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FINANCIAL  
MANAGEMENT

Some DOD  
Contractors Abuse the  
Federal Tax System  
with Little  
Consequence



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-04-95](#), a report to congressional requesters

## FINANCIAL MANAGEMENT

# Some DOD Contractors Abuse the Federal Tax System with Little Consequence

### 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](http://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](mailto: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. 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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# Contents

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## Letter

Results in Brief	1
Background	3
DOD Contractors Owe Billions in Unpaid Federal Taxes	6
DOD and IRS Are Not Collecting Millions in Unpaid Federal Taxes from Contractors	13
DOD Contractors Involved in Abusive or Potentially Criminal Activity Related to the Federal Tax System	19
Contractors with Unpaid Taxes Are Not Prohibited by Law from Receiving Contracts from the Federal Government	32
Conclusions	41
Matters for Congressional Consideration	44
Recommendations for Executive Action	45
Agency Comments and Our Evaluation	45

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## Appendixes

<b>Appendix I: Scope and Methodology</b>	53
<b>Appendix II: DOD Contractors with Unpaid Federal Taxes</b>	56
<b>Appendix III: Comments from the Department of Defense</b>	61
<b>Appendix IV: Comments from the Internal Revenue Service</b>	66
<b>Appendix V: GAO Contacts and Staff Acknowledgments</b>	68
GAO Contacts	68
Acknowledgments	68

---

## Tables

Table 1: Types of Goods and Services Provided by DOD Contractors in Case Studies	33
Table 2: DOD Contractors with Unpaid Federal Taxes—Business	35
Table 3: DOD Contractors with Unpaid Federal Taxes—Individual	39
Table 4: DOD Contractors with Unpaid Federal Taxes—Business	56
Table 5: DOD Contractors with Unpaid Federal Taxes—Individual	59

---

## Figures

Figure 1: Fiscal Year 2002 Federal Contract Award Amounts by Agency	7
Figure 2: DOD Contractor Unpaid Taxes by Tax Type	14

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Figure 3: DOD Contractor Unpaid Taxes by Fiscal Year

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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.

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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,<sup>1</sup> 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)<sup>2</sup> and Federal Payment Levy Program (FPLP)<sup>3</sup> 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.

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<sup>1</sup> U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury*, [GAO-03-109](#) (Washington, D.C.: January 2003).

<sup>2</sup> 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.

<sup>3</sup> 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.

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## Results in Brief

Some DOD contractors abuse the federal tax system with little consequence.<sup>4</sup> 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<sup>5</sup> 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

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<sup>4</sup> 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.

<sup>5</sup> 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.

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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<sup>6</sup> 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.<sup>7</sup> 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.

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<sup>6</sup> We characterized as “potentially criminal” any activity related to federal tax liability that may be a crime under a specific provision of the Internal Revenue Code. Depending on the potential penalty provided by statute, the activity could be a felony (punishable by imprisonment of more than 1 year) or a misdemeanor (punishable by imprisonment of 1 year or less). 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.

<sup>7</sup> 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.



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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

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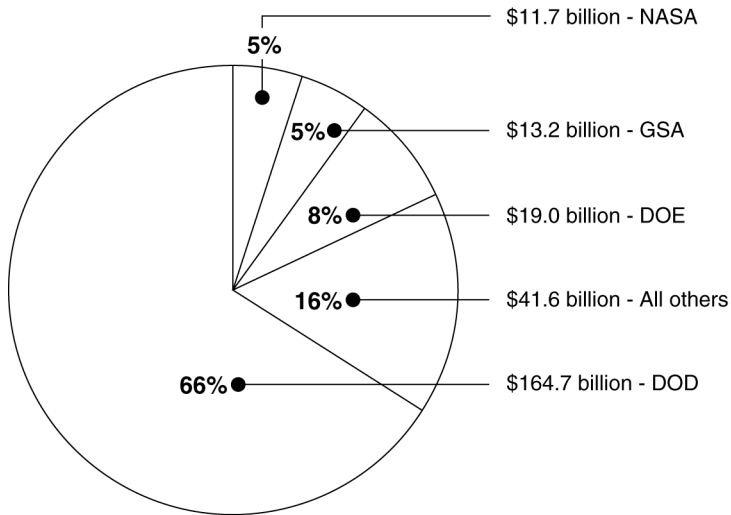
years ago. We continue to believe that Congress may wish to consider such oversight as the federal government is missing opportunities to collect hundreds of millions of dollars in unpaid taxes owed by DOD contractors. In oral comments, OMB questioned the need for developing or pursuing additional mechanisms 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.

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## 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<sup>8</sup> that generally requires all federal contractors to register in the CCR database.

<sup>8</sup> 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).

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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.<sup>9</sup> The single DOD automated system<sup>9</sup> used in contract pay disbursed over \$86 billion to contractors in fiscal year 2002. While somewhat of a misnomer, vendor pay<sup>10</sup> 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

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<sup>9</sup> Mechanization of Contract Administration Services.

<sup>10</sup> The vendor pay systems include payments for contracts not administered by DCMA, plus miscellaneous noncontractual payments such as utilities.

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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,<sup>11</sup> including interest and penalties, totaling \$249 billion, of which \$112 billion has some collection potential and thus is at risk.<sup>12</sup>

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.<sup>13</sup> 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

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<sup>11</sup> 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.

<sup>12</sup> [GAO-03-109](#).

<sup>13</sup> 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).

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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<sup>14</sup> 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.

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

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Treasury established the TOP as part of implementing the DCIA.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup>

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.<sup>19</sup> 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.

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<sup>15</sup> Pub. L. No. 104-134, 110 Stat. 1321 (1996).

<sup>16</sup> 31 U.S.C. § 3716(c)(6) (2000).

<sup>17</sup> 31 C.F.R. § 285.5 (c)(2) (2003).

<sup>18</sup> 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).

<sup>19</sup> 31 U.S.C. § 3716(c)(1)(A) (2000) and 31 C.F.R. § 285.5(c)(2) (2003).

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DCIA also requires agencies to refer certain debt to Treasury for centralized collection.<sup>20</sup> 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).<sup>21</sup> Once a notice of impending levy is received, the delinquent taxpayer has several options for action and a minimum of 30 days to respond.<sup>22</sup> 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.<sup>23</sup> IRS is precluded from continuing with a levy action while it considers a taxpayer's proposed installment agreement or offer in compromise.

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<sup>20</sup> 31 U.S.C. § 3711(g)(1) (2000).

<sup>21</sup> IRS must give the taxpayer written notice 30 days before initiating a levy or seizure action. 26 U.S.C. § 6330(a) (2000).

<sup>22</sup> Before receiving a notice of intent to levy, a taxpayer typically receives several balance due notices as part of the IRS standard notification process.

<sup>23</sup> 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.



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- 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,<sup>24</sup> we estimated that IRS could use the levy program to potentially recover hundreds of millions of dollars in tax debt.

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## 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.

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## 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.<sup>25</sup> 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.

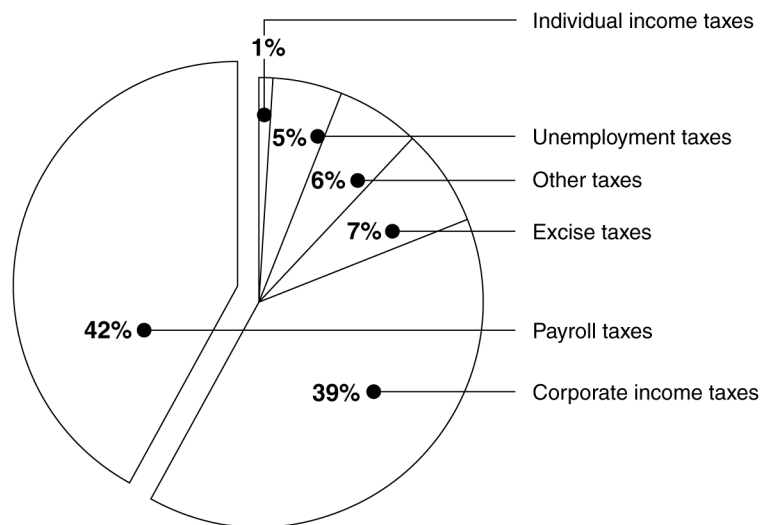
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<sup>24</sup> U.S. General Accounting Office, *Tax Administration: Federal Payment Levy Program Measure, Performance, and Equity Can Be Improved*, [GAO-03-356](#) (Washington, D.C.: Mar. 6, 2003); *Tax Administration: IRS' Levy of Federal Payments Could Generate Millions of Dollars*, [GAO/GGD-00-65](#) (Washington, D.C.: Apr. 7, 2000); and [GAO-01-711](#).

<sup>25</sup> 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.

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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.<sup>26</sup> To the extent these withheld amounts are not forwarded to the federal government, the employer is liable for these amounts, as well as the employer's matching 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).<sup>27</sup> Failure to remit payroll taxes can also be a criminal felony offense<sup>28</sup> punishable by imprisonment of more than a year, while the failure to properly segregate payroll taxes can be a criminal misdemeanor offense<sup>29</sup> 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.<sup>30</sup> 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.<sup>31</sup>

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

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<sup>26</sup> The law further provides that withheld income and employment taxes are to be held in a separate bank account considered to be a special fund in trust for the federal government. 26 U.S.C. § 7512(b) (2000).

<sup>27</sup> 26 U.S.C. § 6672 (2000).

<sup>28</sup> 26 U.S.C. § 7202 (2000).

<sup>29</sup> 26 U.S.C. § 7215 (2000).

<sup>30</sup> [GAO/AIMD/GGD-99-211](#).

<sup>31</sup> 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.

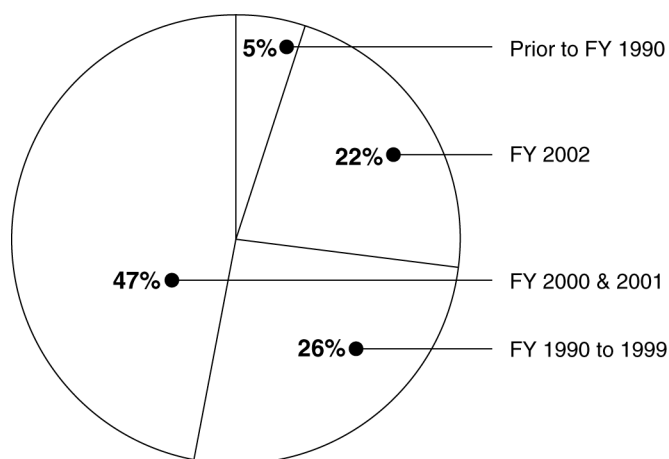
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building maintenance, catering, construction, consulting, custodial, dentistry, music, and funeral services. Several of these contractors provided parts or services related to aircraft components for several DOD and civilian programs.

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.

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**Figure 3: DOD Contractor Unpaid Taxes by Fiscal Year**



Source: GAO analysis of DOD and IRS records.

Our previous work<sup>32</sup> 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.

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<sup>32</sup> 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](#).

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## 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<sup>33</sup> 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.<sup>34</sup> Our examination also identified some invalid TINs<sup>35</sup> 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.<sup>36</sup> 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.<sup>37</sup>

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<sup>38</sup>

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<sup>33</sup> Contractors register their TINs in the CCR database into either the TIN/EIN field (business) or the SSN field (individual).

<sup>34</sup> IRS Master Files are data files that contain tax return filing histories for businesses and individuals.

<sup>35</sup> 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.

<sup>36</sup> 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.

<sup>37</sup> 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).

<sup>38</sup> One Bill Pay, formerly known as Standard Accounting and Reporting System.

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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<sup>39</sup> 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,<sup>40</sup> 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,

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<sup>39</sup> Abatements are reductions in the amount of taxes owed and can occur for a variety of reasons, such as to correct errors made by IRS or taxpayers or to provide relief from interest and penalties. 26 U.S.C. § 6404 (2000).

<sup>40</sup> 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).

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we believe the nearly \$3 billion represents a reasonable yet conservative estimate of unpaid federal taxes owed by DOD contractors.

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## 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.

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## 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.<sup>41</sup> 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.<sup>42</sup> In addition, DFAS did not have an organizational structure in place to implement the TOP payment reporting process. DOD recently

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<sup>41</sup> 31 C.F.R. § 285.5(c)(2) (2003).

<sup>42</sup> 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).



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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.<sup>43</sup> 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

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<sup>43</sup> 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.

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amount in fiscal year 2002 if DOD had been fulfilling its responsibilities under DCIA to compare its payment records with the TOP database.<sup>44</sup>

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## 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.<sup>45</sup>

- **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.

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<sup>44</sup> 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.

<sup>45</sup> 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.

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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.<sup>46</sup> 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.<sup>47</sup> 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

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<sup>46</sup> [GAO-03-356](#).

<sup>47</sup> 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.

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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.<sup>48</sup>

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

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<sup>48</sup> 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.

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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.

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### 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.

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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<sup>49</sup> 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.<sup>50</sup> 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.<sup>51</sup> 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.<sup>52</sup> 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

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<sup>49</sup> 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.

<sup>50</sup> U.S. General Accounting Office, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, [GAO-01-42](#) (Washington, D.C.: Nov. 17, 2000).

<sup>51</sup> 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.

<sup>52</sup> [GAO-01-42](#).

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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

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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.

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### 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.<sup>53</sup> 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

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<sup>53</sup> [GAO-03-356](#).



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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.

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## 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

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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.<sup>54</sup> 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

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<sup>54</sup> [GAO-03-356](#).

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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.<sup>55</sup> 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.

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<sup>55</sup> [GAO-03-356](#).

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## 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,”<sup>56</sup> 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.

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## 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.

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<sup>56</sup> 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).

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**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 <sup>a</sup>	17
<b>Total</b>	<b>47</b>

Source: GAO analysis of DOD and public records.

<sup>a</sup>Includes goods and services such as uniform manufacturing, courier services, medical personnel services, funeral services, weapon parts, and computer equipment.

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## 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<sup>57</sup> 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.

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<sup>57</sup> 26 U.S.C. § 6672 (2000).

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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.<sup>58</sup> Additionally, the failure to comply with certain requirements for the separate accounting and deposit of withheld income and employment taxes is a misdemeanor.<sup>59</sup>

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.

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<sup>58</sup> 26 U.S.C. § 7202 (2000).

<sup>59</sup> 26 U.S.C. § 7215 (2000).

**Table 2: DOD Contractors with Unpaid Federal Taxes—Business**

<b>Case study</b>	<b>Goods or service and nature of DOD work</b>	<b>Unpaid federal tax amount<sup>a</sup></b>	<b>Estimated fiscal year 2002 collections under effective tax levy<sup>b</sup></b>	<b>Fiscal year 2002 DOD payments<sup>c</sup></b>	<b>Comments</b>
1	<i>Base support and custodial services:</i> 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	<i>Engineering research services:</i> 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	<i>Aircraft-related goods:</i> 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	<i>Research services:</i> 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	<i>Janitorial services:</i> 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	<i>Private security services:</i> 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	<i>Furniture sales and construction services:</i> 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 <sup>a</sup>	Estimated fiscal year 2002 collections under effective tax levy <sup>b</sup>	Fiscal year 2002 DOD payments <sup>c</sup>	Comments
8	<i>Custodial services:</i> 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	<i>Construction services:</i> 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	<i>Base support services:</i> 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	<i>Construction services:</i> provides repairs to aircraft hangars at a military base	Over \$700,000	\$422,000	\$2.8 million	
12	<i>Medical personnel services:</i> 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	<i>Aircraft-related goods:</i> 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).

<sup>a</sup>Unpaid tax amount as of September 30, 2002.

<sup>b</sup>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.

<sup>c</sup>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.



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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

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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 <sup>a</sup>	Estimated fiscal year 2002 collections under effective tax levy <sup>b</sup>	Fiscal year 2002 DOD payments <sup>c</sup>	Comments
14	<i>Vehicle repair services:</i> 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	<i>Dentist:</i> 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	<i>Dentist:</i> 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	<i>Training services:</i> 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

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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.

<sup>a</sup>Unpaid tax amount as of September 30, 2002.

<sup>b</sup>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.

<sup>c</sup>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.

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- **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.

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## 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.<sup>60</sup> 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.<sup>61</sup> 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

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<sup>60</sup> 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).

<sup>61</sup> U.S. General Accounting Office, *Debt Collection: Barring Delinquent Taxpayers From Receiving Federal Contracts and Loan Assistance*, GAO/T-GGD/AMMD-00-167 (Washington, D.C.: May 9, 2000).

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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.<sup>62</sup> This statutory requirement is implemented in the FAR, which requires that government purchases be made from, and government contracts awarded to, responsible contractors only.<sup>63</sup> 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,<sup>64</sup> as well as to review a prospective contractor's certification<sup>65</sup> on debarment, suspension, and other responsibility matters. Among the causes for debarment and suspension is tax evasion.<sup>66</sup> In determining

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<sup>62</sup> 10 U.S.C. § 2305 (b) and 41 U.S.C. § 253b (2000).

<sup>63</sup> 48 C.F.R. § 9.103 (a).

<sup>64</sup> 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.

<sup>65</sup> Such certification is required only for contracts exceeding the simplified acquisition threshold.

<sup>66</sup> 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.

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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.<sup>67</sup>

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.<sup>68</sup> As we found in November 2002,<sup>69</sup> unless reported by prospective contractors themselves, contracting officers face significant difficulties obtaining or verifying tax compliance information on prospective contractors.

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<sup>67</sup> 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.

<sup>68</sup> 26 U.S.C. § 6103 (2000).

<sup>69</sup> U.S. General Accounting Office, *Government Contracting: Adjudicated Violations of Certain Laws by Federal Contractors*, [GAO-03-163](#) (Washington, D.C.: Nov. 15, 2002).

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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.<sup>70</sup>

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.

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## 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

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<sup>70</sup> 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.



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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.

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## 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.

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## 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

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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

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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.

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## 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

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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

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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 contractors 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.

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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,<sup>71</sup> 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.

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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

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<sup>71</sup> 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.

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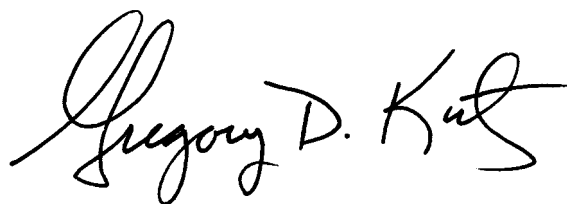
illustrate, contracting officers are not doing so. There is no guidance for contracting officers on considering tax information, even if the information is legally available to them, nor is there any coordinated mechanism to help contracting officers obtain accurate information on contractors that abuse 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>.

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Gregory D. Kutz  
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Managing Director  
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Steven J. Sebastian  
Director  
Financial Management and Assurance



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# Scope and Methodology

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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.<sup>1</sup> 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

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<sup>1</sup> 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.

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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 <sup>a</sup>	Estimated fiscal year 2002 collections under effective tax levy <sup>b</sup>	Fiscal year 2002 DOD payments <sup>c</sup>	Comments
18	<i>Television repair services:</i> provides repairs at military hospital	Over \$160,000	\$5,000	\$32,000	<ul style="list-style-type: none"> <li>Contract for over \$180,000 in late 1990s</li> <li>Long history of not remitting tax withholdings</li> <li>Several federal tax liens filed against the owner</li> </ul>
19	<i>Clothing manufacturer:</i> provides military uniforms for DOD agency	Over \$1 million	\$137,000	\$914,000	<ul style="list-style-type: none"> <li>Numerous DOD contract awards totaling over \$10 million</li> <li>Offer in compromise, subsequently withdrawn</li> </ul>
20	<i>Courier service</i>	Over \$300,000	\$5,000	\$34,000	<ul style="list-style-type: none"> <li>DOD contract of over \$30,000</li> <li>Bankruptcy filed</li> <li>Several tax liens filed against the business</li> </ul>
21	<i>Construction services:</i> provides fencing installation, maintenance and renovations on military bases	Nearly \$60,000	Nearly \$60,000	\$1.1 million	<ul style="list-style-type: none"> <li>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</li> <li>Has unpaid child support debt</li> <li>Two tax liens filed against business</li> </ul>
22	<i>Weapon parts manufacturer:</i> supplies weapons parts and tools to various military organizations	Over \$400,000	\$54,000	\$363,000	<ul style="list-style-type: none"> <li>Nearly \$1.9 million in DOD contracts</li> <li>IRS tax liens filed against business</li> </ul>
23	<i>Cleaning services:</i> provides cleaning and inspections of fire suppression systems	Over \$250,000	\$6,000	\$40,000	<ul style="list-style-type: none"> <li>Awarded over \$200,000 in DOD contracts</li> <li>Several tax liens filed against business and its owner</li> </ul>

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

(Continued From Previous Page)

<b>Case study</b>	<b>Goods or service and nature of DOD work</b>	<b>Unpaid federal tax amount<sup>a</sup></b>	<b>Estimated fiscal year 2002 collections under effective tax levy<sup>b</sup></b>	<b>Fiscal year 2002 DOD payments<sup>c</sup></b>	<b>Comments</b>
24	<i>Computer equipment supplier: supplies computer-related hardware to military services</i>	Over \$500,000	\$7,000	\$45,000	<ul style="list-style-type: none"> <li>• Over \$1.3 million in DOD contracts</li> <li>• 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</li> <li>• Several federal, state, and county tax liens filed against business</li> </ul>
25	<i>Information technology personnel services: provides support for various military organizations</i>	Nearly \$1 million	\$140,000	\$932,000	<ul style="list-style-type: none"> <li>• Federal payments received from three other federal agencies</li> <li>• Multiple DOD contracts valued up to approximately \$13 million</li> <li>• Potential money laundering activities</li> <li>• Defaulted on installment agreements</li> </ul>
26	<i>Aircraft-related goods: supplies aircraft maintenance equipment</i>	Over \$1.5 million	\$33,000	\$221,000	<ul style="list-style-type: none"> <li>• Nearly \$2 million in DOD contracts</li> <li>• Several federal and state tax liens filed against this business</li> <li>• Several judgments were made against this contractor</li> </ul>
27	<i>Aircraft-related goods: supplies instruments to military services</i>	Nearly \$300,000	\$7,000	\$48,000	<ul style="list-style-type: none"> <li>• Numerous DOD contracts totaling over \$350,000</li> </ul>
28	<i>Research services: provides research for military service programs</i>	Over \$400,000	\$4,000	\$30,000	<ul style="list-style-type: none"> <li>• DOD contract for over \$100,000</li> <li>• Federal tax liens filed against business</li> </ul>
29	<i>Catering services</i>	Over \$60,000	\$4,000	\$29,000	<ul style="list-style-type: none"> <li>• Several IRS tax liens and state tax liens filed against this business</li> </ul>
30	<i>Ammunition: manufactures ammunition</i>	Over \$2 million	\$100	\$1,000	<ul style="list-style-type: none"> <li>• Over \$8 million in DOD contracts</li> <li>• Currently involved in a criminal investigation on product quality</li> </ul>
31	<i>Consulting services: provides technical support services for military installations</i>	Nearly \$2 million	\$410,000	\$2.7 million	<ul style="list-style-type: none"> <li>• Nearly \$30 million in DOD contracts</li> <li>• Bankruptcy filed</li> <li>• Federal and state tax liens filed</li> </ul>
32	<i>Moving services: provides furniture and office equipment for military installations</i>	Over \$50,000	Over \$50,000	\$399,000	<ul style="list-style-type: none"> <li>• Over \$200,000 in DOD contracts</li> <li>• Several federal and state tax liens filed</li> </ul>
33	<i>Power equipment: manufactures power supplies and regulators for various military organizations</i>	Over \$200,000	\$86,000	\$571,000	<ul style="list-style-type: none"> <li>• Over \$3 million in DOD contracts</li> <li>• Tax lien filed against this business</li> <li>• Several judgments filed against the business and its owner in the mid-1990s</li> </ul>

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

(Continued From Previous Page)

<b>Case study</b>	<b>Goods or service and nature of DOD work</b>	<b>Unpaid federal tax amount<sup>a</sup></b>	<b>Estimated fiscal year 2002 collections under effective tax levy<sup>b</sup></b>	<b>Fiscal year 2002 DOD payments<sup>c</sup></b>	<b>Comments</b>
34	<i>Custodial services:</i> provides janitorial and housekeeping services at military installations	Over \$5 million	\$188,000	\$1.3 million	<ul style="list-style-type: none"> <li>• About \$4 million in DOD contracts</li> <li>• Multiple bankruptcies filed</li> <li>• Several federal and state tax liens filed against business</li> </ul>
35	<i>Construction services:</i> provides construction services at military installations	Nearly \$150,000	\$23,000	\$152,000	<ul style="list-style-type: none"> <li>• Bankruptcy filed in late 1990s</li> <li>• IRS received over \$70,000 from levied payments from agencies other than DOD</li> </ul>
36	<i>Funeral home:</i> provides funeral services	Over \$360,000	\$2,000	\$14,000	<ul style="list-style-type: none"> <li>• Continued to incur delinquent taxes after emerging from bankruptcy</li> </ul>
37	<i>Procurement services:</i> obtains parts and equipment for various military organizations	Over \$100,000	\$12,000	\$81,000	<ul style="list-style-type: none"> <li>• Several federal and state tax liens filed against this business and its owner</li> </ul>
38	<i>Information technology personnel services:</i> provides information technology support to military organizations	Over \$1 million	\$289,000	\$1.9 million	<ul style="list-style-type: none"> <li>• Corporate officer assessed a trust fund recovery penalty</li> </ul>

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).

<sup>a</sup>Unpaid tax amount as of September 30, 2002.

<sup>b</sup>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.

<sup>c</sup>DOD payments from MOCAS, One Bill Pay, IAPS, and CAPS automated systems identified by GAO.

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

**Table 5: DOD Contractors with Unpaid Federal Taxes—Individual**

<b>Case study</b>	<b>Goods or service and nature of DOD work</b>	<b>Unpaid federal tax amount<sup>a</sup></b>	<b>Estimated fiscal year 2002 collections under effective tax levy<sup>b</sup></b>	<b>Fiscal year 2002 DOD payments<sup>c</sup></b>	<b>Comments</b>
39	<i>Music services:</i> provides musicians and music services	Over \$30,000	\$2,000	\$16,000	<ul style="list-style-type: none"> <li>• Over \$50,000 in DOD contracts</li> <li>• Debt for unpaid child support</li> <li>• Individual has personal debt that has been turned over for collection action</li> </ul>
40	<i>Maintenance services:</i> repairs shielded doors for secure areas	Over \$50,000	\$4,000	\$28,000	<ul style="list-style-type: none"> <li>• Over \$100,000 in DOD contracts</li> <li>• Bankruptcies filed in mid-1990s</li> <li>• Several court judgments filed against the contractor in the mid- to late 1990s</li> </ul>
41	<i>Music services:</i> provides musicians for religious services	Over \$160,000	\$33,000	\$217,000	<ul style="list-style-type: none"> <li>• Individual has not filed an income tax return since 1997</li> <li>• Defaulted on installment agreement in the late 1990s</li> </ul>
42	<i>Construction services:</i> provides general carpentry, electrical, painting, and building repairs	Nearly \$70,000	\$19,000	\$130,000	<ul style="list-style-type: none"> <li>• Over \$100,000 in DOD contracts</li> <li>• Federal tax lien filed against this individual</li> </ul>
43	<i>Consulting services:</i> provides software development services	Over \$50,000	\$8,000	\$56,000	<ul style="list-style-type: none"> <li>• Individual has personal credit accounts in collection</li> <li>• Federal tax lien filed against this individual</li> </ul>
44	<i>Training services:</i> provides diversity and sexual harassment training	Over \$60,000	\$13,000	\$89,000	<ul style="list-style-type: none"> <li>• Over \$90,000 in DOD contracts</li> <li>• Student loan debt</li> <li>• Individual owes over \$10,000 in past due debt</li> <li>• Several civil judgments and state tax liens filed against contractor</li> </ul>
45	<i>Equipment maintenance:</i> provides maintenance and repair of boilers, generators, and compressors	Nearly \$260,000	\$17,000	\$113,000	<ul style="list-style-type: none"> <li>• Individual owes over \$10,000 in past due debt</li> <li>• Defaulted on installment agreement</li> <li>• One judgment against individual</li> </ul>
46	<i>Environmental engineering:</i> prepares environmental reports	Over \$10,000	Over \$10,000	\$286,000	<ul style="list-style-type: none"> <li>• Owner is federal employee and reserve military officer</li> </ul>
47	<i>Consulting services:</i> provides advice to a military medical command	Nearly \$140,000	\$13,000	\$89,000	<ul style="list-style-type: none"> <li>• Nearly \$300,000 in DOD contracts</li> <li>• Student loan debt with a federal agency</li> <li>• Individual has several accounts with collection agency</li> <li>• Federal tax lien filed against individual</li> </ul>

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

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

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proprietorship). For cases selected as individuals, we reviewed both the owner and related business information, if it could be identified.

<sup>a</sup>Unpaid tax amount as of September 30, 2002.

<sup>b</sup>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.

<sup>c</sup>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](mailto:tom.summers@osd.mil) or by telephone at (703) 697-3193.

Sincerely,

A handwritten signature in black ink, appearing to read "Dov S. Zakheim".

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

**Appendix III  
Comments from the Department of Defense**

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	Shipyards 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

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**Appendix III**  
**Comments from the Department of Defense**

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**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 reevaluated as the program progresses.

**Estimated Completion Date:** Ongoing.

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**Appendix III**  
**Comments from the Department of Defense**

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**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

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 Pays Billions 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 one program that can become a more effective tool to collect delinquent federal taxes owed by businesses and individuals who receive 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 its Treasury Offset Program 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.

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 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.

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 65

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percent of offers were resolved in excess of six months. In Fiscal Year 2003 we reduced that number to 44 percent.

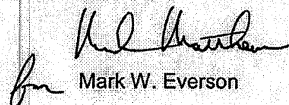
Finally, we have reviewed the systemic blocks in our FPLP procedures and information systems and found that some of these prevent certain cases from entering the levy program. We will be making changes to our information systems to modify a number of these blocks including current blocks on cases that 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 inclusion in the FPLP may appear cost beneficial, concerns for taxpayer rights and statutory requirements sometimes require us to remove a taxpayer from FPLP or prevent us from taking any enforcement action at all. For that reason, we believe a balanced approach to the FPLP, rather than a cost benefit analysis, is more appropriate. Therefore, we do not plan 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 inaccurate or bogus 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 File Accurate Information Returns," we will work with the DOD to ensure that the vendor TINs on 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 contacts and contractors.

We are working with your office to secure additional information on the 47 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) 283-7650.

Sincerely,

  
for Mark W. Everson

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Arthur W. Brouk, (214) 777-5633  
Lawrence Malenich, (202) 512-9399  
John J. Ryan, (202) 512-9587

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## Acknowledgments

In addition to the individuals named above, Tida Barakat, Gary Bianchi, Ray Bush, William Cordrey, Francine DeVecchio, 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.



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