Direct Debit Installment Agreement Procedures Addressing Taxpayer Defaults Can Be Improved

February 5, 2016

Reference Number: 2016-30-011

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.

Redaction Legend:
1 = Tax Return/Return Information

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DIRECT DEBIT INSTALLMENT AGREEMENT PROCEDURES ADDRESSING TAXPAYER DEFAULTS CAN BE IMPROVED

Highlights

Final Report issued on February 5, 2016

Highlights of Reference Number: 2016-30-011 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Direct debit installment agreements (DDIA) give taxpayers a convenient way to make payments on their installments while eliminating the need for checks or paper forms and IRS resources to process the payments each month. During Fiscal Year 2014, more than 500,000 taxpayers entered into DDIAs, and approximately $2.8 billion was collected. Revising DDIA procedures to automatically add new liabilities to existing DDIAs could increase revenue collection and reduce taxpayer burden.

WHY TIGTA DID THE AUDIT

Taxpayers are required to remain in tax compliance as a condition of entering into an installment agreement, and systemic processes exist to default an installment agreement if a taxpayer incurs and fails to pay a new tax liability. These defaults may occur even if the taxpayer would have preferred adding the new liability to the installment agreement. This audit was initiated to determine whether the systemic default of DDIAs due to new tax liabilities causes unnecessary burden on taxpayers and the IRS or improves taxpayer compliance.

WHAT TIGTA FOUND

DDIAs provide benefits for both the taxpayer and the IRS. Taxpayers benefit from establishing DDIAs because they do not have to manually write a check and mail it in order to fulfill their obligations. The IRS benefits because taxpayer payments can be posted faster and do not require IRS employee involvement. In addition, taxpayers who enter into DDIAs are less likely to default on their agreement compared with taxpayers who enter into traditional installment agreements.

In order to maintain a DDIA, taxpayers must pay any new tax liability when due or the DDIA will systemically default. When defaulted, the IRS stops automatic collection from the taxpayer's financial accounts. TIGTA found that when DDIA defaults are due to a new tax liability, most taxpayers want to include the new balance due into their existing DDIA. In addition, the IRS has a procedure that eliminates the need to default the DDIA if a taxpayer incurs a new tax liability, but it is only used when taxpayers request it.

As a result, systemic DDIA defaults increased taxpayer burden because taxpayers incurred additional interest on their unpaid balances. In addition, revenue collection was suspended until the DDIAs were restructured, and some DDIAs were not reestablished.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) consider establishing systemic programming to allow DDIA taxpayers who incur a new unpaid tax liability to absorb the new liability into the current agreement without stopping the automatic payment in qualifying situations; 2) in the interim, provide taxpayers with information as to how they can avoid a default of their DDIA in the event of a new unpaid liability on Form 9465, *Installment Agreement Request*, and Form 433-D, *Installment Agreement*; and 3) for taxpayers who cannot absorb their liabilities in existing DDIAs, establish procedures so that direct debit payments do not stop while the DDIA is suspended and the IRS actively addresses the new balance due.

IRS management agreed that systemically adding a new tax liability to an existing DDIA could save time and collect additional revenue, but did not commit to ensuring that qualifying new liabilities would be absorbed into existing DDIAs or discontinuing the practice of stopping automatic collection when the DDIA is suspended due to a new liability. Management did agree to provide taxpayers with more information on how to avoid default. TIGTA believes that all of the recommendations would benefit the IRS and taxpayers.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 5, 2016

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Direct Debit Installment Agreement Procedures Addressing Taxpayer Defaults Can Be Improved (Audit # 201530014)

This report presents the results of our review to determine whether the systemic default of direct debit installment agreements due to new tax liabilities causes unnecessary burden to the taxpayer and the Internal Revenue Service or improves taxpayer compliance. This audit is included in our Fiscal Year 2016 annual audit plan and addresses the major management challenges of *Tax Compliance Initiatives* and *Achieving Program Efficiencies and Cost Savings*.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. 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

CP	Computer Paragraph
CSCO	Compliance Services Collection Operations
DDIA	Direct Debit Installment Agreement
FY	Fiscal Year
IRS	Internal Revenue Service
TIF	Taxpayer Information File

Background

Although the majority of Americans get a tax refund from the Internal Revenue Service (IRS) each year, there are many taxpayers who owe and some who cannot pay the tax all at once. When full payment is not possible, taxpayers may be allowed to pay their liabilities over a prescribed period of time. Specifically, the Internal Revenue Code allows taxpayers to make payments on any tax in installment payments if such an arrangement will facilitate collection of the liabilities.[1] The IRS refers to these arrangements as installment agreements.

In general, taxpayers can satisfy their installment agreements through three types of payment arrangements:

- Traditional Installment Agreements: Taxpayers make monthly payments to the IRS via check, money order, or credit card. The majority of installment agreements are traditional installment agreements.
- Direct Debit Installment Agreements (DDIA): Taxpayers make payments through a monthly direct debit from their bank or other shared draft account.
- Payroll Deduction Installment Agreements: Taxpayer payments are withheld from their paycheck and paid by their employer. Taxpayers and employers must also file Form 2159, *Payroll Deduction Agreement*.

Although all three types of installment agreements benefit both the taxpayers and the IRS, traditional installment agreements can create some taxpayer burden because taxpayers must take proactive action each month to send payments to the IRS. In addition, IRS employees must process the payments each month, which requires resources. For these reasons, DDIAs and Payroll Deduction Installment Agreements may be more attractive options for both taxpayers and the IRS. This report focuses on DDIAs.

Taxpayers benefit from establishing DDIAs because they do not have to manually write a check and pay postage to mail it every month in order to fulfill their obligations. Also, because the payment comes out of their account automatically each month, they are less likely to incur late fees or further action from the IRS. In addition, the fees associated with DDIAs are lower than the fees associated with other types of installment agreements with the IRS.[2] Finally, unlike traditional installment agreements, taxpayers who owe between $25,000 and $50,000 can establish a DDIA without the need to file Form 433-F, *Collection Information Statement*.

[1] Internal Revenue Code § 6159.
[2] The fee for a traditional installment agreement is $120, while the fee for a DDIA is $52.

The IRS also realizes benefits when taxpayers establish DDIAs. For example, taxpayer payments can be posted faster and do not require IRS employee involvement. Also, there is no risk that a paper check will be lost, mishandled, or misapplied. In addition, taxpayers who enter into DDIAs are less likely to default on their agreement compared with taxpayers who enter into traditional installment agreements.

Taxpayers are required to meet the terms of their DDIA or it will default. These terms include:

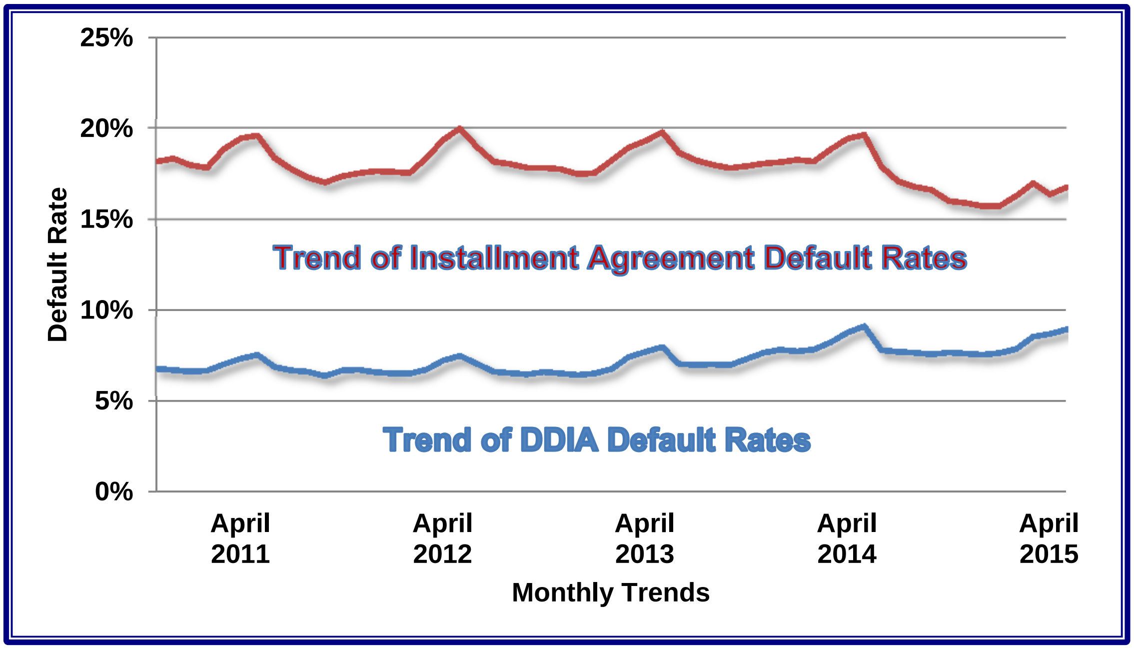
- Making the installment payment when due.
- Paying any new tax liabilities when the liabilities are due.
- Providing an updated financial statement upon request.
- Providing correct information.

A taxpayer's DDIA automatically enters default status (defaulted agreement) when the IRS sends the taxpayer a Computer Paragraph (CP) 523, *Installment Agreement Default Notice*. At that time, the DDIA is suspended and no money is debited from the taxpayer's financial account. The CP 523 allows taxpayers 45 calendar days to contact the IRS in order to correct the issue causing the default. Taxpayers have the option of reinstating their DDIA for a fee.[3] However, if the DDIA is not reinstated, the DDIA is terminated 45 calendar days after the date the CP 523 was issued. After 45 calendar days in terminated status, the amount remaining in the DDIA will be classified as a balance due and the taxpayer's case may be assigned to the Automated Collection System,[4] Field Collection,[5] or the Queue,[6] from which taxpayers may face collection enforcement action such as levy[7] or filing a notice of lien.[8]

Figure 1 shows that while the combined default rate for all types of installment agreements ranged from approximately 16 to 20 percent from April 2011 to April 2015, the default rate for DDIAs ranged from approximately 6 to 9 percent.[9]

[3] The fee to reinstate a DDIA is $50.
[4] A telephone contact system through which telephone assistors collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.
[5] Field Collection provides post-filing services helping taxpayers understand and comply with applicable tax laws and is also responsible for protecting the revenue and interests of the Government through direct collection and enforcement activities.
[6] An automated holding file for unassigned inventory of delinquent cases for which the Collection function does not have enough resources to immediately assign for contact.
[7] A method used by the IRS to collect outstanding taxes from sources such as bank accounts and wages.
[8] An encumbrance on property or rights to property as security for outstanding taxes.
[9] The total installment agreement default rate represents the default rate for all installment agreements, including DDIAs.

Figure 1: Default Rates for All Installment Agreements Compared With DDIAs



Source: Treasury Inspector General for Tax Administration analysis of IRS management information reports.

Between April 2011 and April 2015, the overall installment agreement default rate was often twice as high as the DDIA default rate. Because DDIAs are included in the overall installment agreement default rate, the default rate for traditional installment agreements would be even higher because the DDIA default rate is lower than the overall installment agreement default rate.[10] However, the impact on the overall default rate is minimal because DDIAs represent a small portion of all installment agreements. For example, during Fiscal Year (FY) 2014, DDIAs represented 17 percent of overall installment agreements.

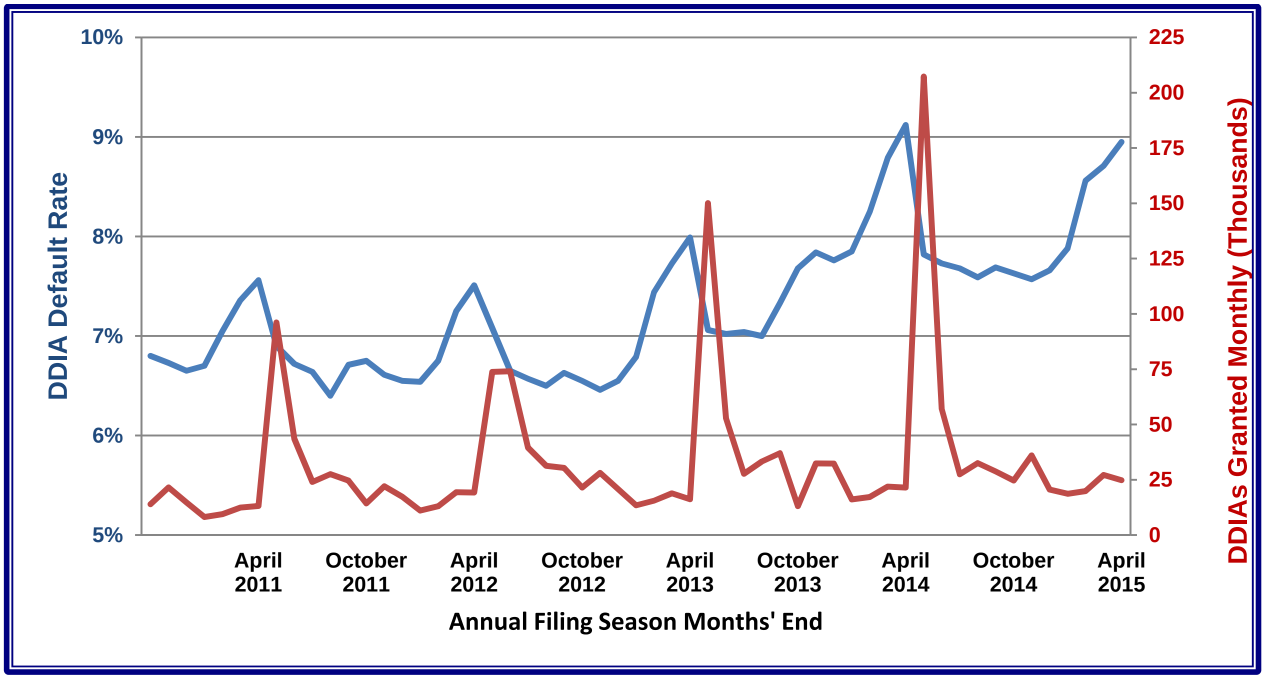
This review was performed at the Small Business/Self-Employed Division Headquarters in New Carrollton, Maryland, during the period January through July 2015. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and 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.

[10] The IRS does not separate the default rate for traditional installment agreements.

Results of Review

In order to maintain a DDIA, taxpayers are required to pay any new tax liability when due or the DDIA will systemically default. Once defaulted, the IRS stops debiting DDIA payments (automatic collection) from the taxpayers' accounts. Although the IRS does not specifically track the reasons why DDIAs default, we determined that as of October 2014, 395,724 (41 percent) of 971,248 defaulted DDIAs were due to new tax liabilities. We identified a relationship between the number of DDIA defaults and the end of the individual tax return filing seasons in April/May and October (which is the return filing due date for taxpayers with filing extensions). Figure 2 shows that the DDIA default rate sharply increased at the end of these two filing seasons. In the weeks following these two increases, there were similar increases in DDIAs granted.

Figure 2: DDIA Defaults and DDIAs Granted



Source: Treasury Inspector General for Tax Administration analysis of IRS management information reports.

While some of the increases in DDIAs granted are due to taxpayers who establish new DDIAs, the trends indicate that taxpayers are also reinstating agreements that were defaulted due to a new liability. Our analysis showed that 50 of the 67 randomly sampled taxpayers who defaulted reestablished their DDIA after they were systemically defaulted due to new liabilities.

Direct Debit Installment Agreement Default Procedures Increased Workload, Burdened Taxpayers, and Interrupted the Collection of Revenue

We reviewed a random sample of 67 taxpayers who were sent a DDIA default notice to determine whether default of the DDIA due to new tax liabilities improved taxpayer compliance. Results showed that while the use of DDIAs is increasing and DDIAs are bringing in more revenue, changes can be made to provide more consistent and effective processing as well as reduce taxpayer burden. Specifically, we determined that DDIA default procedures:

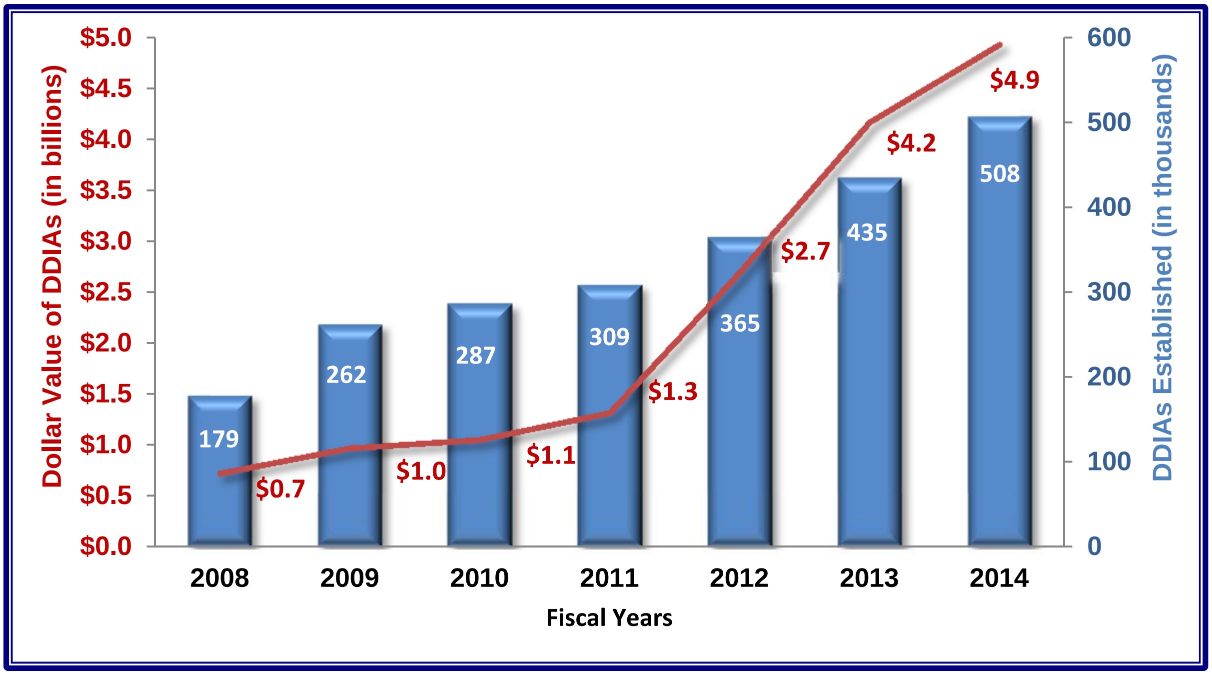
- Increase Compliance Services Collection Operations (CSCO) function[11] workload.
- Increase taxpayer burden and interrupt revenue collection.

DDIA usage is increasing and bringing in more revenue

The IRS has increased the use of DDIAs in recent years. In FY 2014, more than 500,000 taxpayers entered into DDIAs. Figure 3 shows that between FY 2008 and FY 2014, the number of DDIAs increased 184 percent and the dollar value of associated delinquent liabilities grew 583 percent, from $722 million to $4.9 billion.[12]

[11] CSCO processes balance due and nonfiler correspondence and works cases and Collection program areas.
[12] Difference is due to rounding. The dollar value grew from $722,760,476 to $4,933,642,125.

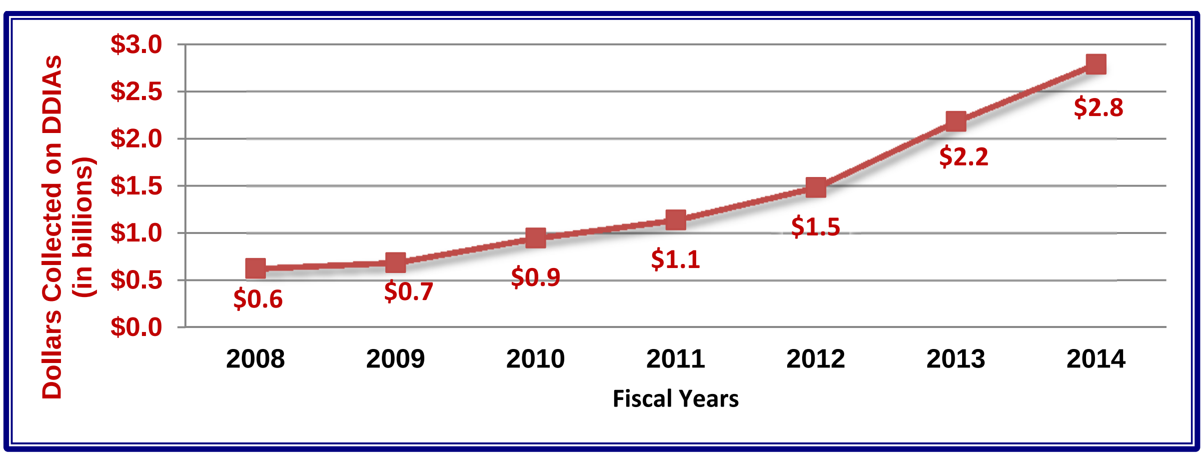
Figure 3: DDIAs Established and Associated Dollars From FY 2008 Through FY 2014



Source: *Treasury Inspector General for Tax Administration analysis of IRS Collection Activity Report 5000-6.*

The IRS collects a significant amount of revenue through DDIAs, which require minimal IRS processing. Figure 4 shows that revenue collected through DDIAs has increased every year since FY 2008. The IRS collected $2.8 billion in FY 2014, up from approximately $600 million in FY 2008.

Figure 4: Dollars Collected From DDIAs – FY 2008 Through FY 2014



Source: *Treasury Inspector General for Tax Administration analysis of IRS Collection Activity Report 5000-6.*

DDIA default procedures increase CSCO function workload

After a taxpayer defaults on his or her DDIA because of a new tax liability, the IRS suspends the taxpayer's account while resolution is attempted. This process can take significant time and resources.

- When the IRS receives a new balance due for a taxpayer, the taxpayer is sent a CP 523 and the DDIA systemically enters into default status. The IRS stops withdrawing payments from the taxpayer's account.
- Taxpayers calling in response to the CP 523 are handled by a campus[13] Accounts Management function or the appropriate revenue officer. Information obtained from the taxpayers regarding the CP 523 is transcribed to Form 4442, *Taxpayer Inquiry Referrals*, or Form 4844, *Request for Terminal Action*, and these forms are then forwarded (via fax) to the appropriate CSCO function.
- When applicable, CSCO function tax examiners work the request to reinstate the DDIA in accordance with DDIA criteria. If the taxpayer meets streamline criteria, the tax examiner can reinstate the DDIA without contacting the taxpayer.[14] However, the tax examiner will need to work with the taxpayer or revenue officer if the DDIA does not meet streamline criteria.
- If taxpayers do not respond to the CP 523, both the new balance due amount and the remaining amount owed on the defaulted DDIA are assigned to either the Automated Collection System or the Queue, from which the IRS may take collection enforcement action such as filing a notice of lien or levy.

However, the IRS has internal procedures that eliminate the need to default the DDIA if a taxpayer incurs a new delinquency that they cannot pay when the return is filed.[15] Specifically, if a taxpayer contacts the IRS before filing a balance due return, the IRS employee may add a code to the taxpayer's account that will prevent the default because it allows the taxpayer to absorb a new balance due amount into the DDIA.[16] This process eliminates the need for the CP 523, Forms 4442 or 4844, further CSCO function tax examiner processing, and possible assignment to other collection functions.

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[13] A campus is the data processing arm of the IRS. Campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[14] Streamline installment agreements benefit taxpayers because they are generally processed quickly without a financial analysis or managerial approval and do not require a lien determination. In general, taxpayers meet streamline criteria if they owe $50,000 or less and their unpaid assessments will be fully paid within 72 months or by the Collection Statute Expiration Date, whichever comes first. The collection statute expiration ends the Government's right to pursue collection of a liability and lasts 10 years after assessment of a tax liability.
[15] Internal Revenue Manual 5.19.1.5.4.16 (Nov. 25, 2014).
[16] With the new balance due amount included, the aggregate unpaid balance of the DDIA must not exceed $50,000 and must be fully paid within the collection statute.

However, the IRS does not clearly communicate this option to DDIA taxpayers. Specifically, information about this internal procedure is not included in the instructions for Form 9465, *Installment Agreement Request*, nor is it included in the instructions for Forms 1040EZ, 1040A, or 1040, *U.S. Individual Income Tax Return*. Moreover, for DDIA taxpayers, the monthly reminder notices (CP 521, *Installment Agreement Reminder Notice*) are sent to the taxpayers' financial institution and not the taxpayers. Although taxpayers are advised at the time the installment agreement is established that subsequent delinquencies can result in termination of the installment agreement, they are not reminded about this consequence when they file a new balance due return, nor are they advised that they can avoid default if they contact the IRS before filing the return.

We interviewed 13 CSCO function tax examiners who work with taxpayers to reinstate defaulted DDIAs.[17] The tax examiners stated that most DDIA defaults were due to new tax liabilities. The majority of these taxpayers wanted to reestablish their DDIA by absorbing the new tax liability into their DDIA, and the taxpayers were generally not aware that a new balance due tax liability would default their agreement.

DDIA default procedures increase taxpayer burden and interrupt revenue collection

We reviewed a random sample of 67 taxpayer DDIA defaults and determined that for 50 (75 percent) defaults, the taxpayers absorbed the new balance due amount into a new or existing DDIA.[18] Specifically:

- Thirty-six of the 50 defaults were reinstated because the taxpayers contacted the IRS during the 45 calendar-day period allowed by the CP 523. These taxpayers incurred a DDIA reinstatement fee of $50.[19]
- Fourteen of the 50 defaults were terminated because the taxpayers did not contact the IRS within 45 calendar days. New DDIAs were eventually established for these taxpayers, after an average of more than four months. These taxpayers were at risk for collection enforcement action such as filing a notice of lien or levy; incurred additional interest for the time they were not making payments; and incurred a new origination fee of $43, $52, or $105 depending on the type of installment agreement established and their financial condition.[20]

[17] The tax examiners were assigned to the IRS campuses in Holtsville, New York, or Philadelphia, Pennsylvania.
[18] We are 90 percent confident that the true percentage of taxpayers that absorbed the new balance due amount into a new or existing DDIA is between 64.4 percent and 83.1 percent.
[19] The DDIA reinstatement or restructuring fee changed from $45 to $50 on January 1, 2014.
[20] Qualifying taxpayers pay an origination fee of $43 instead of $105.

For the 50 defaults in which the taxpayers added the new liability to a new or existing DDIA, the payment amount:

- Did not change in 20 defaults.
- Increased an average of $81 in 29 defaults.
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Collection was delayed for an average of $857 per default before the taxpayer returned to a DDIA status. For these 50 DDIAs, the IRS did not collect $42,846 in payments during the time the DDIAs were in default status.

The remaining 17 of 67 DDIA defaults involved taxpayers who did not restructure or establish a new DDIA:

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- For 14 of the 17 defaults, the IRS was in the process of pursuing collection enforcement action in either the Automated Collection System or Field Collection.
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The IRS did not collect revenue during the time it was pursuing collection enforcement action and reinstating defaulted DDIAs. Specifically, the IRS did not resume automatic collection of $7,450 in monthly payments from the 14 taxpayer defaults that were sent to the Automated Collection System or Field Collection, and those taxpayers still owed $79,964 at the time of their default. When projected to the population of DDIA defaults due to a new balance due, we estimate that the IRS stopped automatic collection from 55,125 taxpayers who owed $314,860,040 when the DDIAs were not reestablished.[21] The 55,125 taxpayers also incurred approximately $297,054 in additional interest expenses the first two months that their debt remained unpaid and they were not in an installment agreement.[22]

The IRS should consider revising DDIA procedures to automatically add any new taxpayer liabilities to existing DDIAs in certain situations, such as when the new liability will not increase

[21] The 90 percent two-sided confidence interval estimates for the number of taxpayers and amounts owed are 34,557 to 81,044 taxpayers and $71.0 million to $444.3 million, respectively.
[22] The IRS publishes the interest rate charged on underpayments quarterly. Since the fourth quarter of Calendar Year 2011, the interest rate has been 3 percent. All 14 taxpayers incurred at least two months of additional interest expense.

the payment amount or the new liability will not result in a defined number of additional payments. For situations that do not meet this criteria, the IRS should consider discontinuing its practice of stopping automatic DDIA collection during the time it is working with the taxpayer to resolve the new liability.

Recommendations

The Director, Collection, Small Business/Self-Employed Division, should:

Recommendation 1: Consider establishing systemic programming to allow DDIA taxpayers who incur a new unpaid tax liability to absorb the new liability into the current agreement without stopping the automatic payment in certain situations, such as when the payment amount does not change or when the number of additional payments does not increase by a specified number. This would require revisions to Form 9465 and Form 433-D, *Installment Agreement*, to request taxpayer agreement at the time the DDIA is established.

> **Management's Response:** Management will carefully consider and assess whether there are taxpayers for whom this recommendation will promote earlier resolution of the delinquent amount without compromising the promotion of future compliance. If the IRS determines that the recommendation has merit, it will revise policies and procedures and update necessary forms to allow DDIA taxpayers to add a new liability to an existing DDIA.
>
> **Office of Audit Comment:** Management did not include the criteria it would use to assess the recommendation, nor did it commit to taking action to ensure that qualifying unpaid liabilities will be added to existing DDIAs. We believe taking such action benefits both the IRS and taxpayers.
>
> Management also did not agree with the outcome measure calculations due to concerns about the sample size and extrapolation of the sample results to the population without adjusting for ineligible cases. We adjusted the precision on our sample projections based on the cases we were able to review. The projections and resulting precision from the sample, calculated using the normal approximation to the binomial distribution, is ± 8.2 percent. We believe that making projections based on this random sample is appropriate.[23]
>
> Management also did not agree that it was appropriate to project increased revenue by taking the remaining balance due on the defaulted DDIAs and assuming that all of the balance would be collected by implementing the recommendations. However, we are not making an assumption in this regard. The facts are that all of these taxpayers were making payments on their existing DDIA's when the IRS stopped accepting these

[23] Based on the reason that certain cases could not be reviewed (*i.e.* older cases did not capture certain information), a related adjustment for sampling bias did not appear to be warranted.

payments because of an additional balance due. Under current procedures, the IRS does not affirmatively solicit the taxpayers to add the new balance due to the DDIA's or even inform them of this option, which leaves them to figure out for themselves that this is an option. The IRS agrees with the premise that engaging these taxpayers will result in fewer defaulted DDIA's but is reluctant to quantify how many taxpayers will continue doing what they were already doing, *i.e.* making payments. We would reduce the outcome measure to account for those taxpayers who might alter their decision to make payments on the DDIA; however, the IRS does not have historical data because it has not yet informed these taxpayers about their payment options.

Recommendation 2: In the interim, provide taxpayers with information on Form 9465 and Form 433-D as to how they can avoid a default of their DDIA in the event of a new unpaid liability.

Management's Response: Management agreed with this recommendation. In their response, management agreed that educating taxpayers with information on future compliance and keeping them informed of their payment options is a key component of assisting taxpayers in resolving their unpaid tax liabilities. The IRS will review relevant IRS communications and revise language in Form 9465 to Form 433-D. However, these revisions will not take place until routine update schedules (November 2016).

Recommendation 3: For taxpayers who do not meet the criteria in Recommendation 1, such as when the new tax liabilities exceed the streamline criteria or when taxpayers are unable to afford increased installment agreement payments, establish procedures so that direct debit payments do not stop while the DDIA is suspended and the IRS actively addresses the new balance due.

Management's Response: Management disagreed with this recommendation. In their response, management stated that expanding the default exceptions beyond the criteria to be developed in response to Recommendation 1 would ultimately undermine the future compliance incentives that the IRS has built into the installment agreement framework.

Office of Audit Comment: We do not believe that this recommendation expands the default exceptions beyond the criteria to be developed in response to Recommendation 1. As noted in our report, after a taxpayer defaults on his or her DDIA because of a new tax liability, the IRS suspends the taxpayer's account while resolution is attempted. At that time, the taxpayer is sent a CP 523 and the IRS stops withdrawing payments from the taxpayer's account. Our recommendation applies only to taxpayers whose accounts are in the suspended status (*i.e.*, taxpayers who respond to the CP 523 attempts to resolve their new tax liability). We agree that for those taxpayers who do not respond to the CP 523, the IRS should stop withdrawing payments from the taxpayer's account after they move from suspended status to default status (at which time their cases are assigned to either the Automated Collection System or the Queue and the IRS may take collection enforcement action such as filing a notice of lien or levy).

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the systemic default of DDIAs due to new tax liabilities causes unnecessary burden to the taxpayer and the IRS or improves taxpayer compliance. To accomplish this objective, we:

I. Evaluated policies, procedures, and guidance related to the DDIA program and systemic DDIA defaults.

II. Analyzed statistics and trends pertaining to the DDIA program and DDIA defaults.

  A. Obtained and reviewed Collection Activity Reports for data related to the DDIA program and DDIA defaults.

  B. Obtained and reviewed internal reports used by the IRS to monitor and evaluate the performance of the DDIA program and DDIA defaults.

III. Assessed the current state of the DDIA program and DDIA default process through interviews with IRS employees.

IV. Determined whether the current DDIA default process improves taxpayer compliance as related to the collection of delinquent taxes.

  A. Identified and obtained a data extract of taxpayers who have participated in the DDIA program and subsequently defaulted on their agreement.

    1. Obtained an extract of active DDIAs from the IRS Taxpayer Information File (TIF) that defaulted due to a new tax liability before October 15, 2014.

    2. Validated the extracted data by selecting a sample and reconciling to IRS systems and taxpayer records and determined the data to be reliable for purposes of the audit.

    3. Selected a random sample from the TIF DDIA data extract. We consulted with our contract statistician for our sampling methodology and projections.

      a) Selected 105 taxpayer DDIA defaults from a TIF population of 263,814 taxpayers with a new tax liability default using a 90 percent confidence rate, a 50 percent error rate, and a ± 8.1 percent precision. We used a random sample to ensure that each taxpayer had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results. However, only 64 percent (67 of 105 cases) contained the information needed for a full audit assessment. The resulting precision from this reduced sample, calculated using the normal approximation to the binominal distribution, is ± 8.2 percent. For the sampled 38 cases (36 percent) that did not contain complete information, we would expect that in the general population approximately 36 percent of cases would also not contain complete information for evaluation. However, we found no reason to suspect that the exception rate for the cases not able to be reviewed would be any different from those we were able to review.

B. Performed case reviews to assess the efficiency, effectiveness, and use of resources for DDIAs which defaulted due to a new tax liability.

   1. Determined if defaulted cases were reinstated to the DDIA program.

   2. Reviewed taxpayer records to identify the length of time that DDIA payments were not processed due to default prior to reinstatement of the DDIA.

C. Quantified and projected findings or the results of case reviews as appropriate in accordance with documented sampling methodologies and consultation with our contract statistician.

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 Small Business/ Self-Employed Division's collection policies, procedures, practices, and trends for DDIA defaults. We evaluated these controls by performing a review of DDIA defaults from TIF cases and interviewing tax examiners from two campuses.

Appendix II

Major Contributors to This Report

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Carl Aley, Director
Timothy Greiner, Audit Manager
Curtis Kirschner, Lead Auditor
Meaghan Tocco, Lead Auditor
Brian Foltz, Senior Auditor

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Small Business/Self-Employed Division
Director, Collection, Small Business/Self-Employed Division
Director, Campus Collection, Small Business/Self-Employed Division
Director, Field Collection, Small Business/Self-Employed Division
Director, Headquarters Collection, Small Business/Self-Employed Division
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Audit Liaison: Commissioner, Small Business/Self-Employed Division

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; the IRS discontinued automatic collection from 55,125 taxpayers who defaulted on their DDIA and owed $314,860,040 (see page 5).

Methodology Used to Measure the Reported Benefit:

From a statistically valid sample of 67 taxpayer DDIA defaults that were due to a new tax liability, we determined that for 14 (21 percent) of the 67 taxpayer DDIA defaults, the IRS was in the process of pursuing collection enforcement action in either the Automated Collection System or Field Collection. The IRS was no longer collecting monthly payments from these taxpayers who owed a total of $79,964, for an average of $5,712 ($79,964 / 14) per DDIA. When our exception rate of 21 percent is projected to the total population of 263,814 taxpayer DDIA defaults due to a new tax liability as of October 2014, we estimate that the IRS stopped automatic collection from 55,125 taxpayers[1] who owed $314,860,040.[2]

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; $297,054 in interest incurred for two months by 55,125 taxpayers who owed $314,860,040 (see page 5).

Methodology Used to Measure the Reported Benefit:

From a statistically valid sample of 67 taxpayer DDIA defaults due to a new tax liability, we determined that for 14 (21 percent) of the 67 taxpayer DDIA defaults, the IRS was in the process of pursuing collection enforcement action in either the Automated Collection System or Field Collection. These 14 taxpayers owed $79,964 (an average of $5,712 per DDIA), and because the IRS was no longer collecting monthly payments, they incurred more interest than they would have if they continued making payments. All 14 taxpayers had a minimum of two months of

[1] Difference is due to rounding. The exception rate of 21 percent (14/67 = 20.8955 percent) multiplied by 263,814.
[2] The 90 percent two-sided confidence interval estimates for the number of taxpayers and amounts owed are 34,557 to 81,044 taxpayers and $71.0 million to $444.3 million.

payments remaining on their DDIAs.[3] Using a 3 percent interest rate, we calculated the interest that the 14 taxpayers would have incurred if they stayed on their installment agreement for two more months.[4] When the average two-month interest amount for the 14 (21 percent) of 67 taxpayers is projected to the total population of 263,814 taxpayer DDIA defaults, we estimate that 55,125 taxpayers would have incurred $1,277,246 in interest, as calculated below:

- 14 taxpayers owed a total of $79,964 with two months' worth of DDIA payments at $14,900. We subtracted the two months' worth of DDIA payments from total amount owed:
    - $79,964 - $14,900 = $65,064
- Calculated the average amount owed by the 14 taxpayers:
    - $65,064 / 14 = $4,647
- Calculated one year's worth of interest at 3 percent for average amount owed:
    - $4,647 x 3 percent = $139
- Calculated two months' worth of interest for one taxpayer:
    - $139 / 12 x 2 = $23.17
- Calculated two months of interest for all 55,125 taxpayers after making two payments:
    - 55,125 x $23.17 = $1,277,246

To calculate the additional interest these taxpayers would incur if their liability remained unpaid for two months, we multiplied $314,860,040 by three percent ($9,445,801), and calculated what they would incur in interest for two months:

- $9,445,801 / 12 x 2 = $1,574,300

We then reduced the $1,574,300 by the amount taxpayers would have paid if they stayed on their installment agreement ($1,277,246), to arrive at an estimated $297,054.

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[3] All 14 taxpayers had at least two months of payments remaining on their DDIA at the time of their defaults. Specifically,***1**
***********************************1*************************************.

[4] The IRS publishes the interest rate charged on underpayments quarterly. Since the fourth quarter of Calendar Year 2011, the interest rate has been 3 percent.

Appendix V

Management's Response to the Draft Report

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

SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEC 18 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Direct Debit Installment Agreement Procedures Addressing Taxpayer Defaults Can Be Improved (Audit # 201530014)

Thank you for the opportunity to review your draft report titled: "Direct Debit Installment Agreement Procedures Addressing Taxpayer Defaults Can Be Improved" (Audit # 201530014). We appreciate your acknowledgement of the importance of the Direct Debit Installment Agreements (DDIA) as part of the overall installment agreement program. The IRS is committed to helping taxpayers meet their payment obligations. The DDIA provides a convenient and economical vehicle for taxpayers to repay an existing debt. There are many benefits in using a DDIA as outlined in the report. The IRS completes over three million installment agreements a year, and there has been an increase in the use of DDIAs in the past two years. The On-Line Payment Agreement application provides an opportunity for a taxpayer to secure a DDIA with no wait time.

An installment agreement is a contract between the IRS and the taxpayer and it is contingent upon the taxpayer meeting the terms of the agreement. Ensuring future compliance (i.e., the timely filing and payment of future tax liabilities) is one of the conditions that a taxpayer must agree to in order to enter into an installment agreement with IRS. This requirement is aimed at changing taxpayer behavior, by incentivizing taxpayers to timely file and pay tax debts on a going forward basis. Like all contracts, failure to meet a material term of the agreement will generally result in default – otherwise, the terms become meaningless. As such, while your recommendation for the IRS to automatically add new liabilities to an existing DDIA instead of defaulting the agreement would save IRS resources, we have to be mindful of addressing and resolving the condition that created the additional balance due period. The purpose of the DDIA is not only to collect the delinquent balance owed but also to influence the taxpayer's future compliance with filing and paying requirements. Automatically adding all new debts to an existing DDIA creates incentives that are ultimately not in the best interest of tax administration.

Although we generally agree with some of your recommendations, we do not agree with the outcome measures in the report. We have concerns with the sample size and extrapolation of the sample results to the population without adjustment for ineligible cases. We also do not agree that it is appropriate to project increased revenue by taking the remaining balance due on the defaulted DDIAs and assuming that all of the balance will be collected by implementing the recommendations. Finally, we contend the measurement of reduced taxpayer burden (decreased interest) does not adequately consider other variables that affect net burden that may be of higher value to taxpayers, for example, the reduced burden of time and money spent paying off the DDIA over a period of time versus resolving the delinquency immediately with a full payment. Again, we agree the recommendations will yield benefits to the Service and taxpayers, but disagree with the calculation of the amounts.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact Scott Prentky, Director, Collection, at (954) 423-7318.

Attachment

Attachment

RECOMMENDATION 1:
Consider establishing systemic programming to allow DDIA taxpayers who incur a new unpaid tax liability to absorb the new liability into the current agreement without stopping the automatic payment in certain situations, such as when the payment amount does not change or when the number of additional payments does not increase by a specified number. This would require revisions to Form 9465 and Form 433-D, *Installment Agreement*, to request taxpayer agreement at the time the DDIA is established.

CORRECTIVE ACTION:
We agree that systemically adding a new balance due liability to an existing DDIA could save staff hours and result in additional revenue collected. However, future compliance is a condition of any agreement the Service establishes with the taxpayer and we have to be mindful of addressing and resolving the condition that created the additional balance due period. The purpose of the DDIA is not only to collect the delinquent balance but also to influence the taxpayer's future compliance with filing and paying requirements. We will carefully consider and assess whether there are some taxpayers for whom the recommendation can promote earlier resolution of the delinquent amount, without materially compromising the promotion of future compliance. If we determine the change has merit, then we will revise policies, procedures and update necessary forms to allow DDIA taxpayers to add a new liability to an existing DDIA.

IMPLEMENTATION DATE:
November 15, 2016

RESPONSIBLE OFFICIAL:
Director, SB/SE Collection Policy

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor these corrective actions as part of our internal management system of controls.

RECOMMENDATION 2:
In the interim, provide taxpayers with information on Form 9465 and Form 433-D as to how they can avoid a default of their DDIA in the event of a new unpaid liability.

CORRECTIVE ACTION:
We agree that educating taxpayers on future compliance and keeping them informed of their payment options is a key component of assisting taxpayers in resolving their unpaid tax liabilities. We will review relevant IRS communications and revise language in Form 9465 to Form 433D, which will occur during the routine update schedules.

2

IMPLEMENTATION DATES:
November 15, 2016

RESPONSIBLE OFFICIAL(S):
Director, SB/SE Collection Policy

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor these corrective actions as part of our internal management system of controls.

RECOMMENDATION 3:
For taxpayers who do not meet the criteria in Recommendation 1, such as when the new tax liabilities exceed the streamline criteria or when taxpayers are unable to afford increased installment agreement payments, establish procedures so that direct debit payments do not stop while the DDIA is suspended and the IRS actively addresses the new balance due.

CORRECTIVE ACTION:
We do not agree with this recommendation. The purpose of the DDIA is not only to collect the delinquent balance but also to influence the taxpayer's future compliance, incentivizing them to becoming timely with their filing and payment obligations. Expanding the default exceptions beyond the limited criteria to be developed in response to Recommendation 1 would ultimately undermine the future compliance incentives that we have built into the installment agreement framework.

IMPLEMENTATION DATES:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A