*TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION*

# *Improvements Are Needed in the Withholding Compliance Program*

**September 20, 2018**

**Reference Number: 2018-30-072**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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HIGHLIGHTS

**IMPROVEMENTS ARE NEEDED IN THE WITHHOLDING COMPLIANCE PROGRAM**

# Highlights

**Final Report issued on September 20, 2018**

Highlights of Reference Number: 2018-30-072 to the Commissioner of Internal Revenue.

## IMPACT ON TAXPAYERS

The withholding of employment taxes is a critical component of tax administration. Proper income tax withholding helps increase voluntary compliance if the withholding amounts are sufficient to pay the amount of taxes due. If the withholding amounts are insufficient, taxpayers may face compliance issues due to the underpayment of taxes.

## WHY TIGTA DID THE AUDIT

During Fiscal Year 2017, $1.33 trillion was secured through income tax withholding, which represented 39 percent of total tax revenues for the year. This audit was initiated to determine the effectiveness of the Withholding Compliance Program in addressing taxpayers' underwithholding.

## WHAT TIGTA FOUND

In July 2014, IRS management discontinued accepting referrals from other IRS functions of taxpayers whom they identified as having withholding issues. The IRS planned to issue more lock-in letters systemically. However, the number of lock-in letters issued in Tax Year 2016 was less than the number issued in Tax Year 2014.

Internal Revenue Code Section 3403 provides that employers are liable for underwithholding of Federal income taxes. However, the IRS does not track or hold liable employers that do not comply with the changes requested in the lock-in letters. Our review identified that 26 (33 percent) of the 79 sample cases continued to have insufficient withholding based on the rate stated on the lock-in letter, and the employer did not adjust the withholding as instructed.

TIGTA determined that the Withholding Compliance Program prioritizes unenforceable or unproductive cases. In Fiscal Year 2016, 41 percent of all lock-in letters were issued to Federal Employee/Retiree Delinquency Initiative (FERDI) employees despite the fact that FERDI employees represented only 3 percent of all taxpayers who were identified as having underwithheld taxes. In addition, according to the IRS, in Tax Year 2016, 87 percent of the cases identified for lock-in letters were nonfilers, but tests of a sample of 60 cases showed that only 13 ultimately filed a balance due return. Lastly, due to a management oversight, the IRS has not issued lock-in letters to IRS employees since Tax Year 2013.

## WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS:
1) determine the feasibility of providing revenue officers, and potentially other IRS functions, with the ability to issue lock-in letters when an underwithholding issue is identified; 2) identify noncompliant employers and hold employers liable for failing to comply with the lock-in letter; 3) work with Federal Government agencies that are not complying with the lock-in letters; 4) assess the most effective use of resources for issuing lock-in letters and analyze the current selection criteria; and 5) update the Internal Revenue Manual to include that IRS employees will now be part of the review process.

In response to the report, IRS management agreed with the recommendations and plans to take corrective actions.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 20, 2018

**MEMORANDUM FOR** COMMISSIONER OF INTERNAL REVENUE

**FROM:** Michael E. McKenney
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Improvements Are Needed in the Withholding Compliance Program (Audit # 201730033)

This report presents the results of our review to determine the effectiveness of the Withholding Compliance Program in addressing taxpayers' underwithholding. This audit is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

Management's complete response to the draft report is included as Appendix VI.

If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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# Abbreviations

| | |
|---|---|
| AMS | Account Management System |
| FERDI | Federal Employee/Retiree Delinquency Initiative |
| FY | Fiscal Year |
| IRM | Internal Revenue Manual |
| IRS | Internal Revenue Service |
| TIGTA | Treasury Inspector General for Tax Administration |
| TY | Tax Year |
| WHC | Withholding Compliance Program |
| WHCS | Withholding Compliance System |

# Background

Internal Revenue Code Section 3402 generally requires employers to withhold the proper amount of taxes from their employees' compensation to ensure that withheld taxes can be paid to the Internal Revenue Service (IRS) throughout the year. The withholding of employment taxes is a critical component of tax administration. During Fiscal Year (FY)[1] 2017, $1.33 trillion was secured through income tax withholding, which represented 39 percent of total tax revenues for the year.[2]

Proper income tax withholding helps increase voluntary compliance if the withholding amounts are sufficient to pay the amount of taxes due. If the withholding amounts are insufficient, taxpayers may face compliance issues due to the underpayment of taxes. Taxpayers who owe taxes at the end of the year may be deterred from filing their returns, and those who do file may face a balance due. In order to combat insufficient withholding amounts, in FY 2004, the IRS established the Withholding Compliance (WHC) Program to help taxpayers and businesses stay compliant with their withholding requirements. The WHC is located in the Collection Inventory, Delivery, and Selection function within the Small Business/Self-Employed Division's Headquarters Collection organization. As of May 2018, there were 175 employees working in the program.

Employees are required to provide employers a Form W-4, *Employees Withholding Allowance Certificate*, with which the employees identify the withholding exemptions they plan to claim. The employer uses the completed Form W-4 to determine the amount to withhold for taxes from the employees' pay. At the end of the year, the employer completes Form W-2, *Wage and Tax Statement*, to provide employees with details of their pay for the year, including the total amount of withholding. The employer files a copy of Forms W-2 with the Social Security Administration. The Forms W-2 are subsequently transmitted to the IRS and are ultimately used to identify underwithheld taxes by the Withholding Compliance System (WHCS).

The WHC is tasked with correcting withholding to ensure that taxpayers have enough income tax withheld to meet their withholding tax obligations.[3] As part of an automated process, the WHCS identifies taxpayers with withholding problems and will potentially issue lock-in letters to both the employer and employee depending on the number of letters IRS management decides to issue for the year. According to WHC management, approximately 30 percent of the taxpayers that receive a lock-in letter contact the IRS to provide additional information about their withholding. The decision on the number of lock-in letters issued each year is based on the available employee

[1] See Appendix V for a glossary of terms.
[2] FY 2017 IRS Data Book.
[3] IRM 5.19.11.1 (Oct. 11, 2016).

resources to respond to taxpayers lock-in letter inquiries. Letter 2800-C, *WHC Lock-in Letter to Employer*, is sent to the employer and instructs it to disregard the Form W-4 submitted by the taxpayer. The employer is instructed to instead withhold at the marital status and the number of allowances determined by the IRS, effective on the first pay period after the date specified in the letter (60 days from the date of the letter). This time period provides the employee with an opportunity to dispute the determination before the employer adjusts the withholding. Letter 2801-C, *WHC Lock-in Letter to Employee*, is sent to the taxpayer and advises that the employer has been instructed to disregard the Form W-4 that was submitted and withhold at the rate specified in the letter unless the Form W-4 results in more tax withheld than the lock-in letter. The letter includes an IRS telephone number and address in case the taxpayer disagrees with the amount of withholding proposed by the IRS and wants to provide additional information. During Tax Year (TY) 2016, the WHC issued 213,924 lock-in letters.

This review was performed during the period September 2017 through June 2018 with information obtained from the Small Business/Self-Employed Division Headquarters in Washington, D.C. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

# Results of Review

## Policy Prohibits Field Collection Employees From Issuing Lock-In Letters and Making Referrals to Withholding Compliance

Revenue officers who work in Field Collection have frequent contacts with taxpayers who have delinquent taxes. For some of these taxpayers, insufficient withheld payroll taxes contributed to their tax liabilities. The Internal Revenue Manual (IRM) requires that Field Collection employees check for underwithholding issues and instruct the taxpayer to correct his or her underwithholding if an issue is present.[4] However, if taxpayers do not correct their withholding, Field Collection employees do not have the ability to issue a lock-in letter or submit a referral to the WHC. We identified a population of 1,991 taxpayers who were assigned to Field Collection, had consecutive balances due for TYs 2014 through 2016, and had a corresponding Form W-2 for each year.

Prior to July 2014, the IRS had a process by which the WHC would accept referrals from other IRS functions. This process allowed other IRS employees to refer to the WHC those taxpayers whom they had identified as having underwithholding issues present. WHC employees would determine whether a lock-in letter was warranted, and if applicable, they would issue a lock-in letter to the taxpayer and the employer. In FY 2014, the WHC issued 42,376 taxpayer lock-in letters based on referrals from other IRS functions.

In July 2014, IRS management decided to discontinue the referral program, citing that it was labor intensive and that the WHC had staffing and budget constraints.[5] Additionally, management reasoned that the systemic process used by the WHC would eventually identify the same taxpayers that were referred by other functions. Instead of accepting referrals, the WHC planned to issue more lock-in letters to taxpayers it systemically identified. According to WHC reports, for TYs 2014 and 2015, the WHC issued 345,000 lock-in letters—an increase of 65,000 letters (23 percent) over the 280,000 that it issued in TY 2013. However, the number of lock-in letters issued for TY 2016 dropped to 213,924—a decrease of 131,076 (38 percent) from TY 2015.

Based on a study completed in September 2013, management believed that eliminating referrals would be less labor intensive and more productive.[6] However, it did not have any data or studies

[4] IRM 5.19.1.4.4.3 (Sep. 29, 2014).
[5] IRM 5.19.11.6 (Sep. 8, 2014).
[6] IRS Wage and Investment Division, WHC Lean Six Sigma Study, September 5, 2013.

to confirm that cases that would have previously been referred by other functions were systemically identified.

We reviewed a random sample of 98 cases that were assigned to Field Collection for which taxpayers had consecutive balances due for TYs 2014 through 2016 and had a corresponding Form W-2 for each year. Taxpayers meeting these criteria had a higher likelihood of recurring underwithholding issues that could have been referred to the WHC if referrals were still being accepted. Our analysis identified that 56 of 98 taxpayers had insufficient withholding and were not issued a lock-in letter from the WHCS systemic process between TYs 2014 and 2016. Figure 1 shows the total underwithholding amounts for these 56 cases for TYs 2014 through 2016.

**Figure 1: Values of Insufficient Tax Withholdings for Sampled Taxpayers**

| Tax Year | Total Underwithholding for Sampled Cases |
|---|---|
| **2014** | $505,865 |
| **2015** | $469,446 |
| **2016** | $445,754 |
| **TOTAL** | $1,421,065 |

*Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of sampled cases.*

Between TYs 2014 and 2016, these 56 taxpayers had underwithholding from their paychecks. To project the results, we used the lesser of the underwithheld taxes or the balance due on the taxpayer's account to determine that approximately $1.4 million of taxes could have potentially been collected if the underwithholding was corrected. These taxpayers may have avoided liabilities, including interest and penalties, if a lock-in letter had been issued. Revenue officers were already working with these taxpayers and could have issued the lock-in letters to them if the IRS permitted it. When projected to the population of cases worked in Field Collection, we estimate that the IRS could have potentially collected approximately $18.6 million in underwithheld taxes if lock-in letters had been sent to those employers and taxpayers.[7]

[7] The projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the actual total amount is between $8,540,307 and $28,646,706.

## Recommendation

***Recommendation 1:*** The Commissioner, Small Business/Self-Employed Division, should determine the feasibility of providing revenue officers, and potentially other IRS functions, with the ability to issue lock-in letters when an underwithholding issue is identified.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will evaluate the effectiveness and feasibility of having revenue officers and potentially other IRS functions issue lock-in letters. However, IRS management disagreed with the related outcome measure for this recommendation and for Recommendations 3 and 5, stating the dollar estimates have wide confidence intervals, indicating a large degree of uncertainty.
>
> ***Office of Audit Comment:*** Projecting outcomes involves a degree of uncertainty, and TIGTA disclosed the confidence intervals and all calculations used to make all estimates. All of the samples and resulting projections in this report were statistically valid and verified by TIGTA's contracted statistician.

## *Employers Are Not Held Accountable for Disregarding Lock-In Letters*

Internal Revenue Code Section 3403 provides that employers are liable for Federal income tax that should have been withheld under the law but was not. The lock-in letter sent to employers includes the following wording:

> *Under IRC Section 3403, every employer required to withhold federal income tax is liable for the payment of such tax. If you don't withhold federal income tax from your employee as instructed in this letter, you will be liable for paying the additional tax required to be withheld.*
>
> *IRC Section 3403 also states that the employer shall not be liable to any person for the amount of any such payment. Thus, your employee doesn't have a "cause of action" (basis for legal action) against you to recover the amount of income tax withheld and/or prevent you from withholding the amount directed by IRS.*

Even though the law provides that employers are liable for underwithholding of Federal income taxes, the IRS does not track or hold employers liable who do not comply with the changes requested in the lock-in letters.

In FY 2008, TIGTA reported that the WHC did not have a process in place to identify employers who failed to comply with a lock-in letters and recommended that the IRS develop a process to identify employers that do not adequately withhold taxes after receiving the lock-in letter.[8] The

[8] TIGTA, Ref. No. 2008-40-167, *The Withholding Compliance Program Is Improving Taxpayer Compliance; However, Additional Enforcement Actions Are Needed* p. 12 (Aug. 2008).

IRS planned to develop a report that identified employees who continued to work for the same employer after a lock-in letter was issued and for whom there was no significant change in withholding. The report was to be generated annually and distributed to the appropriate IRS functions, such as the Examination function. During this audit, IRS management advised us that although the WHC submits the report annually to the Examination function for use in the case selection or classification process, the Examination function has never used it for case selection. Since the IRS is not enforcing the law, it is allowing employers to continue underwithholding employee taxes.

We reviewed a random sample of 79 taxpayers who were issued lock-in letters in TY 2014 based on their TY 2013 Form W-2 wages and withholding. Those taxpayers continued working for the same employer in TY 2015, but their percentage of withholding to wages did not increase. In TY 2015, 34 of those taxpayers no longer had underwithholding based on their circumstances; therefore, the employer would not be held liable. However, 26 (33 percent) of the 79 cases continued to have insufficient withholding based on the rate stated on the lock-in letter—and the employer had not adjusted the withholding as instructed. Therefore, the employers should have been liable for $379,184 of underwithheld Federal income taxes from wages. Employers may not be complying with the lock-in letters because the IRS is not holding them accountable when they fail to change employee tax withholding amounts. When projected to the population of 48,093 taxpayers, we estimate when lock-in letters were disregarded, the IRS did not assess the employers or ensure Federal agencies updated withholding amounts for $231 million (approximately $1.15 billion forecast over five years).[9]

Additionally, we analyzed this same population of taxpayers to determine if there were employers that were routinely not increasing withholding as instructed. We identified a population of 17,539 unique employers that potentially were not adjusting withholding based on lock-in letters received. ***********************2******************************
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***********2***********.[10] Although Federal agencies are exempt from certain IRS enforcement efforts, the IRS could engage in outreach to other Federal agencies on the importance of ensuring correct withholding and strictly adhering to lock-in letters if issued to their employees.[11]

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[9] The projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the actual total amount is between $55,051,198 and $406,621,975. See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

[10] ******************************************2*******************************************
******************************************2*******************************************

[11] For example, IRS Policy Statement 20-2 provides that penalties and interest will not be assessed against other Federal agencies.

## Recommendations

***Recommendation 2:*** The Commissioner, Small Business/Self-Employed Division, should identify noncompliant employers and determine the appropriate actions to enforce Internal Revenue Code Section 3403 by holding employers liable that fail to withhold Federal income tax from the employees as instructed in the lock-in letters.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will utilize WHC data to identify employers who are noncompliant with Internal Revenue Code Section 3403. They will evaluate the appropriate enforcement actions to take, if any.

***Recommendation 3:*** The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Tax Exempt and Government Entities Division, should work with Federal Government agencies that are not complying with the lock-in letters to advise them of the requirement to change withholding based on the letters they receive.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS stated that the Tax Exempt and Government Entities Division would analyze internal lock-in letter data to determine the appropriate corrective action required for the agencies.

## *The Withholding Compliance Program Prioritizes Unenforceable and Unproductive Cases*

### *Underwithholding by Federal Employee/Retiree Delinquency Initiative (FERDI) taxpayers*

The WHC identifies approximately two million taxpayers with potential underwithholding issues every year. Due to limited resources, the WHC is unable to issue a lock-in letter to every taxpayer identified by the program. For example, during TY 2016, the WHC identified almost 2.6 million taxpayers with potential underwithholding issues but issued lock-in letters to only approximately 214,000 (8 percent). Because so many cases remain unworked, it is essential that lock-in letter case selection is effectively prioritized.

The WHC separately identifies taxpayers who are Federal employees currently receiving a salary from the Federal Government. The IRS refers to these taxpayers as FERDI taxpayers. Because the IRS compliance functions hold current employees to a higher standard, the WHC treats FERDI taxpayers as priority cases and attempts to issue lock-in letters to most of these taxpayers.[12] Figure 2 compares the number of lock-in letters issued with the number of taxpayers identified as having underwithheld taxes over the last five years.

[12] Federal employees are held to a higher ethical standard for a number of reasons, including that they draw their compensation and funds from Federal taxes.

**Figure 2: WHC Taxpayers Identified and Issued Lock-In Letters**

| Tax Year | All Taxpayers | | | FERDI Taxpayers | | |
|---|---|---|---|---|---|---|
| | Taxpayers Identified[13] | Taxpayers Issued Lock-In Letters | Percentage of Issued Letters | Taxpayers Identified | Taxpayers Issued Lock-In Letters | Percentage of Issued Letters |
| **2012** | 2,174,089 | 270,000 | 12% | 85,247 | 26,878 | 32% |
| **2013** | 1,944,239 | 280,000 | 14% | 85,924 | 83,831 | 98% |
| **2014** | 2,082,288 | 345,000 | 17% | 85,854 | 83,775 | 98% |
| **2015** | 2,328,452 | 345,000 | 15% | 86,686 | 84,732 | 98% |
| **2016** | 2,594,348 | 213,924 | 8% | 89,711 | 87,569 | 98% |
| **Total** | 11,123,416 | 1,453,924 | 13% | 433,422 | 366,785 | 85% |

*Source: TIGTA analysis of WHC case creation inventory reports.*

Over the past five years, the IRS issued lock-in letters to 13 percent of taxpayers who were identified as having underwithheld taxes. During the same period, the IRS issued lock-in letters to 85 percent of FERDI taxpayers identified as having underwithheld taxes. Figure 3 shows how many of the issued lock-in letters were sent to FERDI employees.

**Figure 3: WHC Taxpayers Identified and Issued Lock-In Letters**

| Tax Year | Taxpayers Issued Lock-In Letters | FERDI Taxpayers Issued Lock-In Letters | Percentage of Lock-In Letters Sent to FERDI Taxpayers | Percentage of Inventory Involving FERDI |
|---|---|---|---|---|
| **2012** | 270,000 | 26,878 | 10% | 4% |
| **2013** | 280,000 | 83,831 | 30% | 4% |
| **2014** | 345,000 | 83,775 | 24% | 4% |
| **2015** | 345,000 | 84,732 | 25% | 4% |
| **2016** | 213,924 | 87,569 | 41% | 3% |

*Source: TIGTA analysis of WHC case creation inventory reports.*

In TY 2016, 41 percent of all lock-in letters were issued to FERDI employees despite the fact that FERDI employees represented only 3 percent of all taxpayers who were identified as having underwithheld taxes. As previously discussed, IRS policy prohibits certain enforcement action

[13] The total taxpayers' columns includes FERDI taxpayers.

against Federal agencies. In addition, TIGTA has previously reported that FERDI cases can be resolved with the collection of revenue through the Federal Payment Levy Program.[14]

### Overemphasis on nonfilers

The WHCS sends lock-in letters to nonfilers using withholding-to-income ratios based on taxpayers' Forms W-2 regardless of whether the taxpayer filed a tax return or has a balance due account. According to the IRS, in TY 2016, 87 percent of the cases that were identified for lock-in letters were nonfilers (taxpayers who had not filed a tax return for the previous tax year).

During our review of the 79 sampled taxpayers described above (who were issued lock-in letters in TY 2014 and continued working for the same employer in TY 2015 but for whom withholding did not increase ), we determined that 60 (76 percent) of the 79 taxpayers were nonfilers for the tax year in which they were issued the lock-in letter. Of those 60, 13 (22 percent) subsequently filed a balance due return. In addition, 15 (25 percent) received a refund or had no balance due after filing their tax returns.[15] Although the IRS cannot determine if the taxpayer will have a balance due based solely on their Form W-2 wages and withholding, it should consider changing the mix of cases worked to include more taxpayers with known balance due accounts.

Due to diminishing resources, for TY 2016 wages, the WHCS issued lock-in letters for underwithholding to only 213,924 taxpayers of almost 2.6 million taxpayers identified for lock-in letter issuance. In addition, the IRS plans to send approximately 235,000 lock-in letters for underwithholding on wages received in TY 2017. The WHC should analyze its current selection criteria for issuing lock-in letters to determine if it is optimally prioritizing its limited resources. For example, WHC management should consider prioritizing accounts with multiple years of underwithholding, accounts with known balances due, and a more balanced mix of FERDI and non-FERDI taxpayers.

## Recommendations

The Commissioner, Small Business/Self-Employed Division, should:

**Recommendation 4:** Assess whether the WHC's focus on FERDI taxpayers is the most effective use of resources, considering the high percentage of unfiled returns that ultimately might result in refund returns when filed as well as the compliance resources that are already in place as part of the FERDI.

> **Management's Response:** The IRS agreed with this recommendation. The IRS will determine whether the current prioritization of FERDI cases within the WHC program is appropriate or should be modified.

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[14] TIGTA Ref. No. 2015-30-051, *Most Federal Employee/Retiree Delinquency Initiative Cases Are Resolved With the Collection of Revenue; However, Some Program Improvements Can Be Made* (June 2015).
[15] The remaining taxpayers had not yet filed a return.

***Recommendation 5:*** Analyze the current selection criteria used by the WHCS to determine if the taxpayers identified for systemic lock-in letter issuance are the best use of limited resources. This would include potentially identifying taxpayers with multiple years of underwithholding and the percentage of inventory that includes nonfilers.

> ***Management's Response:*** Although the IRS agreed with this recommendation, it believes the extensive programming changes needed to accomplish this objective are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, the IRS cannot provide an implementation date at this time. The IRS will place this recommendation on hold.
>
> ***Office of Audit Comment:*** TIGTA believes IRS management should analyze WHC inventory selection criteria to identify better case selection criteria so they can optimize their limited resources. By determining the best selection criteria now, they will be ready to make any programming changes when information technology resources become available.

## *Release and Modification Actions of Lock-In Letters Were Not Always Properly Documented*

The lock-in letter sent to the taxpayer includes contact information so that taxpayers can contact the IRS if they disagree with the amount of withholding proposed. If the taxpayer contacts the IRS, the WHC employee researches IRS systems and obtains documentation from the taxpayer to support the claims. Depending on the information provided, the WHC employee can release the taxpayer from the lock-in letter, which would leave the withholding at the previous amount claimed by the taxpayer, or the employee can modify the withholding amount. If any change is made to the withholding amount based on the additional information, the employer is issued a letter to notify it of the change.

The IRM requires that the WHC staff document the Account Management System (AMS) case histories for releases and modifications of lock-in letters to include the following:

- Case documentation to include a line-by-line summary of Form W-4 Worksheet calculations supporting any change in the lock-in rate.[16]
- Disclosure, telephone, and address verification.[17]
- Filing delinquencies reviewed.[18]

[16] IRM 5.19.11.3.3(4) (Dec. 31, 2010).
[17] IRM 5.19.11.3.1(6) (Oct. 11, 2016).
[18] IRM 5.19.11.3.1(6) (Oct. 11, 2016).

- Spousal consent obtained.[19]
- Releases for undeliverable mail.[20]
- A list of the verification documents or information requested from the taxpayer or employer.
- The specific reason for releasing the lock-in letter.

We reviewed a random sample of 104 cases from a population of 77,698 taxpayers who were issued a lock-in letter in TY 2015 and who had the lock-in letter subsequently released or modified after contacting the WHC staff. We determined that the case histories for 63 (61 percent) of the 104 releases or modifications did not include complete documentation to support the actions that were taken. Specifically,

- 32 cases for which the histories showed the incorrect tax return figures or did not include pertinent information needed to accurately calculate the Form W-4.
- 39 cases for which the histories did not notate the case status for any filing delinquencies.
- 14 cases for which the histories did not include a list of verification documents or information requested from the taxpayer or employer.
- 6 cases for which the histories did not secure the necessary spousal consent.
- 3 cases for which the histories were missing a complete line-by-line summary of the Form W-4 worksheet calculation.[21]

Adequate documentation is needed in case histories to support any releases or modifications so that any person subsequently reading the history can easily determine what decisions were made, why those decisions were made, what actions were taken, and what further actions are required to resolve the case if additional taxpayer contact is needed.

In addition to the documentation issues, we identified three taxpayers who were erroneously released from the terms of the lock-in letter. The errors occurred due to employee mistakes, and IRS management agreed that the taxpayers should not have been released from the lock-in letter terms.

We also identified four taxpayers who were released from lock-in letter terms because the lock-in letters sent to their employers were returned as undeliverable and the WHC employee could not locate a new address for the employers. As a result, the IRS released the taxpayers from the increased withholding amount because of the employer's invalid address, and the taxpayers did not have to take any action to correct their underwithholding. The IRM does not

[19] IRM 5.19.11.7(12) (Oct. 11, 2016).
[20] IRM 5.19.11.9(6) (Oct. 11, 2016).
[21] Some of the releases or modification cases had multiple documentation issues.

provide detail on specifically what research should be conducted for WHC employees to locate an employer's address after receiving a lock-in letter back as undeliverable.[22] Before releasing these taxpayers, the WHC should ensure that it has made every effort to locate an employer's address.

Although managers perform quality reviews of the release and modifications of lock-in letters, their reviews do not include verifying that the case history is properly documented. Without complete documentation, it is unclear if the WHC employee accurately released or modified a case. This can make it difficult for management to perform adequate quality reviews.

## Recommendations

The Commissioner, Small Business/Self-Employed Division, should:

***Recommendation 6:*** Update the quality review process for lock-in letters that are released or modified to verify that the required case documentation is included in the AMS case histories.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will review the current quality review process and documentation requirements for WHC case processing and make adjustments as needed.

***Recommendation 7:*** Update procedures to provide specific instructions on how to find employer addresses so that lock-in letters are not released based on employer undeliverable mail.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will review the current procedures for processing undelivered WHC mail from employers and make adjustments as needed.

## Lock-In Letters Were Not Sent to Internal Revenue Service Employees

The WHC uses the wage and tax information reported on Form W-2 to systemically identify taxpayers who have not had enough taxes withheld and are not compliant with filing or paying their taxes. There are three potential outcomes to the WHCS systemic process:

- Outcome 1: No tax compliance problem is indicated; therefore, a WHC case is not created.
- Outcome 2: A withholding compliance problem is identified; therefore, a WHC case is created.
- Outcome 3: A withholding compliance problem is identified; however, a manual review is required prior to creating a WHC case.

[22] IRM 5.19.11.9(6) (Oct. 11, 2016).

For Outcome 2 cases, lock-in letters can be systemically issued to both the employer and employee; however, the IRS limits the number of lock-in letters it issues each year based on employee resources since workload is impacted by the number of lock-in letters issued. The conditions that require a manual review on Outcome 3 cases include an issue with the taxpayer's Social Security Number or address, the taxpayer being in a disaster area, a pending bankruptcy or offer in compromise, or a taxpayer under a criminal investigation. All of these examples require a further review that is not possible at a systemic level prior to issuing the lock-in letters. ***************************************2***********************************
****2****

The IRM also includes IRS employees with underwithholding issues in the Outcome 3 category.[23] When we questioned WHC staff about whether IRS employees were being issued lock-in letters, we were informed that the IRM was incorrect. WHC employees advised us that IRS employees are not in the Outcome 3 category, and they automatically receive lock-in letters.

We reviewed a random sample of 104 cases from the population of 7,212 IRS employees with one or more balance due tax periods from TYs 2013 through 2016. Of these, 39 cases had a balance due because of underwithholding issues, and 12 of the 39 had underwithholding for two or more years. The 39 employees should have had their underwithholding corrected (a total of $187,737 in underwithholding). When projected to the population, we estimate that the IRS should have issued lock-in letters to 2,705 IRS employees. This could have potentially changed their withholding (approximately $13 million in underwithholding).[24]

IRS management subsequently confirmed that they were not automatically issuing lock-in letters to IRS employees with balances due because of underwithholding. **********2***********
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**********2***********. If lock-in letters had been issued, the IRS employees underwithholding could have been corrected, avoiding a potential balance due.

***Management Action:*** The IRS updated the WHCS programming requirements so that IRS employees will now be included with FERDI employees and will systemically receive lock-in letters beginning in TY 2018.

[23] IRM 5.19.11.5 (Oct. 11, 2016).
[24] The projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the actual total amount is between $8,174,273 and $17,509,740.

## *Recommendation*

***Recommendation 8:*** The Commissioner, Small Business/Self-Employed Division, should update the IRM to remove IRS employees from the Outcome 3 category and reflect that they will now be included as part of the WHC review process.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS noted since only minor programming changes were needed, they are working with the Information Technology, Application Development organization to modify the WHC case creation process, which will move IRS employees from the Outcome 3 file to the Outcome 2 file, allowing them to be processed during the systemic lock-in letter processing. IRM 5.19.11.5.4, *IRS Employees (IRS)*, will be modified to reflect the changes to WHC case creation for IRS employees.

## Appendix I

# Detailed Objective, Scope, and Methodology

The overall objective was to determine the effectiveness of the WHC in addressing taxpayers' underwithholding. To accomplish our objective, we:

I. Identified the WHC criteria and guidelines, including any planned changes, and determined if there is appropriate guidance and oversight.

   A. Identified general polices, processes, and procedures for the WHC.

   B. Determined how IRS management evaluated program effectiveness to include obtaining inventory reports and program results.

II. Determined if inventory selection procedures are adequate and if allowing other IRS functions to issue lock-in letters would improve taxpayer compliance.

   A. Evaluated current inventory selection procedures to determine how cases are selected to receive a lock-in letter.

   B. Identified the population of taxpayers currently in Field Collection inventory that had three or more consecutive tax years with a balance due and had an associated Form W-2 for those years to determine if underwithholding was the reason for the balances due. We selected a random sample and determined the impact of giving other IRS functions the ability to issue lock-in letters when withholding issues are identified. We selected a random sample so that we could project our results to the population. TIGTA's contracted statistician reviewed and assisted in developing the sampling plans and projections.

      Population – 1,991 taxpayers
      Sample Size – 98 taxpayers
      Confidence Level – 95 percent
      Expected Error Rate – 50 percent
      Precision Factor – ± 10 percent

III. Obtained a random sample of taxpayers who received lock-in letters for TY 2015. We selected a random sample so that we could project our results to the population. TIGTA's contracted statistician reviewed and assisted in developing the sampling plans and projections.

      Population – 77,698 taxpayers
      Sample Size – 104 taxpayers
      Confidence Level – 95 percent

Expected Error Rate – 50 percent
Precision Factor – ± 10 percent

A. Determined if WHC employees properly verified the information received from the taxpayer and documented the decision in the AMS.

B. Determined WHC compliance with the requirements for releasing or modifying the lock-in letter.

IV. Identified the population of taxpayers who were issued lock-in letters in two subsequent years and worked for the same employer in both years but their withholding had not changed to determine the compliance of employers in making changes to employee withholding based on the lock-in letter process.

A. Selected a random sample of employers that were potentially noncompliant with lock-in letters. We selected a random sample so that we could project our results to the population. TIGTA's contracted statistician reviewed and assisted in developing the sampling plans and projections.

Population – 48,093 taxpayers
Sample Size – 79 taxpayers
Confidence Level – 95 percent
Expected Error Rate – 24 percent
Precision Factor – ± 10 percent

B. Determined if the IRS is enforcing employer compliance requirements on employers that were issued lock-in letters and quantified the amount of withholding the employers could be held liable for if they did not change the withholding as instructed in the lock-in letter.

V. Obtained the population of IRS employees who had underwithholding in TYs 2013 through 2017 and did not receive a lock-in letter to determine the impact of the IRS discontinuing the review of Outcome 3 cases, which includes IRS employees. We selected a random sample to determine the impact of not sending lock-in letters to those employees to correct their underwithholding. We selected a random sample so that we could project our results to the population. TIGTA's contracted statistician reviewed and assisted in developing the sampling plans and projections.

Population – 7,212 IRS employees
Sample Size – 104 IRS employees
Confidence Level – 95 percent
Expected Error Rate – 50 percent
Precision Factor – ± 10 percent

***Data reliability methodology***

During this review, we assessed the reliability of the data we received from the TIGTA Data Center Warehouse for reasonableness by performing validity tests and tracing a judgmental sample of cases to the IRS Integrated Data Retrieval System. The validity tests supported the data were sufficiently reliable and could be used to meet the objective of this audit.

***Internal controls methodology***

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRM and IRS policies related to the WHC. We evaluated these controls by interviewing WHC employees and reviewing statistical samples of taxpayer and employer issued lock-in letters.

**Appendix II**

# *Major Contributors to This Report*

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Carl L. Aley, Director
Beverly Tamanaha, Audit Manager
Jessica Davis, Lead Auditor
Carrie Mares, Auditor

**Appendix III**

## Report Distribution List

Deputy Commissioner for Services and Enforcement
Director, Campus Collection, Small Business/Self-Employed Division
Director, Collection, Small Business/Self-Employed Division
Director, Field Collection, Small Business/Self-Employed Division
Director, Headquarters Collection, Small Business/Self-Employed Division
Director, Office of Audit Coordination

## Appendix IV

# Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

### Type and Value of Outcome Measure:

- Increased Revenue – Potential; $18,593,507 (see page 3).

### Methodology Used to Measure the Reported Benefit:

We reviewed a random sample of 98 cases from a population of 1,991 cases that were assigned to Field Collection for which taxpayers had consecutive balances due for TYs 2014 through 2016 and had a corresponding Form W-2 for each year. Taxpayers meeting these criteria had a higher likelihood of recurring underwithholding issues that could have been referred to WHC if referrals were still being accepted.

Our analysis identified that 56 of the 98 taxpayers had insufficient withholding and were not issued a lock-in letter from the WHCS systemic process between TYs 2014 and 2016. To project the results, we used the lesser of the underwithheld taxes or the balance due on the taxpayer's account to determine that approximately $1.4 million of taxes could have potentially been collected if the underwithholding was corrected. These taxpayers may have avoided liabilities, including interest and penalties, if a lock-in letter had been issued. When projected to the population of cases worked in Field Collection, we estimate that the IRS could have potentially collected approximately $18.6 million in underwithheld taxes if lock-in letters had been sent to these employers and taxpayers. Our random sample was selected using a 95 percent confidence interval, a 50 percent error rate, and a ± 10 percent precision factor. To project our results of our statistical sample, we are 95 percent confident that the actual amount is between $8,540,307 and $28,646,706.

### Type and Value of Outcome Measure:

- Increased Revenue – Potential; $1,154,182,935 (see page 5) based on a five-year forecast.[1]

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[1] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

## ***Methodology Used to Measure the Reported Benefit:***

We reviewed a random sample of 79 taxpayers from a population of 48,093 taxpayers who were issued lock-in letters in TY 2014 based on their TY 2013 Form W-2 wages and withholding. These taxpayers continued working for the same employer in TY 2015, but their percentage of withholding to wages did not increase. In TY 2015, 34 of these taxpayers no longer had underwithholding based on their circumstances; therefore, the employer would not be held liable. However, 26 (33 percent) of the 79 cases continued to have insufficient withholding based on the rate stated on the lock-in letter, and the employer did not adjust the withholding as instructed. Therefore, the employers should have been liable for $379,184 of underwithheld Federal income tax from wages. When projected to the population of 48,093 taxpayers, we estimate when lock-in letters were disregarded, the IRS did not assess the employers or ensure Federal agencies updated withholding amounts for $231 million and approximately $1.15 billion when forecasted over five years. Our random sample was selected using a 95 percent confidence interval, a 24 percent error rate, and a ± 10 percent precision factor. To project our results of our statistical sample, we are 95 percent confident that the actual amount is between $55,051,198 and $406,621,975. We forecasted the total to five years of future noncompliance for which employers should be held liable.

## ***Type and Value of Outcome Measure:***

- Increased Revenue – Potential; $12,842,006 (see page 11).

## ***Methodology Used to Measure the Reported Benefit:***

We reviewed a random sample of 104 cases from the population of 7,212 IRS employees with one or more balance due tax periods from TYs 2013 through 2017. Of these, 39 cases had a balance due because of underwithholding issues, and 12 of these 39 had underwithholding for two or more years. The 39 employees should have had their underwithholding corrected, for a total of $187,737. When projected to the population, we estimate that the IRS should have issued lock-in letters for 2,705 IRS employees, and employers would have potentially changed their withholding (approximately $13 million in underwithholding). Our random sample was selected using a 95 percent confidence interval, a 50 percent error rate, and a ± 10 percent precision factor. To project our results of our statistical sample, we are 95 percent confident that the actual amount is between $8,174,273 and $17,509,740.

## Appendix V

# Glossary of Terms

| Term | Definition |
|---|---|
| Account Management System | Provides employees access to multiple IRS systems through their computers and allows for inventory management, case delivery, history narratives, print-to-fax capabilities for sending information to taxpayers, and electronic referral generation. |
| Federal Payment Levy Program | Through this program, the IRS collects overdue taxes using a continuous levy on certain Federal payments disbursed by the Bureau of Fiscal Service. |
| Field Collection | The unit in the area offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled returns. |
| Fiscal Year | Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30. |
| Internal Revenue Manual | The primary, official source of instructions to staff relating to the organization, administration, and operation of the IRS. |
| Revenue Officer | Employees in the field who attempt to contact taxpayers and resolve collection matters that have not been resolved through notices sent by the IRS campuses or the Automated Collection System. |
| Tax Year | A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year. |
| Withholding Compliance System | A database application that stores the withholding compliance case inventory. Records include case actions, letters issued, taxpayer information (including name, address, Social Security Number), W-2 information, and employer information. |

**Appendix VI**

## Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

September 4, 2018

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy Mary Beth Murphy
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements are Needed in the Withholding Compliance Program (Audit #201730033)

Thank you for the opportunity to review the subject draft report. Proper income tax withholding helps increase voluntary compliance. Attempting to bring noncompliant taxpayers into compliance ensures fairness and reduces the burden on the taxpayers who fully pay their taxes on time.

Over the past six years, the Withholding Compliance (WHC) program has issued over 1.5 million "lock-in" letters directing employers to withhold taxes at an adequate level from the pay of employees who have potential underwithholding issues. The program has been very successful in bringing additional withholding into the Treasury; we estimate that it brings in over $700 million per year. It also positively impacts compliance. For those taxpayers whose cases are worked by the WHC program who go on to file returns, the percentage who file a balance due return is reduced by 47%.

We agree with your recommendations directed at improving the efficiency and effectiveness of the program. We will identify noncompliant employers and will determine the appropriate enforcement actions to take. We will reach out to Federal Government agencies that are not complying with lock-in letters, to advise them of the requirement to change withholding based on the letters they receive. We will study the feasibility of allowing revenue officers, and potentially employees in other IRS functions, to issue lock-in letters.

We have already begun working with Information Technology staff to modify the WHC case creation process so that IRS employees are evaluated for inclusion in the WHC program. (IRS employee tax delinquencies are already subject to special requirements and procedures through the IRS's Employee Tax Compliance program, but including them in the WHC program may help avoid underwithholding issues.) We will also

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assess whether WHC's existing focus on Federal Employee/Retiree Delinquency Initiative (FERDI) cases should be modified.

We disagree with the three increased revenue outcome measures in the report. All three of the dollar estimates have wide confidence intervals, indicating a large degree of uncertainty. In the second outcome measure, this uncertainty was compounded by multiplying the results by five. The resulting five-year estimate only contains data from one year, relies on many assumptions, and cannot be accurately bounded.

In closing, we appreciate your continued support and insight as we strive to further strengthen our processes and programs throughout the Service. Attached is a detailed response outlining our planned corrective actions. If you have any questions, please contact me, or a member of your staff may contact Paul Mamo, Director, Collection Operations, Small Business/Self-Employed (SB/SE) Division.

Attachment

Attachment

**RECOMMENDATION 1:**
The Commissioner, Small Business/Self-Employed Division, should determine the feasibility of providing revenue officers, and potentially other IRS functions, with the ability to issue lock-in letters when an underwithholding issue is identified.

**CORRECTIVE ACTION:**
We agree to evaluate the effectiveness and feasibility of having Revenue Officers and potentially other IRS functions issue lock-in letters.

**IMPLEMENTATION DATE:**
March 15, 2019

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 2:**
The Commissioner, Small Business/Self-Employed Division, should identify noncompliant employers and determine the appropriate actions to enforce Internal Revenue Code Section 3403 by holding employers liable that fail to withhold Federal income tax from the employees as instructed in the lock-in letters.

**CORRECTIVE ACTION:**
We agree to utilize WHC data to identify employers who are noncompliant with Internal Revenue Code Section 3403. We will evaluate the appropriate enforcement actions to take, if any.

**IMPLEMENTATION DATE:**
December 15, 2019

**RESPONSIBLE OFFICIAL:**
Director, Examination Case Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

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**RECOMMENDATION 3:**
The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Tax Exempt and Government Entities Division, should work with Federal Government agencies that are not complying with the lock-in letters to advise them of the requirement to change withholding based on the letters they receive.

**CORRECTIVE ACTION:**
We agree with the recommendation. TE/GE will analyze internal lock-in letter data to determine the appropriate corrective action required for the agencies.

**IMPLEMENTATION DATE:**
October 15, 2019

**RESPONSIBLE OFFICIAL:**
Commissioner, Tax-Exempt/Government Entities Division

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 4:**
The Commissioner, Small Business/Self-Employed Division, should assess whether the WHC's focus on FERDI taxpayers is the most effective use of resources, considering the high percentage of unfiled returns that ultimately might result in refund returns when filed as well as the compliance resources that are already in place as part of the FERDI.

**CORRECTIVE ACTION:**
We agree with the recommendation. We will determine whether the current prioritization of FERDI cases within the WHC program is appropriate or should be modified.

**IMPLEMENTATION DATE:**
May 15, 2019

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 5:**
The Commissioner, Small Business/Self-Employed Division, should analyze the current selection criteria used by the WHCS to determine if the taxpayers identified for systemic lock-in letter issuance are the best use of limited resources. This would include potentially identifying taxpayers with multiple years of underwithholding and the percentage of inventory that includes nonfilers.

**CORRECTIVE ACTION:**
We agree with this recommendation; however, the extensive programming changes needed to accomplish this objective are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, we cannot provide an implementation date at this time. We will place this recommendation on hold.

**IMPLEMENTATION DATE:**
N/A

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this recommendation as part of our internal management system of controls.

**RECOMMENDATION 6:**
The Commissioner, Small Business/Self-Employed Division, should update the quality review process for lock-in letters that are released or modified to verify that the required case documentation is included in the AMS case histories.

**CORRECTIVE ACTION:**
We will review the current quality review process and documentation requirements for WHC case processing and make adjustments as needed.

**IMPLEMENTATION DATE:**
February 15, 2019

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 7:**
The Commissioner, Small Business/Self-Employed Division, should update procedures to provide specific instructions on how to find employer addresses so that lock-in letters are not released based on employer undeliverable mail.

**CORRECTIVE ACTION:**
We will review the current procedures for processing undelivered WHC mail from employers and make adjustments as needed.

**IMPLEMENTATION DATE:**
February 15, 2019

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 8:**
The Commissioner, Small Business/Self-Employed Division, should update the IRM to remove IRS employees from the Outcome 3 category and reflect that they will now be included as part of the WHC review process.

**CORRECTIVE ACTION:**
We agree with the recommendation. Since only minor programming changes were needed, we are working with IT-AD to modify the WHC Case creation process, which will move IRS employees from the Outcome 3 file to the Outcome 2 file, allowing them to be processed during the systemic lock-in letter processing. IRM 5.19.11.5.4, *IRS Employees (IRS)*, will be modified to reflect the changes to WHC case creation for IRS Employees.

**IMPLEMENTATION DATE:**
December 15, 2018

**RESPONSIBLE OFFICIAL:**
Director, Collection Inventory Delivery & Selection, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.