amounts withheld from employees, and IRS can assess a TFRP[57] equal to the total amount of taxes not collected or not accounted for and paid over against individuals who are determined by IRS to be "willful and responsible" for the nonpayment of withheld payroll taxes. Typically, these individuals are the officers of a corporation, such as a president or treasurer. As we have found in previous reviews, collections of TFRP assessments from officers are generally minimal.

[57] 26 U.S.C. § 6672 (2000).

In addition to civil penalties, criminal penalties exist for an employer's failure to turn over withheld employee payroll taxes to IRS. The act of willfully failing to collect or pay over any tax is a felony.[58] Additionally, the failure to comply with certain requirements for the separate accounting and deposit of withheld income and employment taxes is a misdemeanor.[59]

Our audit and investigation of the 34 case study business contractors showed substantial abuse or potential criminal activity as all had unpaid payroll taxes and all diverted funds for personal or business use. In table 2, and on the following pages, we highlight 13 of these businesses and estimate the amounts that could have been collected through the levy program based on fiscal year 2002 DOD payments. For these 13 cases, the businesses owed unpaid taxes for a range of 6 to 30 quarters (tax periods). Eleven of these cases involved businesses that had unpaid taxes in excess of 10 tax periods, and 5 of these were in excess of 20 tax periods. The amount of unpaid taxes associated with these 13 cases ranged from about $150,000 to nearly $10 million; 7 businesses owed in excess of $1 million. In these 13 cases, we saw some cases where IRS filed tax liens on property and bank accounts of the businesses, and a few cases where IRS collected minor amounts through the levying of non-DOD federal payments. We also saw 1 case in which the business applied for an offer in compromise, which IRS rejected on the grounds that the business had the financial resources to pay the outstanding taxes in their entirety, and 2 cases in which the business is entered into, and subsequently defaulted on, installment agreements to pay the outstanding taxes. In 5 of the 13 cases, IRS assessed the owners or business officers with TFRPs, yet no collections were received from these penalty assessments.

[58] 26 U.S.C. § 7202 (2000).

[59] 26 U.S.C. § 7215 (2000).

Table 2: DOD Contractors with Unpaid Federal Taxes—Business

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
1	*Base support and custodial services:* provides dining, trash removal, security, cleaning, and recycling programs on military bases	Nearly $10 million	$527,000	$3.5 million	State tax authorities levied the business bank account. The owner borrowed nearly $1 million from the business. The owner bought a boat, several cars, and a home outside the United States. The business was dissolved in 2003 and transferred its employees to a relative's business, where it submitted invoices and received payments from DOD on a previous contract through August 2003.
2	*Engineering research services:* conducts studies for DOD	Over $1 million	$58,000	$390,000	The owner paid $1 million to purchase a house and furnishings in the mid-1990s. At around the same time, the owner borrowed nearly $1 million from the business, and the business stopped paying its taxes in full. DOD awarded the business contracts totaling over $600,000.
3	*Aircraft-related goods:* manufactures structural parts for DOD aircraft	Nearly $2 million	$50,000	$336,000	The business received over 30 DOD contracts from 1997 through 2002 totaling nearly $2 million.
4	*Research services:* provides research for DOD	Over $700,000	$13,000	$86,000	DOD awarded the business a contract in 2002 for nearly $800,000. Owner has over $1 million in loans related to cars, real estate, and recreational activities, and owner also has a high-performance airplane.
5	*Janitorial services:* provides custodial services at a DOD facility	Over $3 million	$108,000	$719,000	The business did not make tax payments after early 2001, and it made only partial payments prior to that dating back to the mid-1990s. The business also did not file corporate tax returns for 8 years.
6	*Private security services:* provides security guards at military bases	Nearly $6 million	$3,000	$21,000	One of the business's officers, who owns a large boat, paid off a recreation-related loan in 1999. The business paid taxes while in bankruptcy, but largely stopped paying after emerging from bankruptcy.
7	*Furniture sales and construction services:* sells and installs office furniture at military installations	Over $150,000	$6,000	$38,000	The owners used the business to pay personal expenses, such as house mortgage and credit cards. One owner is a retired military officer.

(Continued From Previous Page)

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
8	*Custodial services*: provides janitorial and housekeeping services at military installations	Over $800,000	$219,000	$1.5 million	The business received numerous DOD contracts from 1998 through 2001 totaling nearly $12 million. The business is linked to potential check fraud.
9	*Construction services*: provides housing management services including maintenance, repairs, and renovations, on military bases	Over $1 million	$357,000	$2.4 million	The business owes DOD tens of thousands of dollars for an overpayment in early 2000.
10	*Base support services*: provides landscaping and snow removal at a military base	Nearly $1 million	$33,000	$217,000	The business was awarded contracts from 1999 through 2000 worth over $1 million. The business owes taxes dating back to the early 1990s.
11	*Construction services:* provides repairs to aircraft hangars at a military base	Over $700,000	$422,000	$2.8 million	
12	*Medical personnel services:* provides nursing, pharmacy, physical therapy, and other skilled medical personnel in DOD facilities	Nearly $6 million	$698,000	$4.7 million	Several federal and state tax liens have been placed against the owner.
13	*Aircraft-related goods:* manufactures aircraft components for several DOD and civilian programs	Over $400,000	$29,000	$194,000	The business was awarded numerous DOD contracts in a recent 4-year period totaling over $300,000.

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

Notes: Dollar amounts are rounded. The nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole proprietorship).

[a]Unpaid tax amount as of September 30, 2002.

[b]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[c]DOD payments from MOCAS, One Bill Pay, Integrated Accounts Payable System (IAPS), Computerized Accounts Payable System (CAPS) Clipper, and CAPS Windows automated systems identified by GAO.

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

- **Case # 1** - This base support contractor provided services such as trash removal, building cleaning, and security at U.S. military bases. The business had revenues of over $40 million in 1 year, with over 25 percent of this coming from federal agencies. This business's outstanding tax obligations consisted of unpaid payroll taxes. In addition, the contractor defaulted on an IRS installment agreement. IRS assessed a TFRP against the owner. The business reported that it paid the owner a six figure income and that the owner had borrowed nearly $1 million from the business. The business also made a down payment for the owner's boat and bought several cars and a home outside the country. The owner allegedly has now relocated his cars and boat outside the United States. This contractor went out of business in 2003 after state tax authorities seized its bank account. The business transferred its employees to a relative's business, which also had unpaid federal taxes, and submitted invoices and received payments from DOD on a previous contract through August 2003.

- **Case # 2** - This engineering research contractor received nearly $400,000 from DOD during 2002. At the time of our review, the contractor had not remitted its payroll tax withholdings to the federal government since the late 1990s. In 1996, the owner bought a home and furnishings worth approximately $1 million and borrowed nearly $1 million from the business. The owner told our investigators that the payroll tax funds were used for other business purposes.

- **Case # 3** - This aircraft parts manufacturer did not pay payroll withholding and unemployment taxes for 19 of 20 periods through the mid- to late 1990s. IRS assessed a TFRP against several corporate officers, and placed the business in FPLP in 2000. This business claims that its payroll taxes were not paid because the business had not received DOD contract payments; however, DOD records show that the business received over $300,000 from DOD during 2002.

- **Case # 5** - This janitorial services contractor reported revenues of over $3 million and had received over $700,000 from DOD in a recent year. The tax problems of this business date back to the mid-1990s. At the time of our review, the business had both unpaid payroll and unemployment taxes of nearly $3 million. In addition, the business did not file its corporate tax returns for 8 years. IRS assessed a TFRP

against the principal officer of the business in early 2002. This contractor employed two officers who had been previously assessed TFRPs related to another business.

- **Case # 7 -** This furniture business reported gross revenues of over $200,000 and was paid nearly $40,000 by DOD in a recent year. The business had accumulated unpaid federal taxes of over $100,000 at the time of our review, primarily from unpaid employee payroll taxes. The business also did not file tax returns for several years even after repeated notices from IRS. The owners made an offer to pay IRS a portion of the unpaid taxes through an offer in compromise, but IRS rejected the offer because it concluded that the business and its owners had the resources to pay the entire amount. At the time of our audit, IRS was considering assessing a TFRP against the owners to make them personally liable for the taxes the business owed. The owners used the business to pay their personal expenses, such as their home mortgage, utilities, and credit cards. The owners said they considered these payments a loan from the business. Under this arrangement, the owners were not reporting this company benefit as income so they were not paying income taxes, and the business was reporting inflated expenses.

- **Case # 9 -** This family-owned and operated building contractor provided a variety of products and services to DOD, and DOD provided a substantial portion of the contractor's revenues. At the time of our review, the business had unpaid payroll taxes dating back several years. In addition to failing to remit the payroll taxes it withheld from employees, the business had a history of filing tax returns late, sometimes only after repeated IRS contact. Additionally, DOD made an overpayment to the contractor for tens of thousands of dollars. Subsequently, DOD paid the contractor over $2 million without offsetting the earlier overpayment.

- **Case # 10 -** This base support services contractor has close to $1 million in unpaid payroll and unemployment taxes dating back to the early 1990s, and the business has paid less than 50 percent of the taxes it owed. IRS assessed a TFRP against one of the corporate officers. This contractor received over $200,000 from DOD during 2002.

Examples of Abuse of the Federal Tax System by Individuals

Individuals are responsible for the payment of income taxes, and our audit and investigation of 13 individuals showed significant abuse of the federal tax system similar to what we found with our DOD business case studies. In table 3, and on the following pages, we highlight four of the individual case studies. In all four cases, the individuals had unpaid income taxes. In one of the four cases, the individual operated a business as a sole proprietorship with employees and had unpaid payroll taxes. Taxes owed by the individuals ranged from four to nine tax periods, which equated to years. Each individual owed in excess of $100,000 in unpaid income taxes, with one owing in excess of $200,000. In two of the four cases, the individuals had entered into, and subsequently defaulted on, at least one installment agreement to pay off the tax debt.

Table 3: DOD Contractors with Unpaid Federal Taxes—Individual

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
14	*Vehicle repair services:* provides repair and painting for military vehicles	Over $100,000	$22,000	$147,000	The business was investigated for paying employee wages in cash. Despite a substantial tax liability, the owner recently purchased a home valued at over $1 million as well as a luxury sports car. The owner also owes a federal agency for child support.
15	*Dentist:* provides dental services at a military facility	Over $100,000	$12,000	$78,000	DOD recently increased the individual's contract by over $80,000. The dentist's credit history included several credit card accounts that were identified for collection action.
16	*Dentist:* provides dental services at a military facility	Over $200,000	$11,000	$76,000	DOD awarded the individual a multiyear contract for over $400,000. This individual paid income tax for only 1 year since 1993. The individual previously had a business that owes over $100,000 in unpaid payroll and unemployment taxes going back to the early 1990s.
17	*Training services:* conducts management and leadership courses	Over $100,000	$2,000	$12,000	This individual has not paid income taxes for 5 years.

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

Notes: Dollar amounts are rounded. Nature of unpaid taxes for individuals was primarily due to unpaid income taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with

an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole proprietorship). For cases selected as individuals, we reviewed both the owner and related business information, if it could be identified.

[a]Unpaid tax amount as of September 30, 2002.

[b]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[c]DOD payments from MOCAS, One Bill Pay, IAPS, and CAPS automated systems identified by GAO.

The following provides illustrative detailed information on these four cases.

- **Case # 14** - This individual's business repaired and painted military vehicles. The owner failed to pay personal income taxes and did not send employee payroll tax withholdings to IRS. The owner owed over $500,000 in unpaid federal business and individual taxes. Additionally, the TOP database showed the owner had unpaid child support. IRS levied the owner's bank accounts and placed liens against the owner's real property and business assets. The business received over $100,000 in payments from DOD in a recent year, and the contractor's current DOD contracts are valued at over $60 million. In addition, the business was investigated for paying employee wages in cash. Despite the large tax liability, the owner purchased a home valued at over $1 million and a luxury sports car.

- **Case # 15** - This individual, who is an independent contractor and works as a dentist at a military installation, had a long history of not paying income taxes. The individual did not file several tax returns and did not pay taxes in other periods when a return was filed. The individual entered into an installment agreement with IRS but defaulted on the agreement. This individual received $78,000 from DOD during a recent year, and DOD recently increased the individual's contract by over $80,000.

- **Case # 16** - This individual is another independent contractor who also works as a dentist on a military installation. DOD paid this individual over $200,000 in recent years, and recently signed a multiyear contract worth over $400,000. At the time of our review, this individual had paid income taxes for only 1 year since the early 1990s and had accumulated unpaid taxes of several hundred thousand dollars. In addition, the individual's prior business practice owes over $100,000 in payroll and unemployment taxes for multiple periods going back to the early 1990s.

- **Case # 17** - DOD paid this individual nearly $90,000 for presenting motivational speeches on management and leadership. This individual has failed to file tax returns since the late 1990s and had unpaid income taxes for a 5-year period from the early to mid-1990s. The total amount of unpaid taxes owed by this individual is not known because of the individual's failure to file income tax returns for a number of years. IRS placed this individual in the levy program in late 2000; however, DOD payments to this individual were not levied because DFAS payment information was not reported to TOP as required.

See appendix II for details on the other 30 DOD contractor case studies.

Contractors with Unpaid Taxes Are Not Prohibited by Law from Receiving Contracts from the Federal Government

Federal law does not prohibit a contractor with unpaid federal taxes from receiving contracts from the federal government. Existing mechanisms for doing business only with responsible contractors do not prevent businesses and individuals that abuse the federal tax system from receiving contracts. Further, the government has no coordinated process for identifying and determining the businesses and individuals that should be prevented from receiving contracts and for conveying that information to contracting officers for use before awarding contracts.

In previous work, we supported the concept of barring delinquent taxpayers from receiving federal contracts, loans and loan guarantees, and insurance. In March 1992, we testified on the difficulties involved in using tax compliance as a prerequisite for awarding federal contracts.[60] In May 2000, we testified in support of H.R. 4181 (106th Congress), which would have amended DCIA to prohibit delinquent federal debtors, including delinquent taxpayers, from being eligible to contract with federal agencies.[61] Safeguards in the bill would have enabled the federal government to procure goods or services it needed from delinquent taxpayers for designated disaster relief or national security. Our testimony also pointed out implementation issues, such as the need to first ensure that IRS systems provide timely and accurate data on the status of taxpayer

[60] U.S. General Accounting Office, *Tax Administration: Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season*, GAO/T-GGD-92-23 (Washington, D.C.: Mar. 17, 1992).

[61] U.S. General Accounting Office, *Debt Collection: Barring Delinquent Taxpayers From Receiving Federal Contracts and Loan Assistance*, GAO/T-GGD/AIMD-00-167 (Washington, D.C.: May 9, 2000).

accounts. However, this legislative proposal was not adopted and there is no existing statutory bar on delinquent taxpayers receiving federal contracts.

Federal agencies are required by law to award contracts to responsible sources.[62] This statutory requirement is implemented in the FAR, which requires that government purchases be made from, and government contracts awarded to, responsible contractors only.[63] To effectuate this policy, the government has established a debarment and suspension process and established certain criteria for contracting officers to consider in determining a prospective contractor's responsibility. Contractors debarred, suspended, or proposed for debarment are excluded from receiving contracts and agencies are prohibited from soliciting offers from, awarding contracts to, or consenting to subcontracts with these contractors, unless compelling reasons exist. Prior to award, contracting officers are required to check a governmentwide list of parties that have been debarred, suspended, or declared ineligible for government contracts,[64] as well as to review a prospective contractor's certification[65] on debarment, suspension, and other responsibility matters. Among the causes for debarment and suspension is tax evasion.[66] In determining

[62] 10 U.S.C. § 2305 (b) and 41 U.S.C. § 253b (2000).

[63] 48 C.F.R. § 9.103 (a).

[64] Contractors included on the list as having been declared ineligible on the basis of statutory or regulatory procedures are excluded from receiving contracts under the conditions and for the period set forth in the statute or regulation. Agencies are prohibited from soliciting offers from, awarding contracts to, or consenting to subcontracts with these contractors under these conditions and for that period.

[65] Such certification is required only for contracts exceeding the simplified acquisition threshold.

[66] The government may suspend a contractor suspected of tax evasion, upon adequate evidence, and debar a contractor for a conviction or civil judgment for commission of tax evasion. Further, prospective contractors are required to certify in their bids or proposals whether they or their principals, within the preceding 3 years, were convicted or had civil judgments rendered against them for commission of tax evasion, and whether they or their principals are presently indicted or otherwise criminally or civilly charged with commission of tax evasion.

whether a prospective contractor is responsible, contracting officers are also required to determine that the contractor meets several specified standards, including "a satisfactory record of integrity and business ethics." Except for a brief period during 2000 through 2001, contracting officers have not been required to consider compliance with federal tax laws in making responsibility determinations.[67]

Neither the current debarment and suspension process nor the requirements for considering contractor responsibility effectively prevent the award of government contracts to businesses and individuals that abuse the tax system. Since most businesses and individuals with unpaid taxes are not charged with tax evasion, and fewer still convicted, these contractors would not necessarily be subject to the debarment and suspension process. None of the contractors described in this report were charged with tax evasion for the abuses of the tax system we identified.

A prospective contractor's tax noncompliance, other than tax evasion, is not considered by the contracting officer before deciding whether to award a contract. Further, no coordinated and independent mechanism exists for contracting officers to obtain accurate information on contractors that abuse the tax system. Such information is not obtainable from IRS because of a statutory restriction on disclosure of taxpayer information.[68] As we found in November 2002,[69] unless reported by prospective contractors themselves, contracting officers face significant difficulties obtaining or verifying tax compliance information on prospective contractors.

[67] In December 2000, a controversial revision to the FAR was issued that required contracting officers to consider a prospective contractor's compliance with several areas of law, including tax, in determining a satisfactory record of integrity and business ethics. This revision was revoked in December 2001 after having been effectively suspended for many federal agencies earlier in 2001.

[68] 26 U.S.C. § 6103 (2000).

[69] U.S. General Accounting Office, *Government Contracting: Adjudicated Violations of Certain Laws by Federal Contractors*, GAO-03-163 (Washington, D.C.: Nov. 15, 2002).

Moreover, even if a contracting officer could obtain tax compliance information on prospective contractors, a determination of a prospective contractor's responsibility under the FAR when a contractor abused the tax system is still subject to a contracting officer's individual judgment. Thus, a business or individual with unpaid taxes could be determined to be responsible depending on the facts and circumstances of the case. Since the responsibility determination is largely committed to the contracting officer's discretion and depends on the contracting situation involved, there is the risk that different determinations could be reached on the basis of the same tax compliance information. On the other hand, if a prospective contractor's tax noncompliance results in mechanical determinations of nonresponsibility, de facto debarment could result. Further, a determination that a prospective contractor is not responsible under the FAR could be challenged.[70]

Because individual responsibility determinations can be affected by a number of variables, any implementation of a policy designed to consider tax compliance in the contract award process may be more suitably addressed on a governmentwide basis. The formulation and implementation of such a policy may most appropriately be the role of OMB's Office of Federal Procurement Policy. The Administrator of Federal Procurement Policy provides overall direction for governmentwide procurement policies, regulations, and procedures. In this regard, OMB's Office of Federal Procurement Policy is in the best position to develop and pursue policy options for prohibiting federal contract awards to businesses and individuals that abuse the tax system.

Conclusions

Thousands of DOD contractors that failed in their responsibility to pay taxes continue to get federal contracts. Allowing these contractors to do business with the federal government while not paying their federal taxes creates an unfair competitive advantage for these businesses and individuals at the expense of the vast majority of DOD contractors that do pay their taxes. DOD's failure to fully comply with DCIA and IRS's continuing challenges in collecting unpaid taxes have contributed to this

[70] For example, if the prospective contractor is a small business, the nonresponsibility determination would be reviewed by the Small Business Administration, which could issue a Certificate of Competency stating that the prospective contractor is responsible for the purpose of receiving and performing a specific government contract. A determination of nonresponsibility could also be protested through the bid protest process.

unacceptable situation, and have resulted in the federal government missing the opportunity to collect hundreds of millions of dollars in unpaid taxes from DOD contractors. Working closely with IRS and Treasury, DOD needs to take immediate action to comply with DCIA and thus assist in effectively implementing IRS's legislative authority to levy contract payments for unpaid federal taxes. Also, IRS needs to better leverage its ability to levy DOD contractor payments, moving quickly to use this important collection tool. Beyond DOD, the federal government needs a coordinated process for dealing with contractors that abuse the federal tax system, including taking actions to prevent these businesses and individuals from receiving federal contracts.

Matters for Congressional Consideration

In view of congressional interest in both tax collection and government contracting, Congress may wish to consider the following two actions.

Until such time as DOD is able to demonstrate that it is meeting its responsibilities under DCIA, including providing payment information to TOP for offsetting unpaid federal taxes, and to facilitate action by the department, Congress may wish to consider requiring that DOD report periodically to Congress on its progress in implementing DCIA for each of its contract and vendor payment systems. This report should include details of actual collections by system and in total for all contract and vendor payment systems during the reporting period.

In addition, Congress may wish to consider requiring that OMB report to Congress on progress in developing and pursuing options for prohibiting federal government contract awards to businesses and individuals that abuse the federal tax system, including periodic reporting of actions taken.

Recommendations for Executive Action

To improve collection of DOD contractor tax debt, we recommend that DOD take four corrective actions, IRS take four corrective actions, and OMB take one corrective action.

To comply with the DCIA and support IRS efforts under the Taxpayer Relief Act of 1997 to collect unpaid federal taxes, we recommend that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to take four long- and short-term actions. For the long term, we recommend that the Under Secretary develop a formal plan to implement DCIA by providing payment information to TOP for all DFAS payment

systems. At a minimum, the plan should designate officials responsible for implementing DCIA responsibilities for each payment system, including firm implementation dates for each payment system.

For the short term, we recommend that the Under Secretary

- collaborate with Treasury's FMS to develop interim procedures for identifying active DOD contactors in TOP and
- develop manual procedures so that the levy of contractor payments can be started immediately for all DOD payment systems.

For both the long and short term, we recommend that the Under Secretary devote sufficient resources to implementing all aspects of TOP and the DOD plan.

To help improve the effectiveness of IRS collection activities, we recommend that the Commissioner of Internal Revenue capitalize on the potential of the FPLP by taking the following three actions:

- using the levy program as one of the first steps in the IRS collection process,
- changing or eliminating policies that prevent businesses and individuals with federal contracts from entering the levy program, and
- evaluating the cost versus benefits of keeping businesses and individuals in the levy program once placed in the program until the taxes are fully paid.

We further recommend that the Commissioner of Internal Revenue evaluate the 47 referred cases detailed in this report and consider whether additional collection action or criminal investigation is warranted.

To help ensure that the federal government does not award contracts to businesses and individuals that have flagrantly disregarded their federal tax obligations (e.g., failed to remit payroll taxes for several tax periods or broken installment agreements), we recommend that the Director of OMB develop and pursue policy options for prohibiting federal contract awards to contractors in cases in which abuse to the federal tax system has occurred and the tax owed is not contested. Options could include designating such tax abuse as a cause for governmentwide debarment and

suspension or, if allowed by statute, authorizing IRS to declare such businesses and individuals ineligible for government contracts. We further recommend that any option OMB develops should

- consider whether additional legislation is needed;
- minimize administrative burdens on contracting officials, for example, by distributing the names of abusive contractors debarred, suspended, or declared ineligible on the governmentwide list of excluded parties that contracting officers are already required to check before awarding contracts;
- fully comply with the statutory restriction on disclosure of taxpayer information; and
- address any necessary exceptions, such as when the goods or services cannot be obtained from other sources or for national security.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Under Secretary of Defense (Comptroller) (see app. III) and the Commissioner of Internal Revenue (see app. IV).

DOD concurred with three of the four recommendations and partially concurred with the remaining recommendation. However, DOD disagreed with our matter for congressional consideration related to progress reporting. For the three recommendations with which it concurred, DOD stated that actions are under way to address our recommendations and provided a schedule of estimated implementation dates for all DFAS vendor payment systems. The schedule estimates completion of 17 vendor payment systems by March 2005. However, our report discusses 15 vendor pay systems because, during our review, DOD represented that there were only 15 vendor payment systems. We encourage DOD to continue to identify additional payment systems to be included in its implementation schedule. DOD added that it will devote the necessary resources to support the offset/levy program and will reevaluate the level of resources as the program progresses.

Although DOD concurred with our second recommendation regarding collaboration with Treasury for identifying active DOD contractors in TOP, the comments point out that for the one payment system that DOD has included in the levy program, the initial matches of contractors with the

TOP database have been low. We did not review the methodology or process used by DFAS or by Treasury to make the matches. However, as stated in this report, we believe that an effective levy program at DOD would yield hundreds of million of dollars in tax collections. DOD further noted that it has been and will continue to be proactive in working with Treasury to generate as many collections as possible. With the exception of actions taken with the MOCAS system, this statement is not accurate. DOD's comments in response to this report represent its initial schedule for reporting payment information to TOP for the 15 reported vendor payment systems through which it disbursed almost $97 billion to contractors in fiscal year 2002.

Regarding the partial concurrence to our third recommendation dealing with development of manual procedures as a short-term corrective action, DOD stated that its implementation plan has been accelerated to 6 months for most payments systems, and that DOD's focus should remain on implementing a system-based process rather than temporary manual procedures. As previously mentioned, until the drafting of DOD's comments to this report, there were no formal plans for reporting payment information to TOP for any of DOD's vendor payment systems. Therefore, there was no plan for DOD to accelerate. In addition, we believe that given the magnitude of potential collections, it is unreasonable to wait for a systems solution, which may not be available for a long time. Manual procedures should be employed so that the offset of DOD payments can be started immediately.

Regarding the disagreement with the matters for congressional consideration, DOD stated that a requirement is not necessary for DOD to report to Congress on its progress in implementing the DCIA. We continue to believe that Congress may wish to consider such oversight since DOD has failed to fully implement the offset requirements of DCIA since its passage more than 7 years ago, and the federal government continues to miss opportunities to collect hundreds of millions of dollars in unpaid taxes owed by DOD contractors.

IRS agreed with the issues raised in the report with respect to DOD contractors that abuse the federal tax system, and agreed that FPLP can become a more effective tool for collecting delinquent federal taxes owed by businesses and individuals that receive federal payments, including DOD contractors. Although IRS did not explicitly agree or disagree with the recommendations in our report, it noted a number of actions that it had taken or was taking to address the issues raised in this report, including

steps to accelerate the collection of delinquent taxes. Specifically, IRS noted that it had made enhancements to its Inventory Delivery System to identify certain businesses with payroll taxes as high-priority work and that such cases would bypass the ACS phase of the collection process. IRS pointed out that it had made improvements to the cycle time of a number of its collection processes and cited recent improvements in expediting processing of offers in compromise. IRS stated that it had reviewed the systemic blocks on its FPLP procedures and information systems and, based on this review, will be making changes to its information systems to modify a number of blocks on cases in the queue and certain ACS business-related cases. IRS will also work with DOD to ensure that contractor TINs in the CCR database are accurate and will work with both DOD and OMB in support of any changes they make with respect to how the federal government deals with contactors with unpaid taxes. Finally, IRS indicated that it would review the 47 case studies included in our report and take additional action as appropriate.

While IRS agreed with the issues raised in the report, it pointed out that the statutory requirements under which IRS must operate, coupled with concerns for taxpayer rights, sometimes require IRS to remove a taxpayer from FPLP or prevent it from taking any enforcement action. IRS added that such requirements and considerations require IRS to take a more balanced approach to FPLP versus a cost-benefit approach. We recognize the statutory environment in which IRS operates in its efforts to collect outstanding taxes and that statutory requirements affect how the FPLP is used. We continue to believe, however, that FPLP provides an effective, reliable means of ensuring at least some collections on unpaid taxes and that IRS needs to consider a more aggressive and likely administratively efficient approach, subject to legal requirements, for government contractors that fail to pay their tax debt.

On January 15, 2004, we received oral comments from representatives of OMB's Office of Federal Procurement Policy, Office of Federal Financial Management, and Office of the General Counsel. OMB questioned the need for developing or pursuing additional mechanisms to prohibit federal contract awards to "tax abusers." OMB said that defining "tax abuse" would not be a function of OMB and would be more appropriate for the Treasury Office of Tax Policy or Congress. In addition, officials said that current FAR guidance on responsibility (48 C.F.R. Subpart 9.1) as well as causes for suspension and debarment (48 C.F.R. Subpart 9.4) and the Nonprocurement Common Rule on Suspension and Debarment,[71] recently updated November 26, 2003 (68 Fed. Reg. 66533), provide contracting officers and grant officers with ample discretion to consider tax-related problems as a criterion for making awards. Specifically, they noted that FAR 9.104-1(d) requires prospective contractors to have, among other things, satisfactory records of integrity and business ethics. Accordingly, they said, failure to pay taxes or abuse of the tax system would be a factor in making this determination.

OMB's comments provide us no basis to change our recommendation that OMB develop and pursue policy options for prohibiting federal contract awards to contractors that abuse the tax system. While we agree with OMB that the definition of "tax abuse" should be developed in consultation with those government officials responsible for administering the nation's tax laws, as the agency responsible for governmentwide procurement policy, we believe that OMB should assume a leadership role in ensuring that contractors that abuse the tax system are prohibited from receiving federal contracts.

As we discussed in this report, contracting officers have the discretion to consider tax-related concerns in making determinations as to a contractor's responsibility, specifically as to its record of integrity and business ethics. However, contracting officers are not required to consider a prospective contractor's tax noncompliance, other than tax evasion, in deciding whether to award a contract and, as all 47 case studies in our report clearly

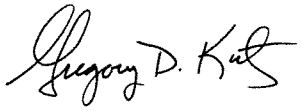
[71] The Nonprocurement Common Rule is the procedure used by federal executive agencies to suspend, debar, or exclude individuals or entities from participation in nonprocurement transactions such as grants, cooperative agreements, scholarships, fellowships, contracts of assistance, loans, loan guarantees, subsidies, insurance, payments for specified use, and donation agreements.

illustrate, contracting officers are not doing so. There is no guidance for contracting officers on considering tax information, even if the information is legally available to them, nor is there any coordinated mechanism to help contracting officers obtain accurate information on contractors that abuse the tax system.

As OMB pointed out, the existing suspension and debarment process includes an "other" category that provides for consideration of matters of "so serious or compelling a nature" that they affect a contractor's present responsibility. However, OMB did not explain how this effectively prevents awards to contractors that abuse the federal tax system or provide examples of such debarred or suspended contractors. Because the debarment and suspension process does not appear to be preventing federal awards to contractors that abuse the tax system, we continue to suggest that tax abuse be specifically designated or authorized as a cause for debarment, suspension, or ineligibility.

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 Defense; the Secretary of the Treasury; the Director, Office of Management and Budget; the Commissioner of the Financial Management Service; the Commissioner of Internal Revenue; the Under Secretary of Defense for Acquisition, Technology, and Logistics; the Under Secretary of Defense (Comptroller); the Director, Defense Finance and Accounting Service; the Director, Defense Logistics Agency; and interested congressional committees and members. We will 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, John J. Ryan at (202) 512-9587 or ryanj@gao.gov, or Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov if you or your staff have any questions concerning this report.



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Appendix I

Scope and Methodology

To identify DOD contractors, we obtained a copy of Department of Defense's (DOD) Central Contractor Registration (CCR) database as of February 2003 from the Defense Logistics Information Service (DLIS) in Battle Creek, Michigan. Because DOD does not have all contractor information in a single automated system, the CCR database provided the best available source of DOD contractor information.

To identify DOD contractors with unpaid federal taxes, we matched contractor records from the CCR database to Internal Revenue Service (IRS) tax records using the tax identification number (TIN) fields, which resulted in about 27,100 matching records with nearly $3 billion in unpaid taxes. We used data mining software to select, match, summarize, and report on DOD and IRS records. We also identified over 5,000 contractors with potentially invalid TINs by matching the contractor employer identification number (EIN) and Social Security number (SSN) fields from CCR to IRS tax records, and by providing an electronic file of contractor SSNs from CCR to the Social Security Administration for matching against its records.

To evaluate DOD and IRS processes and controls over the collection of unpaid federal taxes, we discussed this issue and reviewed current policies and procedures with the Defense Finance and Accounting Service (DFAS), IRS, and Financial Management Service (FMS) officials. We did not audit the effectiveness of the DFAS process for providing Mechanization of Contract Administration Services (MOCAS) payment information to Treasury Offset Program (TOP). In December 2003, we obtained information from IRS on FPLP collections from MOCAS payments through September 2003. We visited the IRS Processing Center in Kansas City, Missouri, to help determine the effectiveness of the continuous levy program. In addition, we reviewed related laws and regulations governing the levy program and TOP process.

To determine the DOD business activity of the about 27,100 contractors, we obtained copies of fiscal year 2002 payment files for five of the largest DOD payment systems: MOCAS for Defense Contract Management Agency (DCMA) payments, One Bill Pay for Navy payments, Integrated Accounts Payable System (IAPS) for Air Force payments, and Computerized Accounts Payable System (CAPS) Clipper and CAPS Windows for Army and Marine Corps payments. These payment files represented about 72 percent of the $183 billion disbursed to DOD contractors in fiscal year 2002. The five payment files are used to detect payment fraud and overpayments by the DFAS Internal Review group with the DOD Operation

Mongoose program at the Defense Manpower Data Center in Seaside, California. Using TINs, we matched the about 27,100 contractors to the five fiscal year 2002 DOD payment files.[1] We also estimated the potential fiscal year 2002 collections under an effective tax levy program of at least $100 million using the assumptions that all unpaid federal taxes were referred by IRS to FMS for inclusion in the TOP database, and fiscal year 2002 payment information from the five DOD payment files was provided to FMS for matching against the TOP database. The estimated collection amount under an effective tax levy program was calculated on 15 percent of the DOD contractor payments up to the amount of unpaid taxes.

To identify indications of abuse or potential criminal activity, we selected a group of DOD contractors as case studies for a detailed audit and investigation. To select the case studies, we used the about 27,100 contractors described above and, using TINs, we matched the contractors to the five fiscal year 2002 DOD payment files. This matching yielded about 8,500 active DOD contractors, which we further reduced based on the amount of unpaid taxes, number of unpaid tax periods, and DOD contractor payments. We reviewed the IRS tax records and excluded contractors that had recently paid off their unpaid tax balances or were categorized by IRS as compliance assessments, and considered other factors before reducing the number of cases for study to 47. We selected 34 businesses and 13 individuals for further audit and investigation, and obtained copies of their automated tax transcripts from IRS as of May 2003. We reviewed the transcripts for any steps taken to resolve the unpaid taxes. We also obtained detailed tax records (e.g., tax returns, revenue officer notes, and collection and assessment files) and reviewed them at the IRS processing center in Kansas City, Missouri. We obtained additional information from IRS to determine what enforcement actions had been taken against these contractors. For the 47 case studies, we identified DOD contract awards using the DOD Electronic Document Access system, and had criminal, financial, and public record searches performed by our Office of Special Investigations (OSI). We provided the case study list to FMS to identify the tax and nontax debt in the TOP database. For some case studies, we contacted the responsible DOD contracting officers to inquire about the contractors' goods or services, performance, and current DOD

[1] Because TINs were missing in some DOD payment records, we populated the five payment files with TINs by matching payment records to contractor records in the CCR database using the DOD Commercial and Government Entity code. This procedure identified additional payments made to DOD contractors with unpaid federal taxes.

contracts. OSI investigators contacted some contractors and performed interviews in California, the District of Columbia, Maryland, Michigan, Pennsylvania, Texas, and Virginia.

To determine whether DOD contractors with unpaid federal taxes are prohibited by law from receiving contracts from the federal government, we reviewed prior GAO work and relevant laws.

We performed our work at DOD headquarters in Arlington, Virginia; the DFAS office in Columbus, Ohio; the DLIS in Battle Creek, Michigan; the Defense Manpower Data Center in Seaside, California; IRS and FMS headquarters in Washington, D.C.; and the IRS processing center in Kansas City, Missouri.

DOD Contractors with Unpaid Federal Taxes

Tables 2 and 3 provide data on 17 detailed case studies. Tables 4 and 5 show the 30 remaining business and individual case studies that we audited and investigated. As with the 17 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 30 case studies. The case studies involving businesses with employees primarily involved unpaid payroll taxes, some for as many as 62 tax periods. The case studies involving individuals primarily involved unpaid income taxes.

Table 4: DOD Contractors with Unpaid Federal Taxes—Business

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
18	*Television repair services:* provides repairs at military hospital	Over $160,000	$5,000	$32,000	• Contract for over $180,000 in late 1990s • Long history of not remitting tax withholdings • Several federal tax liens filed against the owner
19	*Clothing manufacturer:* provides military uniforms for DOD agency	Over $1 million	$137,000	$914,000	• Numerous DOD contract awards totaling over $10 million • Offer in compromise, subsequently withdrawn
20	*Courier service*	Over $300,000	$5,000	$34,000	• DOD contract of over $30,000 • Bankruptcy filed • Several tax liens filed against the business
21	*Construction services:* provides fencing installation, maintenance and renovations on military bases	Nearly $60,000	Nearly $60,000	$1.1 million	• Business cooperated with IRS only after being placed in Federal Payment Levy Program and being levied on payments from a participating federal agency; IRS received almost $25,000 from levied payments • Has unpaid child support debt • Two tax liens filed against business
22	*Weapon parts manufacturer:* supplies weapons parts and tools to various military organizations	Over $400,000	$54,000	$363,000	• Nearly $1.9 million in DOD contracts • IRS tax liens filed against business
23	*Cleaning services:* provides cleaning and inspections of fire suppression systems	Over $250,000	$6,000	$40,000	• Awarded over $200,000 in DOD contracts • Several tax liens filed against business and its owner

(Continued From Previous Page)

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
24	*Computer equipment supplier:* supplies computer-related hardware to military services	Over $500,000	$7,000	$45,000	• Over $1.3 million in DOD contracts • Owes tens of thousands of dollars to a federal agency for a civil penalty for failing to meet its fiduciary duties under the employee retirement plan • Several federal, state, and county tax liens filed against business
25	*Information technology personnel services:* provides support for various military organizations	Nearly $1 million	$140,000	$932,000	• Federal payments received from three other federal agencies • Multiple DOD contracts valued up to approximately $13 million • Potential money laundering activities • Defaulted on installment agreements
26	*Aircraft-related goods:* supplies aircraft maintenance equipment	Over $1.5 million	$33,000	$221,000	• Nearly $2 million in DOD contracts • Several federal and state tax liens filed against this business • Several judgments were made against this contractor
27	*Aircraft-related goods:* supplies instruments to military services	Nearly $300,000	$7,000	$48,000	• Numerous DOD contracts totaling over $350,000
28	*Research services:* provides research for military service programs	Over $400,000	$4,000	$30,000	• DOD contract for over $100,000 • Federal tax liens filed against business
29	*Catering services*	Over $60,000	$4,000	$29,000	• Several IRS tax liens and state tax liens filed against this business
30	*Ammunition:* manufactures ammunition	Over $2 million	$100	$1,000	• Over $8 million in DOD contracts • Currently involved in a criminal investigation on product quality
31	*Consulting services:* provides technical support services for military installations	Nearly $2 million	$410,000	$2.7 million	• Nearly $30 million in DOD contracts • Bankruptcy filed • Federal and state tax liens filed
32	*Moving services:* provides furniture and office equipment for military installations	Over $50,000	Over $50,000	$399,000	• Over $200,000 in DOD contracts • Several federal and state tax liens filed
33	*Power equipment:* manufactures power supplies and regulators for various military organizations	Over $200,000	$86,000	$571,000	• Over $3 million in DOD contracts • Tax lien filed against this business • Several judgments filed against the business and its owner in the mid-1990s

(Continued From Previous Page)

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
34	*Custodial services:* provides janitorial and housekeeping services at military installations	Over $5 million	$188,000	$1.3 million	• About $4 million in DOD contracts • Multiple bankruptcies filed • Several federal and state tax liens filed against business
35	*Construction services:* provides construction services at military installations	Nearly $150,000	$23,000	$152,000	• Bankruptcy filed in late 1990s • IRS received over $70,000 from levied payments from agencies other than DOD
36	*Funeral home:* provides funeral services	Over $360,000	$2,000	$14,000	• Continued to incur delinquent taxes after emerging from bankruptcy
37	*Procurement services:* obtains parts and equipment for various military organizations	Over $100,000	$12,000	$81,000	• Several federal and state tax liens filed against this business and its owner
38	*Information technology personnel services:* provides information technology support to military organizations	Over $1 million	$289,000	$1.9 million	• Corporate officer assessed a trust fund recovery penalty

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

Notes: Dollar amounts are rounded. Nature of unpaid taxes for businesses was primarily due to unpaid payroll taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole proprietorship).

[a]Unpaid tax amount as of September 30, 2002.

[b]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[c]DOD payments from MOCAS, One Bill Pay, IAPS, and CAPS automated systems identified by GAO.

Table 5: DOD Contractors with Unpaid Federal Taxes—Individual

Case study	Goods or service and nature of DOD work	Unpaid federal tax amount[a]	Estimated fiscal year 2002 collections under effective tax levy[b]	Fiscal year 2002 DOD payments[c]	Comments
39	*Music services:* provides musicians and music services	Over $30,000	$2,000	$16,000	• Over $50,000 in DOD contracts • Debt for unpaid child support • Individual has personal debt that has been turned over for collection action
40	*Maintenance services:* repairs shielded doors for secure areas	Over $50,000	$4,000	$28,000	• Over $100,000 in DOD contracts • Bankruptcies filed in mid-1990s • Several court judgments filed against the contractor in the mid- to late 1990s
41	*Music services:* provides musicians for religious services	Over $160,000	$33,000	$217,000	• Individual has not filed an income tax return since 1997 • Defaulted on installment agreement in the late 1990s
42	*Construction services:* provides general carpentry, electrical, painting, and building repairs	Nearly $70,000	$19,000	$130,000	• Over $100,000 in DOD contracts • Federal tax lien filed against this individual
43	*Consulting services:* provides software development services	Over $50,000	$8,000	$56,000	• Individual has personal credit accounts in collection • Federal tax lien filed against this individual
44	*Training services:* provides diversity and sexual harassment training	Over $60,000	$13,000	$89,000	• Over $90,000 in DOD contracts • Student loan debt • Individual owes over $10,000 in past due debt • Several civil judgments and state tax liens filed against contractor
45	*Equipment maintenance:* provides maintenance and repair of boilers, generators, and compressors	Nearly $260,000	$17,000	$113,000	• Individual owes over $10,000 in past due debt • Defaulted on installment agreement • One judgment against individual
46	*Environmental engineering:* prepares environmental reports	Over $10,000	Over $10,000	$286,000	• Owner is federal employee and reserve military officer
47	*Consulting services:* provides advice to a military medical command	Nearly $140,000	$13,000	$89,000	• Nearly $300,000 in DOD contracts • Student loan debt with a federal agency • Individual has several accounts with collection agency • Federal tax lien filed against individual

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

Notes: Dollar amounts are rounded. Nature of unpaid taxes for individuals was primarily due to unpaid income taxes. A contractor registers in the CCR database with either an EIN or an SSN. In our report, any contractor registering with an EIN is referred to as a business, and any contractor registering with an SSN is referred to as an individual. An individual in CCR could be a business owner (i.e., sole

proprietorship). For cases selected as individuals, we reviewed both the owner and related business information, if it could be identified.

[4]Unpaid tax amount as of September 30, 2002.

[5]The estimated collections under an effective tax levy use the assumptions that all unpaid federal taxes are referred to TOP at Treasury FMS and all fiscal year 2002 DOD payment information is provided to TOP. The collection amount is calculated on 15 percent of the payment amount up to the amount of unpaid taxes.

[6]DOD payments from MOCAS, One Bill Pay, IAPS, and CAPS automated systems identified by GAO.

Comments from the Department of Defense

COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JAN 15 2004

Mr. Gregory D. Kutz
Director, Financial Management and Assurance
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Kutz:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report (04-95), "FINANCIAL MANAGEMENT: DoD Pays Billions of Dollars to Contractors That Abuse the Federal Tax System," dated December 8, 2003, (GAO Code 192092). The DoD concurs with the four recommendations in the draft report and is already taking action to correct the noted deficiencies.

The Department appreciates the opportunity to comment on the subject report. Mr. Tom Summers will be available to help resolve the issues outlined in this report. He may be contacted by e-mail: tom.summers@osd.mil or by telephone at (703) 697-3193.

Sincerely,

Dov S. Zakheim

Enclosure:
As stated

GAO DRAFT REPORT - DATED DECEMBER 8, 2003
GAO CODE 192092/GAO-04-95

"FINANCIAL MANAGEMENT: DOD PAYS BILLIONS OF DOLLARS TO CONTRACTORS THAT ABUSE THE FEDERAL TAX SYSTEM"

DEPARTMENT OF DEFENSE COMMENTS TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to develop a formal plan to implement the Debt Collection Improvement Act (DCIA) of 1996 by providing payment information to the U. S. Treasury's Offset Program (TOP) for all Defense Finance and Accounting Service (DFAS) payment systems. At a minimum, the plan should designate officials responsible for implementing DCIA responsibilities for each payment system, including firm implementation dates for each payment system.

DOD RESPONSE: Concur. The Defense Finance and Accounting Service (DFAS) Columbus implemented the Treasury Offset Plan (TOP) on December 16, 2002, to offset/levy payments made to DoD contractors in the Mechanization of Contract Administration Services (MOCAS) system. To date, DFAS has collected approximately $1,150,292.21 in offsets/levies.

The following chart summarizes the plan status for 100 percent of the entitlement systems on which DFAS bases its contract and vendor payments. The implementation dates include the time that DFAS will need to establish procedures for withholding funds that Treasury identifies for offset/levy.

The completion date to implement the DoD's offset/levy program for the DFAS payment systems is August 2004. For the non-DFAS systems, DFAS has been requested to work with the appropriate system owners and the Treasury Financial Management Service (FMS) to develop an implementation plan by February 27, 2004. The target date for implementation of the offset/levy program for non-DFAS system owners is March 2005.

Enclosure

Department of Defense
Treasury Offset Program (TOP)
Implementation Plan

Entitlement System Abbreviation	Entitlement System	System Owner	Firm Date for Plan Preparation	Estimated Implementation Date
CAPS-CLIPPER	Computerized Accounts Payable System--Clipper	DFAS	Completed	11 sites by 3/22/04
CAPS-W	Computerized Accounts Payable System--Windows	DFAS	Completed	11 sites by 3/22/04
IAPS	Integrated Accounts Payable System	DFAS	Completed	8 sites by 8/30/04
OBP	One Bill Pay (Previously Called STARS One Bill Pay)	DFAS	Completed	7 sites by 6/28/04
DTRS	Defense Transportation Payment System	DFAS	2/27/04	No later than March 2005
TSS	Transportation Support System	DFAS	2/27/04	No later than March 2005
AVEDS	Automated Voucher Examination Disbursing System	DLA	Completed	1 site by 4/26/04
FAS	Fuels Automated System	DLA	2/27/04	No later than March 2005
DISMS	Defense Integrated Subsistence Management System	DLA	2/27/04	No later than March 2005
FABS	Financial Accounting Budget System	DITCO	2/27/04	No later than March 2005
SAMMS	Standard Automated Material Management System	DLA	2/27/04	No later than March 2005
SAVES	Standard Automated Voucher Examination System	DECA	Completed	1 site by 4/05/04
CUFS	College And University Financial System	USUHS	2/27/04	No later than March 2005
SYMIS	Shipyard Management Information System	USN	2/27/04	No later than March 2005
TMS	Transportation Management System	USMC	2/27/04	No later than March 2005
TFMS-M	Transportation Financial Management System – MTMC	MTMC	2/27/04	No later than March 2005
BSM	Business Systems Modernization	DLA	Completed	1 site by 2/16/04

2

Enclosure

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to collaborate with the U.S. Treasury's Financial Management Service to develop interim procedures for identifying active Defense contractors in the TOP.

DOD RESPONSE: Concur. Once the Department identifies the invoices available for offset, the process of identifying active Defense contractors in the TOP currently is reserved to FMS. The Department will partner with FMS and IRS to assess the possibility of developing more extensive matching logic with the objective of increasing the number of matches available.

The Department has been collaborating in other ways. In addition to providing FMS with the payment availability file on a weekly basis, FMS was provided with a list of the approximately 336,000 open Mechanization of Contract Administration Services (MOCAS) contracts that have Tax Identification Numbers (TINs) in order to predict possible future offset/levy opportunities. From this list, there were 225 matches, which represents 0.067 percent of the open contracts in MOCAS. Additionally, FMS was provided a list of payable invoices from CAPS-W (Columbus), which resulted in one match, that is, 0.032 percent. The Department is also assessing the feasibility of providing payment availability files to FMS more frequently. The Department has been, and will continue to be, proactive in working with Treasury to generate as many collections as possible.

Estimated Completion Date: Ongoing.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to develop manual procedures so that the offset of payments can be started immediately for all DoD payment systems.

DOD RESPONSE: Partially Concur. The Department's implementation plan has been accelerated to 6 months for most payment systems. We believe that our focus should remain on implementing a system-based process rather than temporary manual procedures.

Estimated Completion Date: Not applicable.

RECOMMENDATION 4: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to devote sufficient resources to implement all aspects of the TOP and the DoD plan (identified in recommendation 1).

DOD RESPONSE: Concur. The Department will devote the necessary resources to support the offset/levy program as it is implemented in each system in the plan identified in Recommendation 1. The level of resources will be revaluated as the program progresses.

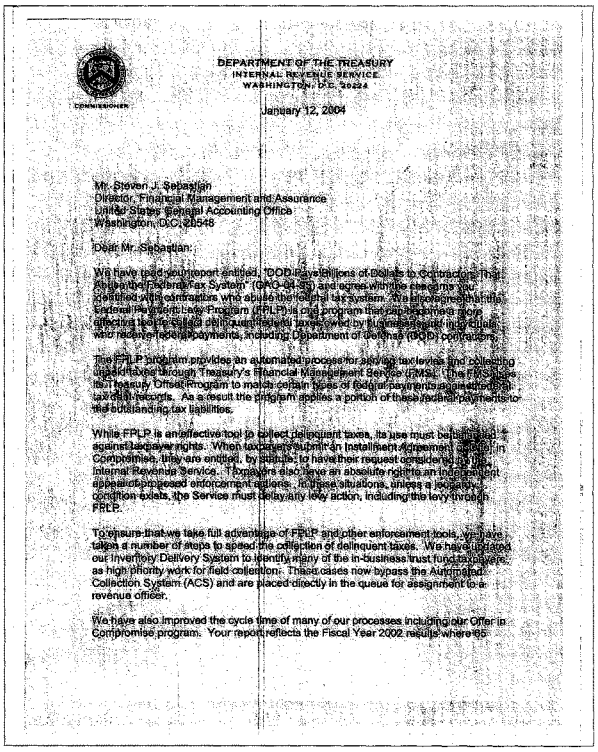
Estimated Completion Date: Ongoing.

3 Enclosure

Matters for Congressional Consideration: Until such time as DoD is able to demonstrate it is meeting its responsibilities under the DCIA, including providing payment information to TOP for purposes of offsetting delinquent federal debt, and to facilitate action by the Department, Congress should consider requiring that DoD report periodically to the Congress on its progress in implementing the Act for each of its contract and vendor payment systems. This report should include details of actual collections by system and in total for all contract and vendor payment systems during the reporting period.

DoD Response: Such a Congressional requirement is not necessary. As the implementation plan proceeds, the Department will report the progress of implementing the requirements of the Debt Collection Improvement Act within each of its contract and vendor payment systems to the GAO.

Comments from the Internal Revenue Service



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

COMMISSIONER

January 12, 2004

Mr. Steven J. Sebastian
Director, Financial Management and Assurance
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Sebastian:

We have read your report entitled, "DOD Paying Millions of Dollars to Contractors That Abuse the Federal Tax System" (GAO-04-95) and agree with the concerns you identified with contractors who abuse the federal tax system. We also agree that the Federal Payment Levy Program (FPLP) is a key program that can help make more effective use of collection resources by targeting by business assets into efforts with recent federal payments, including Department of Defense (DOD) contractors.

The FPLP program provides an automated process for serving tax levies and collecting unpaid taxes through Treasury's Financial Management Service (FMS). The FMS uses the Treasury Offset Program to match certain types of federal payments in addition to tax debt records. As a result the program applies a portion of these federal payments to the outstanding tax liabilities.

While FPLP is an effective tool to collect delinquent taxes, its use must be balanced against taxpayer rights. When taxpayers submit an Installment Agreement or Offer in Compromise, they are entitled, by statute, to have their request considered by the Internal Revenue Service. Taxpayers also have an absolute right to an independent appeal of proposed enforcement actions. In these situations, unless a jeopardy condition exists, the Service must delay any levy action, including the levy through FPLP.

To ensure that we take full advantage of FPLP and other enforcement tools, we have taken a number of steps to speed the collection of delinquent taxes. We have integrated our Inventory Delivery System to identify many of the in-business trust fund taxpayers as high priority work for field collection. These cases now bypass the Automated Collection System (ACS) and are placed directly in the queue for assignment to a revenue officer.

We have also improved the cycle time of many of our processes including our Offer in Compromise program. Your report reflects the Fiscal Year 2002 results where 95

2

percent of offers were resolved in excess of six months. In Fiscal Year 2003 we reduced that number to 44 percent.

Finally, we have reviewed the systemic blocks in our FPLP procedures and information systems and found that some of these prevent certain cases from entering the levy program. We will be making changes to our information systems to remove the underlying blocks, including current blocks on cases that are in the queue and certain Business Master File cases in ACS. As a result of this effort, more delinquent accounts will be included in the FPLP earlier in the collection process. While discussion of the FPLP may appear cost beneficial, concerns for taxpayer rights and statutory requirements sometimes require us to remove a taxpayer from FPLP prior to the point taking any further collection action at all. For that reason, we believe analyses should not be to the FPLP rather than a cost benefit analysis, is more appropriate. Therefore, we are not able to evaluate the cost benefit of keeping these businesses and individuals in the levy program until the taxes are fully paid.

Your report also mentions problems with data quality in the Central Contractor Registration (CCR) database, particularly as it relates to accurate or valid taxpayer identification numbers (TINs) provided by registered taxpayers. As we stated in our response to your audit "More Can Be Done to Ensure Federal Agencies Use Accurate Information Returns," we will work with the DOD to ensure that the vendor TINs in the CCR are accurate. We will also work with the Office of Management and Budget and DOD to support changes they initiate with respect to Federal contracts and contractors.

We are working with your office to secure additional information on the 42 businesses and individuals identified in your audit, with indications of abuse or potential criminal activity. We plan to review each of these case files and refer them for additional action as appropriate. As part of our work with DOD, we will also consider alternative uses of the information in the CCR to help identify these types of egregious cases.

If you have any questions please contact me, or Cheryl Sherwood, Director, Payment Compliance Policy, at (202) 283-7950.

Sincerely,

for Mark W. Everson

Appendix V

GAO Contacts and Staff Acknowledgments

GAO Contacts

Arthur W. Brouk, (214) 777-5633
Lawrence Malenich, (202) 512-9399
John J. Ryan, (202) 512-9587

Acknowledgments

In addition to the individuals named above, Tida Barakat, Gary Bianchi, Ray Bush, William Cordrey, Francine DelVecchio, K. Eric Essig, Kenneth Hill, Jeff Jacobson, Shirley Jones, Jason Kelly, Rich Larsen, Tram Le, Malissa Livingston, Christie Mackie, Julie Matta, Dave Shoemaker, Wayne Turowski, Jim Ungvarsky, and Adam Vodraska made key contributions to this report.

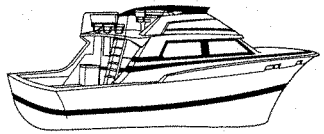
Permanent Subcommittee on Investigations
EXHIBIT #2a

GAO
Accountability • Integrity • Reliability

Potential Diversions of Payroll Taxes for Personal Gain

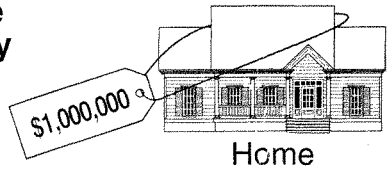
Case study #1

Caribbean home



Cabin cruiser

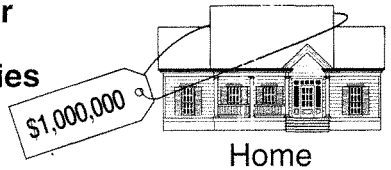
Case study #2



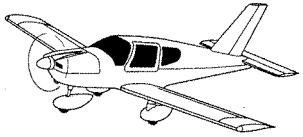
Home

Mercedes

Other case studies



Home



Cessna airplane

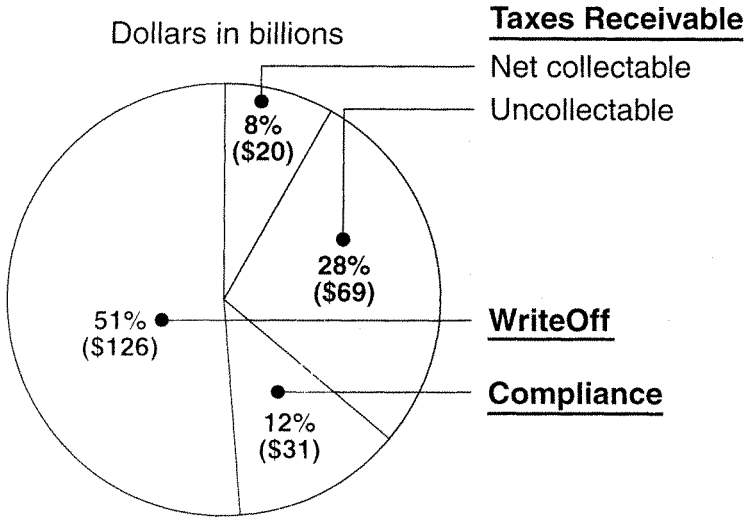
BMW

Source: GAO.

Permanent Subcommittee on Investigations
EXHIBIT #2b

GAO
Accountability * Integrity * Reliability

Composition of the $246 Billion of Unpaid Assessments as of September 30, 2003



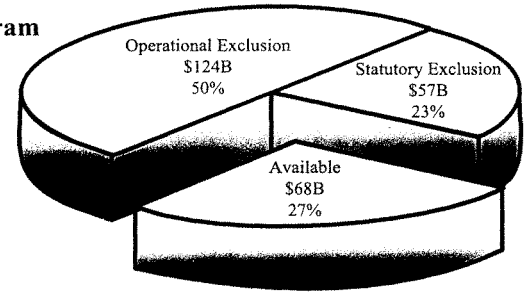
Source: IRS financial statements.

IRS

Increasing Tax Debts Available for Levy

$249B*

Existing Program



Operational Exclusions

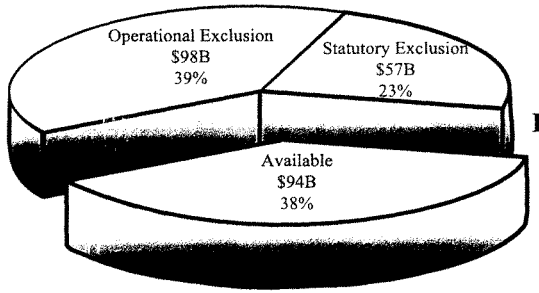
- Hardship
- Deceased Taxpayer/ Out of Business
- Claim Pending/ Amended Returns

- Criminal Investigation
- Revenue Officer Cases
- Selected Automated Collection Function

Statutory Exclusions

- Bankruptcy/Litigation
- Installment Agreement
- Offer-in-Compromise
- Collection Due Process
- Military (Combat Zone)

Interim Improvement ($26B)



*FY2002 Audited Financial Statement

Permanent Subcommittee on Investigations

EXHIBIT #3

RESPONSE FOR THE RECORD OF STEVEN J. SEBASTIAN, DIRECTOR
GAO'S FINANCIAL MANAGEMENT AND ASSURANCE TEAM

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON DOD CONTRACTORS WITH DELINQUENT FEDERAL TAXES
FEBRUARY 12, 2004

In reviewing IRS's fiscal year 2005 budget request and budget justification, there is no clear explanation as to how IRS would utilize its proposed $300 million funding increase to deal more quickly with frivolous settlement and/or installment agreement offers. Neither the fiscal year 2005 budget proposal nor the budget justification discuss IRS's planned efforts to address the issue of frivolous offers made by individuals and businesses with outstanding federal taxes to resolve their tax debt. Consequently, it is unclear how such funding will better enable IRS to more timely deal with this issue in tax settlement cases.

It is important to note that the $300 million funding increase proposed by IRS is much broader than just the issue of addressing frivolous settlement offers. The funding increase, as envisioned by IRS, is to be used across the agency's appropriations to substantially restore an enforcement presence at the agency. IRS's intent is to apply the proposed funding increases to shore up its resources to better cover areas where it believes non-compliance is greatest. These areas include: (1) promoters of tax schemes, (2) misuse of offshore accounts and trusts to hide or improperly reduce income, (3) abusive tax shelters, (4) underreporting of tax by higher-income individuals, and (5) failure to file and pay large amounts of unemployment taxes.

It is encouraging, in light of our work reviewing DOD contractors with outstanding federal taxes, that IRS, in its budget proposal, is targeting those individuals and businesses that fail to file and remit withheld payroll taxes. This by far was the greatest issue of tax abuse we saw in our review of the 47 contractor cases.

Permanent Subcommittee on Investigations
EXHIBIT #4

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO
MARK EVERSON
Commissioner
Internal Revenue Service

QUESTIONS SUBMITTED BY
SENATOR NORM COLEMAN and SENATOR CARL LEVIN

1. **In testimony before the Subcommittee on February 12, 2004, the Commissioner of the Internal Revenue Service (IRS), Mark Everson, indicated that the Administration plans to establish an interagency task force, consisting of experts from the Office of Management and Budget (OMB), Treasury, and Department of Defense (DOD), to review the tax levy process for federal contractors, identify short-term and long-term measures to improve the efficiency and effectiveness of the levy collection process, and provide recommendations for possible legislative improvements.**

   (a) Will the Department of Justice, whose Tax Division enforces the tax levy law, also participate on this task force?

   Answer: Yes, the Department of Justice has agreed to participate on the task force.

   (b) Commissioner Everson indicated that the task force will produce a report by June 2004. Please provide a written description of the task force's mission statement and plan to meet this June 2004 reporting deadline, including specifying intermediate milestones and deadlines.

   Answer: The mission of the task force is to: 1) Identify and implement short and long term operational changes to increase federal tax compliance of Department of Defense (DOD) contractors. This would include increasing the number of tax debts and the number of DOD contractor payments available for matching through the Treasury Offset Program. 2) Identify statutory changes that would enhance IRS enforcement efforts to address federal contractor tax delinquencies, and/or prevent future occurrences of tax abuse by federal contractors. The group will meet bi-weekly to ensure that the preliminary report is completed by June 1. It is also anticipated that a cross agency advisory council would continue to ensure implementation and improve ongoing communication and coordination.

   (c) Will the task force be willing to discuss with Subcommittee staff any proposed findings, improvements, or recommendations?

   Answer: Yes, we welcome their input.

Permanent Subcommittee on Investigations
EXHIBIT #5

2. **In testimony before the Subcommittee on February 12, 2004, Commissioner Everson indicated that the IRS has not previously assigned revenue officers, on a full or part-time basis, to work on the tax levy collection process for federal contractors.**

   (a) Would the IRS be willing to assign one or more full-time revenue officers to specialize in the tax levy collection process for federal contractors?

   Answer: All Revenue Officers have levy authority, and when federal contractor cases are assigned to our field collection operation for action, the revenue officers consider the appropriateness of levy. We are also exploring, jointly with DOD/DFAS, methods which would help both agencies identify federal contactors with tax delinquencies and systemic automated approaches to levying those proceeds. This would be a "stop-gap" measure until DFAS gets all of its payment systems online through the automated processes. Although revenue officer resources and skills, per se, are not being used for this approach, we are devoting personnel with collection expertise and technology resources to this initiative.

   (b) Would the IRS be willing to assign these revenue officers to work with DOD and the Financial Management Service to improve the efficiency and effectiveness of both agencies' tax levy programs?

   Answer: IRS is committed to provide the resources necessary to work with DOD and FMS to improve the efficiency and effectiveness of both agencies' tax levy programs. However, we are not confident that the skills required are revenue officer skills. Initially, we will assign personnel with program analyst skills. Many of the program analysts for collection programs have revenue officer experience, as well as the additional skills necessary to design and implement new work processes, policies and procedures. This issue will also be addressed by the inter-agency task force.

3. **Please identify any statute or regulation which would preclude the IRS from stating in initial or subsequent letters notifying a person of a federal tax delinquency that, if the person is a federal contractor, failure to pay the taxes owed may immediately subject any federal contract payment to the tax levy process. Please explain whether the IRS would be willing to combine the due process notice for tax levies with other IRS notices provided to tax delinquent persons and, if so, its plans for combining the two notices.**

   Answer: IRS is not prohibited by statute, however our policy is to refrain from combining the collection due process notice for tax levies with other IRS notices to delinquent taxpayers unless a levy source is identified for the specific taxpayer account.

At any given point in time, there are approximately 5.6 million delinquent tax debts that FMS matches against federal payments. Of these, approximately 2.6 million modules are business accounts. When GAO conducted its study of contractors with unpaid taxes as of September 30, 2002 with active contracts, they identified 27,000 delinquent accounts with active contracts, and selected 8600 to pursue. Sending a Collection Due Process (CDP) notice to all taxpayers prior to identifying a levy source would mean that IRS would send a CDP notice to millions of taxpayers when it would be legally necessary to send a CDP notice to only 8600 taxpayers. The cost of sending collection due process notices and responding to all taxpayers would be prohibitive.

We would like to work with DOD and FMS to evaluate the feasibility of identifying federal contractors with government contracts who also have delinquent tax accounts at the time of contract award. If there is a match, IRS could initiate the CDP notification so that a levy could be issued when the delinquent taxpayer is first due a payment. This alternative would allow IRS to target resources so that only those taxpayers with a match would receive the accelerated CDP notification. The inter-agency task force will address this issue.

4. In the case of a federal contractor that has previously defaulted on an IRS compromise or installment agreement to repay taxes, please indicate:

(a) Whether the IRS has sufficient authority under existing law to reject from the same contractor another offer-in-compromise or offer to enter into an installment plan as unreasonable and to immediately initiate the tax levy process with respect to federal payments to the contractor?

Answer: Repeated offers following rejection can be immediately returned as having been submitted solely for purposes of delay. If the offer was submitted solely to delay collection, then the IRS may levy to collect the liability that is the subject of that offer at any time after it returns the offer to the taxpayer. Treas. Reg sec. 301.7122-1(g)(4)

(b) Whether the IRS has sufficient authority under existing law to use the tax levy process to carry out an offer-in-compromise or installment agreement?

Answer: Section 6331(k) of the Code does not permit levy while an OIC is pending, for 30 days after it is rejected, and during the period an appeal is pending. Likewise the IRS may not levy while an installment agreement is in effect and for 30 days after the IRS terminates the installment agreement and during any period of appeal of the termination.

(c) Whether the IRS would be willing to work with Congress to eliminate administrative and statutory barriers to initiating and continuing a tax levy on a federal contractor who is negotiating with the IRS to repay a tax debt?

Answer: The IRS has already begun eliminating operational barriers to making contractors' accounts available for collection via the Federal Payment Levy Program. At the same time, the IRS must take into account the fact that taxpayers often will have legitimate disputes regarding the amount of taxes owed or the manner in which those taxes should be paid. The inter-agency task force established in response to the GAO report will identify additional steps that can be taken. The IRS would look forward to working with Congress and the Treasury Department to explore other ways of achieving the goal of maximizing the number of accounts available for collection through this program.

5. **According to GAO's testimony before the Subcommittee, the IRS is required to discontinue a levy initiated under the Federal Payment Levy Program if the taxpayer makes an offer-in-compromise or seeks an installment agreement. Are there any other conditions that require the levy to be suspended? Is the suspension requirement based on a legal or implementing regulatory requirement? Please provide all appropriate citations for this criteria.**

Answer: Section 6331(k) of the Code prohibits levy as set forth in 4(b) above. Section 6331(i) prohibits levy during the pendency of a refund suit for a divisible tax (Employment taxes Section 3101 et. seq). A taxpayer may pay the tax for one quarter and bring the entire liability into issue in the judicial proceeding. The automatic stay in bankruptcy, 11 USC 362, prohibits levy during the pendency of a bankruptcy proceeding. If a taxpayer/contractor filed a petition in bankruptcy, the IRS would be required to suspend the continuous levy due to the automatic stay.

6. **The IRS has included a proposal in the President's FY2005 budget to enable the IRS to apply penalties to and presumably reject frivolous offers-in-compromise, offers to enter into installment agreements, or requests for collection due process hearings. Does the IRS proposal contemplate allowing the IRS immediately to initiate tax collection procedures, including tax levies, if appropriate, for federal contractors whose offers or requests were rejected as frivolous? Please explain why the IRS believes it cannot reject frivolous offers and undertake immediate collection efforts under existing law.**

Answer: The Administration's FY 2005 Budget proposal regarding frivolous submissions would send a clear message to those who would attempt to use frivolous submissions to impede tax collection that such tactics not only will be unsuccessful but will, in fact, be penalized. First, the proposal would allow the IRS to return frivolous submissions or disregard frivolous arguments for a broad

range of documents where existing law currently does not provide an ability to do so. Most significant among these is requests for Collection Due Process hearings under sections 6320 and 6330. Second, the proposal would provide for a penalty of up to $5,000 if a taxpayer does not withdraw a frivolous submission after being given a warning that the document is regarded as frivolous. The IRS believes that this penalty would have a significant deterrent effect.

With respect to offers in compromise, Treasury regulations currently permit the IRS to immediately return an offer in compromise if the IRS determines that the offer "was submitted solely to delay collection." Treas. Reg. § 301.7122-1(d)(2). Return of an offer on this basis cannot be appealed to the IRS Office of Appeals and the IRS can commence collection, including collection by levy, immediately. Similarly, the prohibition on making levies while a request for an installment agreement is pending does not apply if the request was made solely for purposes of delay. Treas. Reg. § 301.6331-4(a)(4). The IRS created these exceptions based on an express statement in the legislative history of the IRS Reform and Restructuring Act of 1998. See H.R. Conf. Rep. 105-599, at 288 (1998). The Administration's proposal would strengthen these provisions by giving taxpayers clear notice of the positions the Service considers frivolous and by permitting the imposition of penalties on taxpayers who abuse these taxpayer protection provisions.

7. **GAO recommends that federal agencies bar tax delinquent persons from bidding on or obtaining federal contracts. In testimony before the Subcommittee on February 12, 2004, DOD indicated that it has considered requiring bidders on DOD contractors to submit a certification, as part of the bidding process, stating that they have no federal taxes in arrears or are current with any installment plan or offer in compromise. Please provide the perspective of the IRS on whether this type of contract bar or certification requirement should be included in federal law and, if so, how it should be worded.**

Answer: The IRS appreciates the concern that those who contract with the Government be compliant with federal laws, including the tax laws. At the same time, any certification system with respect to federal tax compliance would have to take into account the fact that taxpayers often will have legitimate disputes regarding the amount of taxes owed or the manner in which those taxes should be paid. The Internal Revenue Code sets out the procedures to be used by taxpayers and the Service to identify, address and resolve disputes regarding the correct amount of tax owed by a taxpayer as well as disputes regarding the collection of tax. A certification system that is perceived by taxpayers as restricting a taxpayer's ability to avail itself of these procedures to resolve good faith disputes may have a detrimental effect on tax administration. I therefore believe that any decision to implement a certification program must strike the appropriate balance between taxpayer rights and the legitimate policy objective of ensuring that

contractors have a clean bill of financial health. The IRS would look forward to working with Congress, affected federal agencies and the Treasury Department in evaluating this issue further. I have also asked the inter-agency task force to address this issue.

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RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO
MARK EVERSON
Commissioner
Internal Revenue Service

QUESTIONS SUBMITTED BY SENATOR DANIEL K. AKAKA

1. **At the hearing, the General Accounting Office (GAO) testified that one of the challenges of preventing contractors with unpaid taxes from receiving federal contracts is that contracting officials have no way of knowing whether contractor has paid taxes before awarding a contract.**

   What should be done to ensure that contracting officials are informed as to whether or not a contractor has paid their federal and state taxes before contracts are awarded? Do you believe that a central listing identifying contractors with unpaid federal and state taxes should be made available to contract officials before contracts are awarded? If not, why?

   Answer: I appreciate the Committee's concerns about the federal tax compliance status of bidders for federal contracts. As I stated at the hearing, this issue presents a conflict of two important public policy interests: 1) taxpayer rights and 2) the desire of the government to work with vendors who have a clean bill of financial health. Addressing this issue should be done within the framework of existing statutes governing the confidentiality of taxpayer information. In addition, we must consider that the creation and maintenance of a centralized listing or database of the tax compliance status of existing or prospective government contractors would create very significant administration issues.

   We believe that a certification program could be instituted under current law, and that such a program would enable prospective contractors to keep their federal tax payment status confidential by either withdrawing or failing to make a bid. Specifically, a certification by a prospective contractor could include a form of consent sufficient under existing Internal Revenue Code provisions and Treasury regulations to permit IRS to make the disclosure to DoD. I note, however, that the considerations identified above with respect to any potential certification program would have to be addressed before such a program was implemented. In addition, depending on the volume of bids, the disclosure process may result in a paperwork (or electronic) burden for both federal agencies, the IRS, and prospective contractors.

   The inter-agency task force that has been formed to address the problems identified by the GAO will be exploring ways that information can better be shared among contracting agencies, FMS and the IRS to improve the reach and effectiveness of the Federal Payment Levy Program. For example, the task force will explore ways in which contracting agencies can inform the IRS that a contract has been awarded so that statutory prerequisites to collection can be completed in a timely manner.

2. **GAO testified that the 27,100 contractors with $3 billion in unpaid federal taxes also have unpaid state taxes, which support critical services such as workers compensation, health insurance, and public schools.**

   Could you please state, for the record, if you believe that information on contractors' payment of state taxes should be included in the Treasury Offset Program (TOP) so that unpaid state taxes may be levied from payments to contractors?

   Answer: Our priority, of course, is to ensure that all federal taxes are paid. The TOP is an important tool that helps the IRS fulfill this responsibility. I defer to the Financial Management Service (FMS) which administers the Treasury Offset Program to comment on whether the TOP should be used to collect state taxes.

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RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO
MARK EVERSON
Commissioner
Internal Revenue Service

QUESTIONS SUBMITTED BY SENATOR FRANK LAUTENBERG

1. **Senator Coleman's staff at the PSI told us that one in three tax collection actions is frozen because of lack of funds alone.**

   I have heard that one in three cases of tax delinquency is frozen for no other reason than that the IRS does not have the funds to pursue these cases? Is this true? Would additional funds in this area pay for themselves in improved collection rates?

   Answer: In 1999, IRS recognized that it could not work all collection cases in inventory with its available staffing. Therefore, it began deferring collection action on billions of dollars of tax delinquencies. This deferral resulted in a rapidly growing gap between IRS's collection workload and its ability to address it. By the end of fiscal year 2002, after this deferral policy had been in place for about 3 and one-half years, IRS reported that it has deferred collection action on about $15 billion in unpaid taxes, interest, and penalties. GAO has reported that cases in deferred status represented about one out of three new collection cases in FY 2002.

   In order to address this gap and insure we use our limited resources as effectively as possible, we have taken a number of steps, including:

   * *Improved Case Selection Process* – The IRS must both address the most serious areas of noncompliance while still addressing a wide range of cases and issues. Improvements to the case selection process will better enable the IRS to address its compliance priorities.

     The IRS has refined its inventory delivery system which enables it to select higher priority cases for assignment to the collection field function and the Automated Collection System. Compliance risk, potential collectibility, and potential return on investment are related factors used in the filters for the IRS' inventory delivery system. This results in high priority cases being assigned for collection earlier in the delinquency cycle, which means the IRS gets to the case before the taxpayer has gone deeper and deeper into debt. The IRS continues to examine how case selection can be improved further.

* *Strategy to Address Nonpayment of Employment Tax* – The failure of employers to make their federal tax deposits and pay over the withheld trust fund taxes is a serious compliance issue. The IRS is developing and implementing a strategy to improve collection of employment taxes. For instance, the IRS is assigning these cases for collection action early in the delinquency process, when there is a higher probability for collection and less chance for the account to grow with additional employment tax delinquencies.

* *Exploring the Causes for Underpayment and Non-Filing* – The IRS is working to identify the components of its potentially collectible inventory, the main causes of non-compliance, and the contributing market segments. The information obtained is being used to address taxpayers through outreach and education, and to determine potential systems and policy changes. One significant component involves estimated tax compliance.

A case in "deferred status" refers to a case that has been removed from active inventory so that another case with higher priority or higher probability of collection can be assigned and worked by IRS employees. Although cases in "deferred status" are not being actively worked by an IRS employee, there are several systemic processes that remain in effect that insure the case continues to be monitored and collected upon in certain situations. Deferred status cases are monitored systemically for changes in account status that might indicate that the Collectibility has increased. Other systemic processes include:

* Automatic refund offset for as long as the statute of limitations remains open.

* Inclusion of the debt in the Federal Payment Levy Program, which ensures that any federal payments due to the taxpayer are subject to levy.

* Systemic reactivation of the account if a new liability, a source of income or tax filing delinquency occurs.

* Annual notices to remind taxpayers of these tax obligations and to encourage payment.

2. Following up on Question One, you were wondering what kind of additional resources the IRS needs to get its sorry collections operations into shape.

Answer: The President's FY 2005 budget submission requests an additional $300 million for enforcement activities over the FY 2004 consolidated appropriations level. This additional funding will help us carry out four objectives in the enforcement area; 1) discourage cheating and non-compliance, particularly by corporations, high income individuals and tax exempt groups 2) help attorneys,

accountants and other tax professionals adhere to professional standards and obey the law, 3) detect and deter domestic and off-shore tax and financial criminal activity and 4) discourage and deter non- compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance and other purposes.

This funding in the FY 2005 budget will enable us to hire 1,014 collection personnel in our field and campus offices. When fully trained, they will collect roughly $97 million additional revenue in fiscal year 2005 and more than one billion dollars in fiscal year 2006. The Administration also has proposed to allow us to use private collection agencies to locate and contact taxpayers with outstanding tax liabilities. This proposal would greatly assist our collection efforts.

The additional funding combined with the inventory management initiatives and the use of private collection agencies will enable IRS to address significantly more delinquent accounts, therefore making our collection program more effective. We believe we will always need to prioritize our work to insure we are addressing work with the largest compliance risk and impact.

3. **Why are so many cases not being pursued? Does the IRS have the resources, both in money and personnel, to pursue tax cheats? How much more money does the IRS need?**

Answer: As stated in the response to question 1 above, in 1999 the IRS began deferring cases due to staffing deficiencies. We have taken steps (outlined in the response to question 1) to use our limited resources as efficiently as possible to pursue more cases. As discussed in the response to question 2, the President's FY 2005 budget submission requests an additional $300 million for enforcement activities over the FY 2004 consolidated appropriations level. This additional funding would help us to bolster our enforcement efforts.

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RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO

RICHARD L. GREGG
Commissioner
Financial Management Service
U.S. Department of the Treasury

QUESTIONS SUBMITTED BY SENATOR DANIEL AKAKA

1. **At the hearing, the General Accounting Office (GAO) testified that one of the challenges of preventing contractors with unpaid taxes from receiving federal contracts is that contracting officials have no way of knowing whether contractor has paid taxes before awarding a contract.**

   What should be done to ensure that contracting officials are informed as to whether or not a contractor has paid their federal and state taxes before contracts are awarded? Do you believe that a central listing identifying contractors with unpaid federal and state taxes should be made available to contract officials before contracts are awarded? If not, why?

   Answer: See attached letter response.

2. **GAO testified that the 27,100 contractors with $3 billion in unpaid federal taxes also have unpaid state taxes, which support critical services such as workers compensation, health insurance, and public schools.**

   Could you please state, for the record, if you believe that information on contractors' payment of state taxes should be included in the Treasury Offset Program (TOP) so that unpaid state taxes may be levied from payments to contractors?

   Answer: See attached letter response.

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Permanent Subcommittee on Investigations
EXHIBIT #6

COMMISSIONER

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

March 15, 2004

The Honorable Norm Coleman
Chairman
Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your letter and the accompanying supplemental questions for the hearing record submitted by Senator Daniel K. Akaka. My responses follow.

As you know, the General Accounting Office, in the report it released at the hearing (*Financial Management – Some DOD Contractors Abuse the Federal Tax System with Little Consequence*) recommends that the Director of the Office of Management and Budget "develop and pursue policy options for prohibiting federal contract awards to contractors in cases in which abuse to the federal tax system has occurred and the tax owed is not contested." The Financial Management Service (FMS) is committed to working with the Office of Management and Budget, the Internal Revenue Service, and the Department of Defense as part of the inter-agency task force created to address this and other issues. The Treasury Offset Program database includes information regarding delinquent taxpayers. When appropriate and to the extent allowed by law, FMS supports making this data available to assist in preventing contractors with unpaid taxes from receiving federal contracts. Additionally, as noted in my testimony, it is our view that upfront matching of information regarding Department of Defense contractors with information regarding delinquent taxpayers would be beneficial in streamlining and improving the levy process.

With respect to collecting unpaid state income taxes owed by federal contractors, Treasury currently collects past-due, legally enforceable state income tax obligations of individuals by offsetting federal tax refund payments through the Treasury Offset Program. Treasury has collected $383 million since 1997, on behalf of 34 states and the District of Columbia (including Minnesota and Hawaii). In fiscal year 2003, collections totaled $152 million. Although this program is currently limited to collecting debts of individuals through the offset of tax refund payments, the Debt Collection Improvement Act of 1996 (DCIA – 31 USC 3716(h)) authorizes Treasury, upon request from a state, to offset federal non-tax payments (including vendor payments) to collect state non-tax or tax debts of both individuals and businesses. Under that authority, participating states are

required to enter into reciprocal agreements with Treasury setting forth certain requirements and restrictions. We are closely examining this provision of the DCIA as part of our overall and continued work to improve further the collection of delinquent debts.

Again, it was a pleasure to appear before your panel. Please let me know if I can be of further assistance.

Sincerely,

Richard L. Gregg

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO

LAWRENCE J. LANZILLOTTA

Principal Deputy Under Secretary and
Deputy Under Secretary for Management Reform (Comptroller)
U. S. Department of Defense

QUESTIONS SUBMITTED BY
SENATOR NORM COLEMAN and SENATOR CARL LEVIN

1. **On January 16, 2004, the Subcommittee asked DOD to provide a list identifying, by name, each DOD contractor who has been subjected to a tax levy by DOD since December 31, 2003, and, for each such contractor, each date on which a tax levy took place and the amount of levied funds DOD provided to the IRS. DOD has not provided the requested information, apparently claiming it is barred by Section 6103 of the tax code barring the Internal Revenue Service (IRS) from disclosing confidential taxpayer information. In testimony before the Subcommittee on February 12, 2004, Mr. Lanzillotta indicated that DOD would provide a written legal opinion letter explaining why DOD cannot provide the requested information to the Subcommittee.**

   (a) Please provide this legal opinion letter or, alternatively, the requested information.

   (b) Please explain why information about completed tax levies qualifies as confidential taxpayer information and why, in light of Section 6103, DOD has come into possession of allegedly confidential taxpayer information which it cannot share with Congress.

   Answer: The Department is providing a list of DoD Contractors owing back taxes as requested by Senator Levin on February 12, 2004. This information is being made available pursuant to IRS Revenue Rules 2004-53, issued on May 7, 2004.

   [**NOTE**: The IRS Ruling is attached to this exhibit and marked as *Attachment to DOD Question #1*. A List of DoD Contractors owing back taxes was provided to the Permanent Subcommittee on Investigations and made Exhibit #8, a sealed exhibit to this hearing record..]

2. **For each of the forty-seven tax delinquent DOD contractors cited as case studies in the GAO report issued February 12, 2004, please provide the case study number assigned by GAO to the contractor, each date since December 31, 2003, on which DOD completed a tax levy on a contract payment to such contractor, if any, and on each such date the amount of levied funds DOD provided to the IRS. If DOD believes it is barred by Section 6103 from providing this information to the Subcommittee, please explain why.**

   Answer: DoD can not match the names of the forty-seven tax delinquent DoD contractors to the case study number cited in the GAO report. A review of our records indicates that there have been no payable invoices to offset / levy against those contractors since December 31, 2003.

Permanent Subcommittee on Investigations
EXHIBIT #7

3. **In testimony before the Subcommittee on February 12, 2004, Mr. Lanzillotta indicated that DOD has been providing FMS with DOD contractor payment data on a weekly basis, but was prepared to provide this data twice a week to enable FMS to identify more tax delinquent contractors. Please indicate whether DOD can and will provide this data to FMS on a daily basis or, if not, why not.**

   Answer: DoD is able to send the files of available payments as often as is required. However, in order to avoid duplicate offsets / levies, one availability file must be fully processed before the next file can be sent. This process takes time. DFAS sends the availability file to FMS. FMS matches the file to the TOP database and returns any matches to DFAS. This requires approximately one day. DFAS then reviews the match list and prepares a completion report for FMS containing the amount available for offset / levy. Only after FMS has updated the TOP database with the completion report can the next availability report be sent by DFAS. For this reason it is not possible to send availability reports daily. We are reviewing our processes to maximize the number of possible cycles.

4. In testimony before the Subcommittee on February 12, 2004, DOD indicated that it intends to install an automated tax levy system for its remaining payment systems by March 2005. Please provide a written description of DOD's plan to achieve this goal, including identifying specific intermediate milestones and deadlines.

Answer: The following chart provides the plan with milestones and deadlines.

System Abbreviation	Entitlement System	System Owner	Milestone: Est. agreement	Milestone: Obtain access[i]	Deadline[ii]
CAPS-CLIPPER	Computerized Accounts Payable System – in Clipper	DFAS	3/15/04	N/A	8 sites by 5/3/04
CAPS-W	Computerized Accounts Payable System – In Windows	DFAS	3/15/04	N/A	11 sites by 4/26/04
IAPS	Integrated Accounts Payable System	DFAS	3/15/04	N/A	8 sites by 7/19/04
OBP	One Bill Pay (Previously Called STARS One Bill Pay)	DFAS	3/15/04	N/A	7 sites by 6/21/04
DTRS	Defense Transportation Payment System	DFAS	3/15/04	N/A	1 site by 8/16/04
TSS	Transportation Support System	DFAS	3/15/04	N/A	1 site by 8/30/04
AVEDS	Automated Voucher Examination Disbursing System	DLA	3/15/04	February 04	1 site by 3/29/04
FAS	Fuels Automated System	DLA	3/15/04	April 04	1 site by 11/1/04
DISMS	Defense Integrated Subsistence Management System	DLA	3/15/04	February 04	1 site by 3/22/04
FABS	Financial Accounting Budget System	DITCO	3/15/04	October 04	1 site by 11/22/04
SAMMS	Standard Automated Material Management System	DLA	3/15/04	February 04	Implemented 3/15/04
SAVES	Standard Automated Voucher Examination System	DECA	3/15/04	October 04	1 site by 1/24/05
CUFS	College And University Financial System	USUHS	3/15/04	January 05	1 site by 3/21/05
SYMIS	Shipyard Management Information System	USN	3/15/04	January 05	1 site by 2/28/05
TMS	Transportation Management System	USMC	3/15/04	November 04	1 site by 12/13/04
TFMS-M	Transportation Financial Management System – MTMC	MTMC	3/15/04	September 04	1 site by 1/10/05
BSM	Business Systems Modernization	DLA	3/15/04	February 04	Implemented 3/15/04
SRD-1	Standard Finance System Redesign – Subsystem 1	DFAS	3/15/04	N/A	8/12/04
MSC	Military Sea-lift Command	Navy	3/15/04	January 05	2/14/05
MOCAS	Mechanization of Contract Administration Services	DFAS / DCMA	12/10/02	N/A	Implemented 12/16/02

i This milestone is the date on which DFAS will have access to the payment data in systems that are not owned by DFAS.
ii This is the date by which DFAS will be prepared to provide the available payment data to FMS for matching to offsets / levies.

5. **Please indicate whether DOD is willing to stop providing contract payments to any DOD contractor or vendor who fails to supply DOD with a valid taxpayer identification number and, if so, provide a written description of DOD's plan to implement a system to accomplish this goal, including identifying specific intermediate milestones and deadlines. If not, please explain why not.**

   Answer: Currently, there is no basis for withholding payment based on an erroneous taxpayer identification number. The Federal Acquisition Regulation does provide for withholding payments if the electronic funds transfer information provided by the contractor in the Central Contractor Registration is missing or incorrect; however, the taxpayer identification number is not part of the electronic funds transfer information.

   DoD will consider the advisability of withholding payments based on invalid taxpayer identification numbers after the interagency task force has completed its work and made recommendations. Any policy change to withhold payments would need to go through the rulemaking process, which requires consideration of public comments, and presumably would not penalize contractors who make honest mistakes.

6. **At the hearing, the Chairman asked if there was anything that would preclude DOD from requiring all contractors who register in the Central Contract Registration to provide a taxpayer identification number, as a condition precedent to receiving a contract. Mr. Lanzillotta stated that the question was outside his area of expertise. Please provide a response to the question.**

   Answer: All prospective contractors that register in the Central Contract Registration are required to provide taxpayer identification numbers. Since prospective contractors must be registered in the Central Contract Registration to receive a contract award, contractors are effectively required to provide the taxpayer identification numbers as a condition of contract award.

7. **Mr. Lanzillotta, in response to the previous question, stated that DOD made miscellaneous payments for credit cards, airlines and utilities where no contract exists and where the service provider is not registered in the Central Contract Registration.**

   (a) **Given that some form of agreement would likely exist between DOD and these service providers and that the agreement would appear to meet the legal definition of a contract, is it correct to state that DOD does not have contracts with these service providers? For example, under law every properly issued airline ticket is a contract for service, even if federal contracts with specific airline companies to provide commercial**

airline travel accommodations at a fixed rate are based on contracts with the General Services Administration to which DOD is not a signatory.

Answer: It is not correct to say that DoD does not have contracts with these vendors. There is a convention within DoD to refer to contracts that are not governed by the FAR as non-contract or miscellaneous payments, although we recognize that they are contracts under the law. Credit card payments, airline tickets, and utility payments fall into that category.

(b) Why would it be inappropriate to require all individuals or businesses who have entered into any form of legal contractual relationship with DOD to register in the Central Contract Registration?

Answer: Some FAR-based contracts are specifically exempted from the requirement for CCR registration. Many other types of payments are not covered by the FAR. Given this diversity, there is no single answer to if or why it would be inappropriate to require CCR registration. One example is the case of utility payments. The monopolistic bargaining power of the utility and the application of tariffs would make imposing a CCR requirement difficult, and inconsistent. Another example is court ordered attorneys fees in a litigation case. If the attorney will not register in the CCR, it would be inappropriate for DoD to withhold payment in violation of the Judge's order.

(c) If these individuals or businesses provide services to DOD, but do not provide their taxpayer identification numbers, how does DOD fulfill its legal obligation to provide tax information returns to their service providers and the Internal Revenue Service without their taxpayer identification numbers?

Answer: Not all of the vendors paid by DoD require tax information returns. For those that do, DoD requires taxpayer identification number.

8. **According to Mr. Lanzillotta's testimony, DOD does not know if a contractor has provided an incorrect taxpayer identification number until notified by the Financial Management Service following an attempt to match vendor or contract payments against Internal Revenue Service records of tax debt. However, Dr. Dov Zakheim, the Comptroller, in his official response to a General Accounting Office report issued in December 2003 stated that DOD will begin using IRS' Taxpayer Identification Matching Program. While these statements are not necessarily contradictory, please provide a detailed explanation of how DOD plans to verify the accuracy of taxpayer identification numbers in the Central Contract Registration?**

   Answer: Since 1998, DoD has worked with IRS to develop an automated process to validate CCR vendor TINs with the IRS files. In late 2003 the IRS took the position that TIN matching with the CCR would be allowed. However, in January of this year, the IRS determined that current law prohibits such validation. Therefore, at this time, DoD has no plans to verify the accuracy of the TINs in the CCR beyond checking that they contain the proper number of numeric characters.

9. **During the hearing, several references were made to the necessity to make legislative changes before DOD can validate all taxpayer identification numbers in the Central Contract Registration. However, the Internal Revenue Code (26 USC 6103(c)) provides that a taxpayer may consent to disclosure of return information including their taxpayer identification number. Thus, if the registration process for the Central Contract Registration sought and received the registrants' consent to receive their taxpayer identification numbers for verification with the Internal Revenue Service, DOD could verify the correctness of all taxpayer identification numbers, except where consent was not provided. Such verification is generally carried out pursuant to DOD's legal obligation to provide information returns to the contractors who provide DOD with services. Therefore, taxpayer identification number verification is carried out for tax administration purposes.**

   Given that there is a readily available administrative remedy that would provide DOD with legal authority to verify all taxpayer identification numbers in the Central Contract Registration, why would DOD seek a legislative remedy? Will DOD modify the Central Contract Registration process to request registrants' consent to verify their taxpayer identification numbers with the Internal Revenue Service?

   Answer: The IRS has not accepted the concept of Central Contract Registration consents as an acceptable solution in the past. If, however, the IRS were able to validate taxpayer identification numbers based on Central Contract Registration consents, additional legislation may not be required on this issue. The interagency task force will develop recommendations on the need for legislation. If the Central Contract Registration consents are found to be acceptable, DoD will work with the other Federal agencies to revise the Central Contract Registration process accordingly.

10. In testimony before the Subcommittee on February 12, 2004, DOD indicated that it intends to implement a system to require backup withholding of 28% from payments to any DOD contractor who has failed to supply DOD with a valid taxpayer identification number, as required by law. Please provide a written description of DOD's plan to accomplish this goal, including identifying specific intermediate milestones and deadlines.

Answer: Mr. Lanzillotta indicated that we would work out a system of TIN validation with FMS and IRS. However, IRS has since stated that TIN validation is not possible under current law. There is no mechanism for DoD to validate TINs in the CCR. DoD can do no more than ensure the TINs contain the correct number of numeric characters or receive information from IRS that a TIN is incorrect. Therefore, there are few situations where DoD could withhold 28% from payments, because DoD is unable to validate contractors' TINs.

11. During the hearing Mr. Lanzillotta stated that DOD would implement backup withholding requirements provided in the Internal Revenue Code. Will DOD, as part of its implementation, modify the Central Contract Registration process to advise registrants that the failure to provide a verifiable taxpayer identification number may result in backup withholding that is currently set at 28 percent?

Answer: DoD has postponed the decision on how to notify contractors of the backup withholding requirements pending the outcomes of the interagency task force. Our intention is to develop a process whereby we would contact contractors whose taxpayer identification numbers cannot be verified by the IRS to ascertain if the taxpayer identification number was erroneously entered and can be easily corrected. The notification in the Central Contract Registration would specify a requirement to attempt to reconcile the taxpayer identification numbers before backup withholding would be imposed.

12. In testimony before the Subcommittee on February 12, 2004, Mr. Lanzillotta indicated that DOD has considered requiring bidders on DOD contractors to submit a certification, as part of the bidding process, stating that they have no federal taxes in arrears or are current with any installment plan or offer in compromise. Please provide the Department's perspective on whether this type of certification should be required by law and, if so, how it should be worded.

Answer: DoD will consider the advisability of imposing a certification requirement after the interagency task force has completed its work and made recommendations. DoD will request the interagency task force to provide specific recommendations on the advisability of adding a certification requirement and the need for any legislative authority. DoD is reluctant to impose the burden of certification requirements on contractors, especially when we are dealing with divisions of large conglomerates that may not be aware of the company's tax status on a day to day basis.

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Attachment to DOD Question #1

LEXSEE REV. RUL. 2004-53

Rev. Rul. 2004-53

Section 6103--Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103: Confidentiality of Returns

2004 IRB LEXIS 209; 2004-23 I.R.B. 1; REV. RUL. 2004-53

May 7, 2004

[*1]

June 7, 2004

ISSUE

Whether Federal, State and local government officers or employees ("government employees") are subject to the disclosure restrictions of Internal Revenue Code section 6103(a) with regard to returns or return information received as a result of disclosures under:

. section 6103(c) with the consent of the taxpayer (taxpayer consent exception)
. section 6103(e) as a person having a material interest, but not under section 6103(e)(1)(D)(iii) relating to disclosures to certain shareholders (material interest exception), or
. section 6103(k)(6) for investigative purposes (investigative disclosure exception).

FACTS

Situation 1. A requests the assistance of his friend B with respect to a tax matter. A also requests that the Internal Revenue Service provide A's returns and return information to B. B subsequently discloses to a third party returns and return information obtained as a result of A's request that the Service provide the returns and return information.

Situation 2. Same as situation 1, above, except that B happens to be an employee in the office of a State agency.

Situation 3. C is a lawyer employed by a law firm. The firm has [*2] a policy of taking disciplinary action against any of its attorneys who do not properly fulfill their tax obligations. The Service serves a notice of levy with respect to C's tax liability on the payroll department of the firm. A payroll department employee (D) processes the notice of levy and informs the firm's managing partners of C's tax delinquency to enable the firm to take appropriate action consistent with firm policy.

Situation 4. E is an employee of a State agency. The agency has a policy of taking disciplinary action against employees who do not properly fulfill their tax obligations. The Service serves a notice of levy with respect to E's tax liability on the payroll department of the agency. A payroll department employee (F) processes the notice of levy and informs the agency's labor relations office of E's tax delinquency to enable the agency to take appropriate action consistent with its policy.

Situation 5. Same as Situation 4, above, except that E and F are employees of a Federal agency.

Situation 6. G is the unemployed father of 5-year-old film star H. H's mother signs H's return as parent for a minor child and dies shortly thereafter. G [*3] is the guardian of H's estate under applicable State law. G receives notice that H's return is under examination. G does not have a copy of H's return. To assist in the examination, G obtains the return and return information from the Service. When subsequently asked by a news reporter how much income H reported on the return, G replies "three million dollars."

Situation 7. Same as Situation 6, above, except that G happens to be an employee of a Federal agency.

LAW

Generally, section 6103 provides that returns and return information (as defined in section 6103(b)(2)) are confidential and may not be disclosed except as expressly authorized by the Code. Specifically, except as authorized by the Code, section 6103(a) prohibits the disclosure by officers or employees of the United States, of any State, or of specified local government agencies, or by certain other specified persons, of returns and return information obtained in connection with service as such an officer or employee or otherwise. See Girard v. Bentsen, 94-2 U.S.T.C. P50,625 (N.D. Cal. 1994)("or otherwise" modifies "in connection with his service", allowing the [*4] statute to cover those who are neither "officers" nor "employees", namely certain other persons specified in section 6103(a)).

There are, however, exceptions to the general rule of confidentiality. First, the taxpayer consent exception permits the disclosure of returns and return information to a designee of a taxpayer, pursuant to the taxpayer's request or consent. To be valid, a consent must satisfy the requirements of section 6103(c) and § 301.6103(c)-1(a) of the Procedure and Administration Regulations. Second, the material interest exception permits the disclosure of returns and return information to specific persons with a *material interest* in the information. Third, the investigative disclosure exception, in conjunction with § 301.6103(k)(6)-1, authorizes the disclosure of return information (but not returns) to the extent that disclosure is necessary in obtaining information that is not otherwise reasonably available with respect to the correct determination of tax, liability for tax, or the amount to be collected, or with respect to the enforcement of any other provision of the Code.

When the general rule of confidentiality applies, section 6103(p) imposes certain accountings [*5] and safeguards. Section 6103(p)(3) generally requires the Service to maintain a permanent system of standardized records or accountings of all requests for, and disclosures of, returns and return information under particular provisions of section 6103. Section 6103(p)(4) generally requires recipients of returns or return information under particular provisions of section 6103 to keep records of requests and disclosures, to maintain secure storage, to establish restricted access, to report to the Service on confidentiality procedures, to return or destroy the returns or return information upon completion of the prescribed use, and to provide other necessary or appropriate safeguards. These accounting and safeguard requirements do not apply to returns or return information disclosed under the taxpayer consent exception, the material interest exception, or the investigative disclosure exception.

ANALYSIS

Section 6103(c), (e), and (k)(6) contains no limitation or restriction on the redisclosure of returns or return information received pursuant to the taxpayer consent, material interest and investigative disclosure exceptions. Therefore, in Situations 1, 3, and 6 there are no statutory [*6] or regulatory restrictions on the redisclosures made by B, D, or G.

In Situations 2, 4, 5, and 7, however, the prohibition in section 6103(a) on redisclosure by government employees could be read to prohibit redisclosures by B, F, and G because they happen to be government employees. This reading would create a disparity in the application of section 6103(a) based on where the person receiving the disclosure of returns or return information happens to be employed.

By its terms, section 6103(a) does not regulate or control the use of returns and return information received under the taxpayer consent, material interest and investigative disclosure exceptions. Moreover, the requirements for accountings and safeguards that typically apply where redisclosure is limited do not apply to these exceptions.

There is no evidence that Congress intended disparate treatment of individuals receiving disclosures of returns or return information pursuant to these exceptions merely because they happen to be government employees. On the contrary, there are compelling reasons for those government employees to be subject to the same rules as other recipients. For example, a private sector [*7] employer may take disciplinary action against employees who do not properly fulfill their tax obligations. If redisclosure is not permitted because the employer happens to be the Federal

government, the Federal employees who failed to fulfill their tax obligations would be in a significantly better position than their private sector counterparts. This inappropriate result only occurs if section 6103(a) is read to apply to individuals merely because they happen to be government employees.

Accordingly, persons are not barred because of their status as government employees from redisclosing returns and return information received pursuant to section 6103(c), (e), and (k)(6).

HOLDING

Government employees who receive returns or return information pursuant to disclosures under section 6103(c), (k)(6) or (e), other than section 6103(e)(1)(D)(iii)(relating to certain shareholders), are not subject to the disclosure restrictions of section 6103(a) with regard to the returns or return information received.

DRAFTING INFORMATION

The principal author of this revenue ruling is Geoffrey M. Campbell of the Office of Associate Chief Counsel, Procedure & Administration (Disclosure & Privacy Law [*8] Division). For further information regarding this revenue ruling, contact Geoffrey M. Campbell on (202) 622-4570 (not a toll-free call).

LOAD-DATE: May 7, 2004

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
SUBMITTED TO

LAWRENCE J. LANZILLOTTA

Principal Deputy Under Secretary and
Deputy Under Secretary for Management Reform (Comptroller)
U. S. Department of Defense

QUESTIONS SUBMITTED BY SENATOR DANIEL AKAKA

1. **At the hearing, the General Accounting Office (GAO) testified that one of the challenges of preventing contractors with unpaid taxes from receiving federal contracts is that contracting officials have no way of knowing whether contractor has paid taxes before awarding a contract.**

   What should be done to ensure that contracting officials are informed as to whether or not a contractor has paid their federal and state taxes before contracts are awarded? Do you believe that a central listing identifying contractors with unpaid federal and state taxes should be made available to contract officials before contracts are awarded? If not, why?

   Answer: DoD will work with the IRS via the interagency task force to determine what needs to be done to ensure contracting officials have the appropriate contractor tax information prior to contract award. DoD would like to defer its response pending the outcome of the interagency task force.

2. **GAO testified that the 27,100 contractors with $3 billion in unpaid federal taxes also have unpaid state taxes, which support critical services such as workers compensation, health insurance, and public schools.**

   Could you please state, for the record, if you believe that information on contractors' payment of state taxes should be included in the Treasury Offset Program (TOP) so that unpaid state taxes may be levied from payments to contractors?

   Answer: DoD supports a Department of the Treasury analysis of this proposal under its cross-servicing program.

3. **In its response to the GAO report on the offset levy program, the Defense Department partially agreed with the recommendation that DoD develop manual procedures so that the offset of contractors payments can be started immediately for all payment systems. DoD plans to complete implementation of the offset levy program by March 2005.**

   Could you please state, for the record, the actions DoD is taking to so that offset payments can be started immediately before the system is fully implemented?

   Answer: A joint task force consisting of members from the Defense Finance and Accounting Service, DoD, and the IRS has been formed, with the first meeting March 18, 2004. The task force will explore alternative short-term methods for offsets. In the meantime, the Defense Finance and Accounting Service has accelerated their efforts to automate the systems and a schedule is provided in response to question #4 from Senators Coleman and Levin.

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RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
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Principal Deputy Under Secretary and
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QUESTIONS SUBMITTED BY SENATOR FRANK LAUTENBERG

1. **On Dec. 11, the Defense Contract Audit Agency (DCAA) issued a preliminary audit concluding that Halliburton failed to conduct an adequate subcontract pricing evaluation for its Kuwaiti subcontractor. DCAA also found that Halliburton overcharged the U.S. government by as much as $61 million to import fuel. On December 19th, however, the U.S. Army Corps of Engineers called the prices "fair and reasonable" and waived Halliburton's requirement to provide any cost and pricing data. The DCAA then requested that the DoD's Inspector General (IG) open a formal investigation in to the fuel contract. The IG's office thought that the referral involved matters most appropriately investigated by experienced criminal investigators, rather than civil auditors and the IG referred the matter for criminal investigation within the Defense Criminal Investigative Service. As of mid-January, however, the IG's office had not decided whether or not to investigate.**

   As a comptroller, perhaps you could explain what I see as an unprecedented, inexplicable act whereby the Defense Department – the Army Corps – waived its own auditors' data and information request on an overcharge by a contractor of potentially $61 million dollars?

   Answer: Part 15 of Federal Acquisition Regulations (FAR) allows the Head of the Contracting Agency to waive the requirement for submission of cost and pricing data in exceptional cases when the price of the product or service can be determined to be fair and reasonable without the submission of cost and pricing data.

   In the Corps' view, Halliburton – Kellogg, Brown and Root (KBR) obtained adequate price competition for the initial delivery of gasoline into Iraq. However, the Corps states that since the initial award, the Kuwaiti Petroleum Company (KPC) has refused to grant permission to any subcontractor other than the initial offeror, Altanmia Commercial Marketing Company for the additional purchase and delivery of fuels. In the absence of continued competition, KBR requested cost and pricing data from Altanmia to support the pricing arrangement under which the two companies had been operating. To date, Altanmia has refused to provide cost and pricing data as required by FAR because they claim that to do so would violate Kuwaiti law. Despite the fact that KBR has been prevented from competing the purchase of fuel, transport and delivery out of Kuwait, the Corps believes that the contractor has been able provide data that otherwise indicates that the price is fair and

reasonable. Under these circumstances the Corps concluded that the submission of cost and pricing data was not necessary.

The DCAA review was initiated based on deficiencies noted in KBR's subcontract estimating practices. Notwithstanding the subsequent Corps waiver, the review found significant issues related to KBR's pricing and award of subcontract costs. DCAA will address these estimating deficiencies with KBR in a separate review of the contractors estimating policies and practices. During DCAA's review, the auditors came across other information that led them to make a referral to the DoDIG. The DoDIG recently launched a formal investigation of this potential overpricing of gasoline.

2. **The Kuwaiti Parliament is currently investigating Halliburton's business practices in Iraq. But the U.S. government seems reticent to do the same. In mid-December, it was revealed that Halliburton employees were accepting kick-backs. What does your office plan to do to follow up on this new information in terms of an investigation?**

   Answer: KBR referred the kickback case under the Department's Voluntary Disclosure program in mid-December. The Department of Defense encourages contractors to adopt a policy of voluntarily disclosing problems affecting their contractual relations with the DoD. The program is intended to be mutually advantageous to both the Government and contractors. In return for voluntarily disclosing potential fraud and agreeing to cooperate in any Government audit and investigation, the Government will generally allow a contractor to conduct an internal investigation which the Government will verify in an expedited manner.

   The KBR kickback case is currently being reviewed by the DoDIG. KBR has already reimbursed the Government for the estimated impact of $6.3 million. DCAA is verifying that the estimated impact of $6.3 million is accurate and is assuring that it has been removed from KBR's billings to the Government.

3. **It was reported in December that the government will be assuming Halliburton's pension liabilities. This is not typical behavior on the part of the government toward its private sector contractors. How did that come about? Is that a typical arrangement for a contractor?**

   Answer: The Comptroller's office is not aware of any reports that the Government will be assuming KBR's pension liabilities, so it cannot comment on these statements. DCAA did review KBR's December 31, 2003 10-K filing and it does not include information that indicates the Government will be assuming KBR's pension liabilities. As part of its ongoing audits at KBR (its major subsidiary with

Government contracts), DCAA is not aware of any agreement for the Government to assume all pension liabilities (or any portion of the pension liability). DCAA has verified that the Government did receive a pro rata share of pension costs through normal cost allocations distributed to Government and commercial contracts. DCAA is currently reviewing the forward pricing rate proposal submitted by KBR and will assess if there have been any significant increases in pension costs and if the costs are reasonable.

4. **We have heard that DoD has many – I believe it's 20 – different systems to pay its vendors. You mentioned that only the largest, Mechanization of Contract Administration Services or MoCAS, is currently linked to the IRS and Financial Management Service (FMS) systems to collect back taxes. Why does DoD have so many different payment systems, and does the department intend to link its other payment systems into the IRS and FMS systems?**

   Answer: The primary activity in DoD that makes payments is the Defense Finance and Accounting Service (DFAS). DFAS was formed in the early 1990s by consolidation of numerous individual DoD payment operations, each with their own procedures and supporting payment systems including entitlement, contracting, and accounting systems. DoD has reduced the number of systems since the formation of DFAS and continues to streamline operations. The goal of the DoD Business Modernization Management Program (BMMP) is to continue to reduce the number of DoD systems and standardize business practices across DoD. In the interim, DFAS has prepared an aggressive plan and is currently implementing the links between the payment systems and FMS systems to provide the interface between the IRS debt files and the entitlement systems. The schedule is outlined in the response to question #4 from Senators Coleman and Levin.

5. **It seems to me that the whole collection system suffers from terrible management. The President's Budget for this year describes the "President's Management Agenda" (PMA) to improve management in executive agencies. Is the PMA being applied to these processes? What progress is being made?**

   Answer: Yes, the PMA is being applied to these processes. As indicated in the PMA, the President's vision for Government is results oriented and recognizes the need for well-managed financial records. BMMP is a Department of Defense program to integrate and transform financial management and business operations into a joint business enterprise. BMMP includes an Accounting & Finance domain, which would cover the collection system. The BMMP program manager is responsible for working with all BMMP stakeholders to facilitate business transformation. Standard architectures and business rules are being defined.

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