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United States Government Accountability Office
Washington, DC 20548

July 26, 2005

Congressional Requesters

Subject: *Financial Management: State and Federal Governments Are Not Taking Action to Collect Unpaid Debt through Reciprocal Agreements*

The Debt Collection Improvement Act of 1996 (DCIA) allows the federal government to collect state debts from federal payments to contractors. However, before a state can participate in this program, DCIA requires that the state enter into a reciprocal agreement with the Department of the Treasury that would require the state to collect unpaid federal debt from state payments if Treasury collects unpaid state debt from federal payments.

In February 2004, we reported that Department of Defense (DOD) and Internal Revenue Service (IRS) records showed that over 27,000 DOD contractors had nearly \$3 billion in unpaid federal taxes as of September 30, 2002.¹ In a hearing before the Senate Permanent Subcommittee on Investigations on February 12, 2004, we noted that many of those contractors also had unpaid state taxes.²

Based on the issues raised in that hearing, you requested that we determine (1) the extent to which Financial Management Service (FMS) and the states have entered into reciprocal agreements to collect unpaid state and federal debt from their payments to contractors and (2) whether additional opportunities may exist for the Department of the Treasury's FMS to collect unpaid state taxes from federal contractors.³ This report responds to your request by providing information on (1) the extent of states' participation in FMS's debt collection levy and offset⁴ programs, (2) the potential benefits to states of participation in those programs, and (3) the level of state participation in, and the benefits states derive from, the collection of state tax

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

²GAO, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-04-414T](#) (Washington, D.C.: Feb. 12, 2004).

³For this report, the term "state" means the 50 states of the United States and the District of Columbia.

⁴"Levy" generically refers to seizure of property to collect a debt. For federal tax debt, levy is the legal process by which IRS orders a third party—FMS—to turn over property in its possession (e.g., the federal payment) that belongs to the delinquent taxpayer named in a notice of levy. FMS calls the reduction of federal payments to satisfy debt an offset.

debt from federal income tax refunds.⁵ Our work was performed from February 2005 through June 2005 in accordance with generally accepted government auditing standards.

Results in Brief

Neither the federal government nor the states have as yet pursued potentially beneficial reciprocal agreements authorizing the collection of debt from nontax payments, including payments to contractors. According to FMS officials, no state has expressed interest in such agreements, and FMS has not actively pursued avenues to encourage state participation. None of the officials in the 17 states we contacted⁶ said they were aware of the reciprocal agreement provision in DCIA, and all expressed interest in pursuing this debt collection opportunity.

Our comparison of FMS disbursements with the database of state income tax debt that FMS maintains found that thousands of federal contractors paid through FMS have unpaid state tax debt. In fiscal year 2004, FMS disbursed a total of about \$1.8 billion to over 4,600 federal contractors that had approximately \$17 million in state tax debt owed primarily by individuals. According to our analysis, if states had participated in FMS's program that collects debt from nontax payments to contractors, they could have collected over half of the outstanding state tax debt from these federal contractors in fiscal year 2004.

On the other hand, the experiences of the federal government and the states in working together to collect unpaid tax debt from state and federal tax refunds demonstrate that reciprocal agreements to collect tax debt from nontax payments, including contractor payments, have had a significant impact. The federal government and most of the states with income taxes collect tax debt on behalf of one another through the offset of income tax refunds, which has resulted in millions of dollars in collections. In fiscal year 2004, although most states submit only personal income tax debt and not business income tax debt to FMS for collection, FMS still collected over \$217 million on behalf of various states through offsets of federal income tax refunds to pay state income tax debt. Conversely, IRS received over \$77 million from states' levy of state income tax refunds to pay delinquent federal taxes.

We are making three recommendations to the Commissioner of FMS to (1) notify states of the opportunity to enter into reciprocal agreements with FMS to offset state

⁵At your request, we have evaluated and reported separately on the federal government's program designed to levy payments to civilian agency contractors to collect federal tax debt. GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005).

⁶Debt collection officials of the following 17 states were contacted: California, Connecticut, Georgia, Hawaii, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Virginia. Collectively, for fiscal year 2004, the 17 states received over 75 percent of FMS's collections from the federal tax refund offset program as well as over 75 percent of the federal collections from the state income tax levy program.

and federal payments, (2) assess the cost and potential benefits of such agreements, and (3) encourage states to submit more of their business income tax debts to FMS.

FMS generally did not concur with the conclusions and recommendations presented in the report. FMS stated that the legislation authorizing reciprocal agreements did not explicitly provide it the legal authority to enter into reciprocal agreements with states to collect tax debt. FMS also stated that it (1) did not believe reciprocal agreements would be beneficial for either the states or the federal government and (2) believed it had done an effective job encouraging states to send business debts in to the offset program to assist the states in collecting those debts. We disagree with FMS in each of those areas. IRS provided a technical comment on the report and stated that it would discuss our recommendations with the Federal Contractor Tax Compliance Task Force—a multiagency task force established to address issues raised by our February 12, 2004, report and testimony on DOD contractors with tax debt. The [Agency Comments and Our Evaluation](#) section of this report provides a more detailed discussion of the agency comments. We have reprinted FMS's comments in [enclosure II](#).

Background

Treasury is tasked with being the central debt collector for the federal government and is responsible for collecting many types of debt. Within Treasury, FMS is tasked with the responsibility for centralized collection of nontax debt and assisting IRS and the states with collecting tax debt.⁷ DCIA is intended, among other things, to maximize the collection of unpaid nontax debts owed to federal agencies. It requires FMS to withhold or reduce certain federal payments to satisfy delinquent nontax debts owed by payment recipients. This withholding or reduction of payments is referred to as an offset. To the extent legally allowed, federal payments may be offset in whole or in part to satisfy the federal debt. DCIA requires federal agencies to refer their nontax debt that is more than 180 days delinquent to Treasury for collection action.⁸

FMS established the Treasury Offset Program (TOP), a computer matching program, to carry out its responsibilities under DCIA to collect federal debt. TOP compares the names and taxpayer identification numbers (TIN) of debtors with the names and TINs of recipients of federal payments. If there is a match, the federal payment is reduced (levied) to satisfy the overdue debt.

⁷FMS's responsibilities include collecting nontax debt and assisting IRS in collecting tax debt. Examples of nontax debts are (1) loans made, insured, or guaranteed by the federal government, such as student direct and guaranteed loans, Small Business Administration loans, and Department of Housing and Urban Development loans; (2) overpayments, such as salary or benefit overpayments, duplicate payments, or misused grant funds; (3) the unpaid share of any nonfederal partner in a program involving a federal payment and a matching or cost-sharing payment by the nonfederal partner (e.g., the state share of a benefit matching program); (4) fines or penalties assessed by an agency, such as civil monetary penalties or Occupational Safety and Health Administration fines for mine safety violations; (5) delinquent child support; and (6) other amounts of money or property owed to the federal government, such as license fees.

⁸31 U.S.C. §§ 3711(g), 3716(c)(6).

Over the years, numerous types of payments have been added to TOP, including federal payments to contractors for goods and services, federal retirement payments, federal employee salary payments, Social Security benefit payments, and federal income tax refunds. Also, since DCIA's enactment, FMS has been given authority to collect various additional categories of debt, including federal tax debt from federal payments. The Taxpayer Relief Act of 1997 authorized IRS to continuously levy up to 15 percent of certain federal payments to both individuals and federal contractors with unpaid federal tax debt.⁹ IRS coordinated with FMS to use TOP as the means to implement this provision of the act, which is referred to as the Federal Payment Levy Program (FPLP). The FPLP was implemented in July 2000 and provides an automated process for collecting unpaid federal taxes from federal payments.

As the various additions to the types of federal payments that can be levied or offset, as well as the types of federal debt FMS is responsible for collecting, were authorized by separate federal legislation, FMS has gradually included them in TOP to facilitate centralized debt management. According to FMS, the order of preference for the use of levy and offset proceeds is as follows: unpaid federal taxes, certain types of child support debt, federal nontax debt, other types of debt, and state income tax debt in the order in which it was established.

By matching debt in TOP against federal payments, including IRS tax refunds, Social Security payments, federal salary payments, and federal contractor payments, FMS collected about \$2.9 billion to pay federal and other debts in fiscal year 2004. As of September 30, 2004, the TOP database contained about \$87 billion in federal tax debts.¹⁰ From initial implementation of the FPLP in July 2000 through September 2004, FMS has collected a total of \$279.6 million from federal payments through the FPLP to help satisfy federal tax debts.

DCIA also authorized FMS to collect unpaid state debt from federal payments upon request by the appropriate state disbursing official.¹¹ For a state to participate, DCIA requires that the state enter into a reciprocal agreement with Treasury (through FMS) in which the state agrees to collect unpaid federal debt from state payments if FMS collects unpaid state debt by offset of federal payments.

The Internal Revenue Service Restructuring and Reform Act of 1998¹² authorizes, among other things, Treasury to offset up to 100 percent of a federal tax refund

⁹26 U.S.C. § 6331(h).

¹⁰FMS reported in its fiscal year 2004 report to the Congress that TOP had \$105 billion in federal income tax debt that was available for matching to identify potential levies. According to an FMS official, the difference is attributable to the inclusion of rescinded debts in its debt referral calculation. Rescinded debt is debt that IRS has taken out of active status in TOP. IRS rescinds debt for a variety of reasons, such as the debtor having paid the debt in full or the debtor having filed for bankruptcy protection, which makes the debt ineligible for collection through the FPLP.

¹¹31 U.S.C. § 3716 (h).

¹²26 U.S.C. § 6402 (e).

payment to collect state income tax debt.¹³ This provision was also incorporated into TOP to provide for matching of state tax debt against federal tax refunds.

Scope and Methodology

To determine the extent of states' participation in FMS's debt collection programs, including the extent to which FMS and the states have implemented the authority to enter into reciprocal agreements to collect state tax debt from federal payments, we

- interviewed FMS officials regarding the extent to which state disbursing officials have requested that FMS collect state tax debt from federal payments and the extent to which FMS and the states have entered into the reciprocal agreements to assist each other in the collection of debts;
- examined FMS and IRS data on the amount of collections from their levy and offset programs;
- analyzed the amount of state tax debt owed by federal contractors paid through FMS that states have referred to FMS's TOP¹⁴ database to quantify the extent of state participation in FMS's debt collection program by obtaining and analyzing (1) the TOP database containing state tax debt as of February 2005, (2) FMS's Payments, Claims, and Enhanced Reconciliation (PACER)¹⁵ database containing contractor payments made during fiscal year 2004, and (3) various FMS reports showing the results of its programs to collect state debt from federal payments; and
- contacted officials of the National Association of State Auditors, Comptrollers, and Treasurers, the Federation of Tax Administrators, and debt collection officials of the following 17 states: California, Connecticut, Georgia, Hawaii, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Virginia. Collectively, for fiscal year 2004, these 17 states received over 75 percent of FMS's collections from the federal tax refund offset program and generated over 75 percent of the federal collections from the state income tax levy program.

To gain an understanding of federal government debt collection activities that could be used to help states collect unpaid taxes, we

- researched federal statutes and consulted with FMS and IRS officials regarding collaborative debt collection programs, associated regulations in the *U.S. Code of Federal Regulations* related to such statutes, and IRS's *Internal Revenue Manual*;

¹³The term "state income tax" is intended to cover all taxes determined under state laws to be state income tax. The term includes any local income tax that is administered by the chief tax-administering agency of the state.

¹⁴TOP is a computer matching program established by FMS to help it fulfill its debt collection responsibilities under DCIA.

¹⁵PACER maintains payment data and provides online access to these data to federal agencies for which FMS makes disbursements.

- reviewed FMS's and IRS's technical specifications for the FPLP, under which FMS collects unpaid tax debt from its disbursements to federal contractors; and
- reviewed the applicable section of IRS's *Internal Revenue Manual* and interviewed IRS officials responsible for implementing the state income tax levy program, under which IRS enters into agreements with states for the states to respond to an IRS levy of state income tax refunds to collect federal tax debt.

To identify the potential financial benefits to states of participating in FMS's debt collection programs, we

- compared the tax debt states had referred to TOP with the fiscal year 2004 contractor payments in the PACER database to identify the amount of state tax debt that TOP had on record that could potentially be collected by offsets against federal payments to contractors and
- performed additional analysis on the results of our comparison of state tax debts in TOP with contractor payments in PACER to determine the maximum potential value available to pay state tax debts if 100 percent of the payments to contractors with state tax debt in TOP could have been used to offset such debts.

To determine the level of state participation in and benefits actually derived from the offset of federal income tax refunds to pay state tax debts, we obtained and analyzed FMS reports and conducted interviews with FMS officials.

We requested comments on a draft of this report from the Commissioner of the Financial Management Service or his designee and the Commissioner of Internal Revenue or his designee. We received written comments from the Commissioner of the Financial Management Service, which are reprinted in [enclosure II](#) of this report. IRS provided us a technical comment. We conducted our work from February 2005 through June 2005 in accordance with generally accepted government auditing standards.

States and the Federal Government Have Not Taken Full Advantage of Debt Collection Programs

Federal and state governments have not taken full advantage of debt collection programs authorized to help collect federal and state taxes. DCIA authorizes FMS, on behalf of the states, to collect unpaid state debt from federal payments. This provision allows FMS to collect not just from federal contractor payments but also from other federal nontax payments, including federal retirement payments and federal salary payments, to pay state tax debts. Before a state can participate in this program, DCIA requires that the state enter into a reciprocal agreement with FMS that would require the state to collect unpaid federal debt from state payments if FMS collects unpaid state debt by offset of federal payments.

To date, no state has entered into a reciprocal agreement with FMS to participate in such a program to collect state debt, including state income tax debt. According to FMS officials, states have not expressed interest in executing such agreements.

Similarly, FMS has not researched or pursued reciprocal agreements with the states to help collect federal debt, which we believe would include federal tax debt, through offsets of state payments.¹⁶ According to FMS officials, FMS has not developed a pro forma reciprocal agreement or similar information for states that might want to participate, and FMS has not taken steps to encourage states to participate in the program.

FMS officials told us that they had not performed analyses, conducted studies, or consulted with states to identify the potential collections from or costs to either the federal government or the states of initiating reciprocal agreements to collect debt on behalf of each other through offsets of payments to the related debtors. FMS officials said that since no states had approached FMS concerning participation in such debt collection activities, FMS had not conducted research to identify the potential costs and benefits.

However, when we contacted state debt collection officials in 17 states, they told us that they were not aware of the DCIA reciprocal agreement provision or the potential for collecting additional state debt through the offset of federal payments. Each of them also expressed interest in obtaining more information on potential agreements. The state officials we spoke with told us that they had not been contacted by FMS regarding this provision of DCIA. In addition, 16 of the 17 states we contacted are already offsetting their own state payments to collect state income tax debt, which indicates that they could also have the capacity to offset their payments to collect federal debt, including federal tax debt. Officials of the National Association of State Auditors, Comptrollers, and Treasurers, as well as the Federation of Tax Administrators, both of which represent states in monetary matters, told us that they were also not aware of this provision of DCIA. They said that they thought their members would be very interested in pursuing such agreements.

Participation with FMS Could Yield Substantial Benefits Both to States and the Federal Government

Our analysis of state tax debt reported to TOP indicates that states could have collected a substantial portion of their outstanding state tax debt owed by federal contractors if they had participated with FMS in debt collection activities. Our review of contractors paid through FMS identified over 4,600 federal contractors with unpaid state tax debt recorded in the TOP database as of February 2005. We found that Treasury disbursed about \$1.8 billion to these contractors in fiscal year 2004 and that these contractors owed approximately \$17 million in state tax debt recorded in the TOP database. If FMS had offset payments made during fiscal year 2004 to these contractors to pay state tax debt, states could have collected over half of this outstanding amount owed. However, because states do not participate, none of the payments were used to help pay the contractors' state tax debt.

¹⁶Our views concerning FMS's authorization for the reciprocal agreements to include federal tax debt are included in our response to FMS's comments on our report.

Reciprocal agreements permitting the collection of unpaid state tax debt from federal payments could result in even higher collections if states were to send business income tax debt to TOP. According to FMS officials, FMS began accepting state business income tax debt in April 2004 only after a state official inquired whether such debt could be referred to TOP. Our analysis of the TOP database showed that as of February 2005, only two states had referred business income tax debt to TOP. Of the approximately \$4.9 billion of state income tax debt recorded in TOP as of February 2005, less than 1 percent—3.4 million—was business income tax debt.

To a limited extent, the federal government already takes advantage of its ability to collect unpaid federal tax debt from certain nontax payments. FMS collected about \$114 million through TOP to pay federal tax debt during fiscal year 2004. About \$21 million of the \$114 million in federal tax collections was levied from federal payments to contractors. However, our previous work on the levy of payments to contractors showed that collections from such levies could be much greater. We estimated that as much as \$350 million could have been levied in a single year if all FMS payments to contractors included in our review could have been levied.¹⁷

The potential benefit to the federal government of collecting unpaid federal debt from state nontax payments is also significant. IRS's experience with collecting federal tax debt from state income tax refunds, which is discussed below, indicates that reciprocal agreements between FMS and the states related to states' nontax payments could be mutually beneficial.

States and the Federal Government Already Benefit from Tax Refund Offset and Levy Programs

Both the states and the federal government have benefited from their participation in the programs to collect taxes from federal and state tax refunds. The program to use federal income tax refunds to collect state income tax debt is known as the federal tax refund offset program,¹⁸ and the program to use state income tax refunds to collect federal tax debt is known as the state income tax levy program. According to IRS officials, reciprocal agreements are not required for the tax refund offset and levy programs.

FMS is authorized to collect unpaid state income tax debt through offsets of federal income tax refunds.¹⁹ As figure 1 shows, 37 of the 44 states²⁰ with some form of individual income tax participated in the federal tax refund offset program. As of February 2005, the 37 participating states had referred about \$4.9 billion in state income tax debt to TOP for collection, most of which was tax debt owed by

¹⁷GAO-05-637.

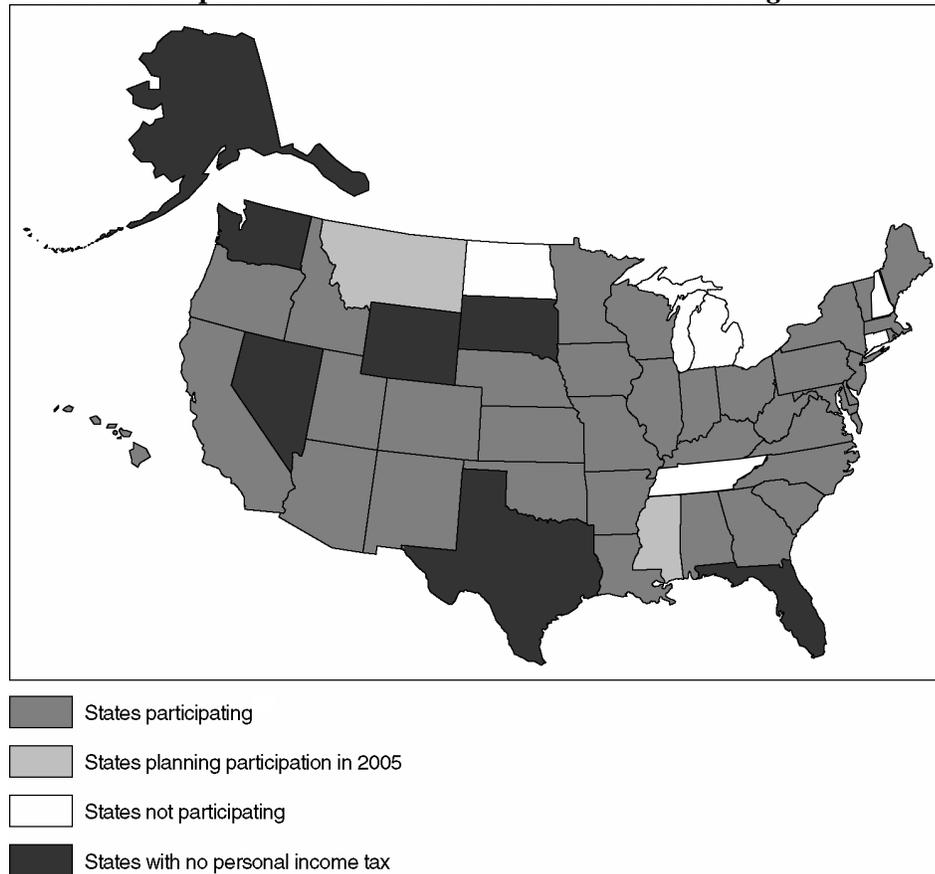
¹⁸In addition to state tax debt, the federal tax refund offset program is also used to collect other debt such as nontax debt owed to federal agencies.

¹⁹26 U.S.C. § 6402(e).

²⁰These 44 states include the District of Columbia and 2 states that have income tax for dividends and interest income only.

individuals. In fiscal years 2003 and 2004, FMS collected over \$169 million and over \$217 million, respectively, on behalf of various states through offsets of federal tax refunds to pay state income tax debt. (See [enclosure I](#) for detail.)

Figure 1: State Participation in the Federal Tax Refund Offset Program



Source: GAO.

Collection of state income tax debt through offsets of federal income tax refunds is somewhat limited, however, because FMS is permitted to offset a federal income tax refund to collect a state income tax debt only if the address of the taxpayer is in the same state where the tax debt recorded in TOP is owed. That is, for example, FMS could not offset a federal income tax refund payment to a taxpayer living in Virginia to pay a state income tax debt owed to the taxpayer's former home state of Maryland. Our analysis of the TOP database indicated that almost half a billion dollars of state income tax debt was not eligible for offset in fiscal year 2004 because the address of the debtor in TOP was not in the state for which there was a recorded state income tax debt.

To help the federal government collect unpaid federal income tax debt, IRS has entered into agreements with states to levy state income tax refunds to collect unpaid federal tax debt.²¹ As of May 2005, IRS had agreements with 27 states to levy individual state income tax refunds to pay federal tax debt. IRS collected over

²¹IRS relies on its levy and distraint authority to conduct the state income tax levy program. 26 U.S.C. § 6331.

\$77 million for payment of federal tax debt through the levy of state tax refunds in fiscal year 2004, and it has collected a total of about \$270 million since July 2000.

Conclusion

In a time of fiscal constraints for both the federal government and state governments, every avenue to identify cost-effective ways of collecting debt should be pursued. Our analysis indicates that a well-administered program to collect unpaid debt from payments that the federal and state governments make to their contractors can be a very effective tool for collecting substantial amounts of both federal and state unpaid debt, which we believe would include tax debt. Investigating ways to promote reciprocal agreements between the federal government and states for the collection of unpaid debts, including tax debts, is consistent with the intent of DCIA. Additionally, encouraging states to expand their reporting of business tax debts for collection under the federal tax refund offset program would further assist states in collecting unpaid taxes from federal contractors.

Recommendations for Executive Action

We recommend that the Commissioner of the Financial Management Service take the following actions:

- notify states of the opportunity to enter into reciprocal agreements with the federal government to collect delinquent debts through offsets of federal and state payments,
- assess the cost and potential benefits of developing reciprocal agreements with the states to collect delinquent debts through offsets of federal and state payments, and
- encourage states to increase their participation in the federal tax refund offset program by submitting more of their business income tax debt to TOP.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Commissioner of the Financial Management Service (See [enclosure II](#)). We received informal comments from IRS.

In written comments, FMS agreed to take certain steps, but generally did not concur with our conclusions and recommendations. FMS stated that the legislation authorizing reciprocal agreements did not provide it the legal authority to enter into reciprocal agreements with states to collect federal tax debt. FMS also stated that it (1) did not believe reciprocal agreements would be beneficial for either the states or the federal government and (2) believed it had done an effective job of encouraging states to send business debts to the offset program to assist the states in collecting those debts. We disagree with FMS in each of those areas.

First, while FMS did not dispute the availability of reciprocal agreements allowing it to collect both tax and nontax state debt and for states to collect federal nontax debt, it stated that we were mistaken to suggest that DCIA authorizes FMS to enter into

reciprocal agreements with states to collect federal tax debt. As support, FMS cited statutory provisions that prohibit it from using its offset authority to collect federal tax debt. Consequently, FMS said it would not be authorized to enter into agreements with states under which the states would collect federal tax debts from their own payments and send the collected amounts to the Treasury.²²

While we understand FMS's interpretation of the statutes, it is not the only reading; and we believe it does not accurately reflect what the Congress intended. Both DCIA and its legislative history recognize that Treasury would have broad authority to specify the scope and terms of reciprocal agreements. The DCIA legislation providing for reciprocal agreements, 31 U.S.C. § 3716(h), was enacted after, and with recognition of, the general prohibition on using FMS's general offset authority to collect federal tax debts as well as certain Social Security debts and debts arising from tariff laws.²³ However, the legislative history states that "Congress anticipates that States will offset Federal debts in which there is no State financial interest or Federal/State cost-sharing (*such as debts owed to the Customs Service.*)" *Id.* (emphasis added). Debts owed to the Customs Service include debts arising from federal tariff laws. This statement in the legislative history regarding the use of reciprocal agreements to collect debts owed to Customs Service was made in light of and in contrast to the preexisting provision restricting FMS from using its general offset authority to collect debts arising from tariff laws.²⁴ In contrast to FMS's interpretation, one can reasonably conclude that if Congress intended Treasury to use reciprocal agreements to collect federal tariff law debts, which are explicitly excluded from offset by the preexisting provision cited by FMS, then Congress also intended that other debts excluded by that provision, such as federal tax debts, would also be authorized to be collected through reciprocal agreements. Second, FMS's interpretation that its authority to offset federal payments is not applicable to federal taxes does not consider that the receipt of a tax debt collected by a state and sent to Treasury would not constitute an offset made by FMS.

To address FMS's concerns regarding its authority to collect tax debts, we have augmented our report to indicate that the reciprocal agreements would cover the collection of federal debt, which we continue to believe would include federal tax debt. However, if FMS believes it lacks statutory authority to enter into reciprocal agreements to collect federal tax debt, it should seek legislative clarification or correction. Further, nothing in FMS's interpretation would preclude the use of reciprocal agreements that call for states to assist Treasury in collecting on federal tax debt short of making actual collections, such as states identifying to FMS any

²²Specifically, FMS stated that 31 U.S.C. § 3701(d)(1) renders inapplicable the offset authority of 31 U.S.C. § 3716 for collection of federal tax debts. Therefore, in its view, FMS could not enter into reciprocal agreements under section 3716(h) that would call for states to withhold amounts from their payees on the behalf of the federal government to collect federal tax debts.

²³See 142 Cong. Rec. 9127 (Apr. 25, 1996). Such authority would be implemented within Treasury by FMS.

²⁴31 U.S.C. § 3107(d).

state payees' assets, such as payments the state is going to make, that could be levied, which FMS could then pass along to IRS to use in its own collection activities.

Second, although FMS agreed with our recommendation to inform states of the opportunity to enter into reciprocal agreements, FMS indicated it did not believe reciprocal agreements would be beneficial to the states, and stated that our report did not take into account operational and legal complexities associated with collecting debt on behalf of the federal government. At this juncture, it would seem that no real basis exists for questioning the merits of entering into reciprocal agreements since neither FMS nor the states have analyzed the potential costs or benefits of these reciprocal agreements to determine whether they would be mutually beneficial despite the fact that such agreements have been a potentially viable collection tool since 1996. This is the whole point behind our recommendation that FMS assess the cost and potential benefits of such reciprocal agreements.

We agree with FMS that states need to carefully consider the net benefits of entering into such agreements, but FMS's response downplays the significant collections that states could receive if FMS were to take action to negotiate reciprocal agreements. As our report indicates, thousands of federal contractors could have payments offset to help collect state tax debt, and over half of all debt states had submitted to FMS for collection in fiscal year 2004 potentially could be paid in a single year through such offsets. Sixteen of the 17 states we contacted during our audit were already offsetting state nontax payments, including contractor payments, to collect their own state taxes and expressed interest in doing so for the federal government. While FMS stated that it will "assist states in assessing the costs and potential benefits of such agreements," in our view, FMS's response falls short of taking an active role in identifying and analyzing available new sources of federal debt collection. We believe FMS needs to take a proactive approach to its debt collection responsibilities.

Finally, with respect to encouraging states to increase their participation in the federal tax refund offset program, FMS indicated that it had done a sufficient job of informing states. We disagree. Although FMS's response pointed out actions it took in early 2004 to inform states that it was accepting business tax debts, only two states had referred business income tax debts to the offset program as of the time of our audit. At least 6 of the 17 states we contacted said they were unaware that states were allowed to send business tax debt to the levy program. As a result, we reiterate our recommendation for FMS to inform states that the program will accept business tax debts.

In its response to our draft report, IRS said that agency officials would discuss our recommendations with the Federal Contractor Tax Compliance Task Force—a multiagency task force established to address issues raised by our February 12, 2004, report and testimony on DOD contractors with tax debt. IRS also suggested one technical correction in the report, which we have made.

As agreed with your office, unless you publicly release its contents earlier we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Chairman of the Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform, as well as to other congressional committees. We are also sending copies to the Secretary of the Treasury, the Commissioner of the Financial Management Service, the Commissioner of Internal Revenue, state governors, and the Mayor of the District of Columbia. The report is also available at no charge on the GAO Web site at <http://www.gao.gov>.

If you have any questions concerning this report, please contact either Gregory D. Kutz at (202) 512-9095 or kutzg@gao.gov or Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report were Ray Bush, Bill Cordrey, Paul Foderaro, Jason Kelly, John Kelly, Rich Larsen, John Ryan, Richard Riskie, Esther Tepper, Quan Thai, and Matthew Valenta.

A handwritten signature in black ink that reads "Gregory D. Kutz". The signature is written in a cursive style with a large, stylized initial 'G'.

Gregory D. Kutz
Managing Director
Forensic Audits and Special Investigations

A handwritten signature in black ink that reads "Steven J. Sebastian". The signature is written in a cursive style with a large, stylized initial 'S'.

Steven J. Sebastian
Director
Financial Management and Assurance

Enclosures - 2

List of Requesters

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

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

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

Enclosure I

**Collections from Federal Tax Refund Offsets
to Help Pay State Tax Debt**

| States | Fiscal year 2003 net collections | Fiscal year 2004 net collections |
|----------------------|---|---|
| Alabama | \$4,231,739 | 3,767,952 |
| Arizona | 1,862,453 | 1,426,054 |
| Arkansas | 117,731 | 156,674 |
| California | 0 | 1,285,212 |
| Colorado | 60,747 | 31,762 |
| District of Columbia | 1,146,384 | 2,756,352 |
| Delaware | 1,636,938 | 1,976,756 |
| Georgia | 6,929,767 | 31,956,602 |
| Hawaii | 6,914 | 228,736 |
| Idaho | 0 | 864,944 |
| Illinois | 8,259,464 | 8,137,602 |
| Indiana | 6,436,163 | 4,973,739 |
| Iowa | 1,522,628 | 1,433,055 |
| Kansas | 2,570,906 | 2,470,630 |
| Kentucky | 4,081,414 | 5,631,173 |
| Louisiana | 22,388,849 | 32,473,126 |
| Maine | 1,681,658 | 1,233,182 |
| Maryland | 20,421,354 | 21,954,110 |
| Massachusetts | 1,672,558 | 2,264,932 |
| Minnesota | 3,636,347 | 4,231,983 |
| Missouri | 12,983,801 | 11,766,741 |
| Nebraska | 0 | 275,879 |
| New Jersey | 4,011,862 | 3,827,253 |
| New Mexico | 0 | 2,365,235 |
| New York | 26,696,396 | 26,713,051 |
| North Carolina | 5,344,976 | 5,657,035 |
| Ohio | 9,215,298 | 3,465,182 |
| Oklahoma | 3,544,721 | 5,329,897 |
| Oregon | 2,432,217 | 3,166,835 |
| Pennsylvania | 6,264,968 | 6,860,565 |
| Rhode Island | 1,105,879 | 1,159,501 |
| South Carolina | 2,211,802 | 1,262,470 |
| Utah | 1,252,681 | 1,477,495 |
| Virginia | 0 | 8,161,039 |
| Vermont | 177,824 | 121,351 |
| Wisconsin | 3,669,275 | 3,911,745 |
| West Virginia | 1,703,362 | 2,584,159 |
| Total | \$169,279,076 | \$217,360,009 |

Source: Department of the Treasury, Financial Management Service.

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Comments from the Financial Management Service



COMMISSIONER

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

June 15, 2005

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

Dear Mr. Sebastian:

Thank you for the opportunity to comment on the Government Accountability Office's proposed report entitled *Debt Collection: State and Federal Governments Are Not Taking Action to Collect Unpaid Tax Debt through Reciprocal Agreements* (GAO-05-697R). The Financial Management Service (FMS) is always interested in improving its performance in Federal financial management, and also in expanding its already successful debt collection services to states. Nevertheless, I have concerns regarding some aspects of this report's recommendations.

First, and most significant, the report mistakenly suggests that the Debt Collection Improvement Act (DCIA) authorizes FMS to collect federal tax debt by entering into reciprocal agreements with states to offset state payments. The DCIA authorizes Treasury, upon the request of a state, to offset Federal nontax payments to collect state debt, provided the state enters into a reciprocal agreement with Treasury. *See* 31 U.S.C. §3716(h). However, the DCIA clearly states that that this authority does not extend to the collection of Federal tax debt. *See* 31 U.S.C. §3701(d):

“Sections 3711(e) and 3716-3719 of this title do not apply to a claim or debt under, or to an amount payable under – (1) the Internal Revenue Code of 1986
....”

Therefore, the recommendation that FMS assess the potential benefits of developing reciprocal agreements with states to collect delinquent Federal tax debt through the offset of state payments, is not appropriate.

With respect to entering into reciprocal agreements, FMS is willing to work with states to: (1) inform them of opportunities to enter into reciprocal agreements with Treasury and (2) assist states in assessing the costs and potential benefits of such agreements. However, states must remain primarily responsible for determining whether such agreements are to their benefit, taking into account operational and legal complexities associated with collecting debt on behalf of the Federal government. The report does not address such complexities, calling into question the broad conclusion that estimated annual collections of approximately \$250,000 per state would represent a net benefit above the amount of related costs associated with program participation. (Note that the report estimates that if contractor payments were offset to collect the state tax debts in the Treasury Offset Program (TOP), over half of the \$17 million in outstanding state tax debt could have been collected. Dividing those

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collections - approximately \$9 million - equally among the participating states results in collections of approximately \$250,000 per state.)

We also disagree with the report's conclusion that the success of the tax refund offset program logically demonstrates the potential success of a program involving the offset of nontax payments. Our experience with the collection of past-due child support on behalf of states is illustrative. While FMS collected almost \$1.5 billion in delinquent child support during FY 2004, only \$2.6 million of that came from nontax payments.

Finally, the report recommends that FMS encourage states to increase their participation in the Federal Tax Refund Offset Program by submitting more of their business income tax debts to TOP. In April 2004, FMS determined, on its own initiative, that income tax debt owed by businesses could be included in TOP. FMS took a proactive stance by issuing a Technical Bulletin (04-05-04) that explained this change. In addition, we held a conference call with states and the Federation of State Tax Administrators (FTA) to further discuss the change. As a result of the conference call, FTA included news of the change in their weekly email newsletter to states on April 12, 2004.

It is also important to note that FMS has supported legislation that would allow states to submit debts owed by out-of-state residents to TOP. The passage of this legislation would yield immediate benefits to states, as it could significantly increase the number of business debts submitted to TOP. States would first have to determine whether or not particular business taxes are considered income taxes (under applicable regulations and individual state laws) and therefore eligible for TOP. (FMS does not make such determinations.) This issue of debtors owing to one state but residing in another is a substantial impediment to states' fully maximizing the collection potential of TOP.

Once again, thank you for the opportunity to comment on this draft GAO report. If you have any questions or wish to discuss these comments in more detail, I can be reached on (202) 874-7000, or you may contact J. Martin Mills on (202) 874-3810.

Sincerely,



Richard L. Gregg

cc: Donald V. Hammond

(192157)

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