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Private Collection Agencies: Addressing a Piece of the Tax Gap Pie

Executive Summary

- The tax gap is the difference between the taxes that should have been paid on time and the amount actually paid in a specific tax year. The net tax gap, which is computed by subtracting late payments from the overall tax gap, is estimated to be $290 billion.
- Discussions about long-term tax reform are essential; however, Congress should not overlook any immediate options that will raise revenues without raising taxes. One option is to use private collection agencies (PCAs) to assist the IRS in its tax collection efforts, a program that Congress authorized in 2004 and which is being implemented by the IRS.
- The purpose of the PCA program is twofold: (1) to help reduce the significant and growing number of resolvable but uncollected cases; and (2) to enable the IRS to focus its existing resources more efficiently on the difficult cases.
- The concerns raised about the PCA program have all been addressed in the program's design.
  - Critics claim that the PCA program will take jobs from IRS employees, but the program is designed to assist IRS agents, not replace them. The IRS will assign the simpler cases to PCAs, and leave the more complex ones to IRS agents.
  - Concerns related to privacy and collection impropriety are important, which is why the IRS plan gives critical attention to taxpayer protections. PCAs must adhere to numerous safeguards designed to protect taxpayer rights.
  - Under no circumstance will PCAs be given cases in which they would need to exercise discretion. The PCA program will focus on taxpayers who either: (1) have filed a return showing a balance due, but have failed to pay it in full; or (2) have been assessed additional tax by the IRS and have made several voluntary payments toward satisfying their obligation, but have not paid in full.
- The use of PCAs to assist the government with its debt collection is nothing new: the Department of Education, the Department of Treasury, and the Department of Health and Human Services all use PCAs to collect debts owed to the federal government.
- The PCA program should be given a *chance*. The tax debt collection arena is an area begging for improvement, and the use of PCAs is a proactive, immediate step towards increasing the number of closed collection cases.

Introduction

The tax gap, approximately $345 billion, is the difference between the taxes that should have been paid on time and the amount actually paid to the federal government for a specific tax year. The net tax gap, which is computed by subtracting late payments from the overall tax gap, is estimated to be $290 billion.[1] The tax gap has ramifications that extend beyond the fiscal health of our nation; indeed, the tax gap undermines taxpayer confidence in the fairness of the tax collection system and forces honest taxpayers to subsidize those who evade their taxes. Over the course of many years, numerous solutions have been proposed to address the tax gap, but history reveals that there is no silver bullet, no quick fix. Addressing the tax gap will require a comprehensive set of strategies ranging from simplification of the tax code to greater reporting requirements to increased compliance strategies.

Discussions about long-term reform are essential; however, Congress should not overlook any immediate options that will raise revenues without raising taxes. One such option, which has been enacted into law, is the use of private collection agencies (PCAs) to assist the IRS in its tax collection efforts. The IRS has designated over $16.1 billion in delinquent tax liabilities as uncollectible.[2] That is, these are taxes due that the taxpayer has not contested, but that, in part, or in whole, remain outstanding. The use of PCAs to help collect this slice of the tax gap pie could result in revenue that might otherwise go uncollected.

After years of planning, the IRS has begun to assign cases to the PCAs.[3] This recent progress has inspired a renewal of old criticisms about the program. In fact, the House-passed FY 2007 Transportation, Treasury and Housing and Urban Development (TTHUD) Appropriations bill included an amendment that would prohibit the IRS from using PCAs for collection purposes.[4] Given the potential benefits that PCAs could bring to tax collection efforts, the Senate should consider the matter further.

Current Tax Collection Attempts

Tax collection efforts need improvement from both a fiscal standpoint and a taxpayer perspective. From a fiscal standpoint, there have been a number of factors that have contributed to the challenges in the IRS' compliance and collection rates.[5] In general terms, however, the number of collection cases that were closed declined more rapidly than the collection workload, causing an increase in the gap between the number of cases assigned for collection action and the number of cases closed each year. This gap between collection workload and collection-case

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[1] "IRS Updates Tax Gap Estimates," IR-2006-028, from www.irs.gov/newsroom/article/0,,id=154496,00.html, February 14, 2006. The $290 billion net tax gap produces an average annual surtax of nearly $2000 on each taxpayer. IRS National Headquarters Office of Research, *Tax Gap Maps for 1998 and 2001* (July 17, 2003).
[2] Treasury's Budget Justification Report, Feb. 2005.
[3] IRS assigned 12,500 accounts to PCAs on September 7, 2006.
[4] Rep. Steve Rothman's (D-NJ) amendment prohibiting PCAs passed out of committee on June 9, 2006; the 2007 TTHUD Appropriations bill prohibiting PCAs passed the House on June 14, 2006.
[5] GAO, *Tax Debt Collection: IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, May 2004.

closures has caused the IRS to defer taking action to collect on billions of dollars of tax delinquencies. Currently, the IRS defers action on one of every three cases that has been converted to "collection" status.[6] That means that one-third of all taxpayers who know they owe the federal government money are not even being pursued. From a taxpayer perspective, if the IRS is not actively working collection cases, it creates perceptions that threaten the voluntary nature of our tax system and unfairly burdens honest taxpayers.

Congress Has Authorized the Use of PCAs

The President, in both his FY 2004 and 2005 budget requests, urged Congress to pass legislation that would authorize the IRS to use private collection agents to assist with the agency's individual tax collection efforts. Congress granted that authority in 2004 by creating a new Internal Revenue Code Section § 6306 that authorizes the IRS to use PCAs for a small subset of taxpayers with outstanding and undisputed tax liabilities.[7] The purpose of the PCA program is twofold: (1) to help reduce the significant and growing number of resolvable but uncollected cases; and (2) to enable the IRS to focus its existing resources more efficiently on the difficult cases.

Status of IRS' PCA Program

The IRS plans to implement the PCA program, which began with a limited implementation phase on September 7, 2006, in two phases.[8] The IRS structured this two-phase approach so that it would be able to evaluate the program's performance and also identify any areas that may warrant attention before full-scale implementation.

The PCA program will focus on taxpayers who either: (1) have filed a return showing a balance due, but have failed to pay it in full; or (2) have been assessed additional tax by the IRS and have made several voluntary payments toward satisfying their obligation, but have not paid in full.[9] The IRS will assign the simpler cases to PCAs, and leave the more complex ones to IRS agents. Absent the PCA program, most of the simpler cases would not be handled by the IRS at all, because it would not be cost effective to pursue them, as they typically tend to be the smaller dollar amounts.[10] By focusing their efforts on the complex cases, the IRS agents will be better equipped to handle matters more closely matching their skill level and enforcement powers.[11] The purpose of the PCA program is to assist IRS agents, not replace them.

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[6] *Id*. The IRS has an increased enforcement spectrum for cases moved into the tax collection category, beginning with a notification of unpaid taxes by letter. Subsequent actions include negotiating alternative payment options or imposing liens.
[7] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[8] Three PCAs have been engaged by IRS for the first collection phase: CBE Group, Inc. of Waterloo, Iowa; Lineberger Goggan Blair & Simpson, of Austin, Texas; and Pioneer Credit Recovery, Inc. of Arcade, New York.
[9] Leslie Laffie, "IRS to outsource debt collection: Private Companies will be able to Pursue Tax Delinquents, *The Tax Advisor Journal of Accountancy*, Vol. 201, No. 1, January 2006.
[10] GAO, *Tax Debt Collection: IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 2004.
[11] Mark Everson, Commissioner, Internal Revenue Service, testimony before House Ways and Means Committee, Subcommittee on Oversight, *Use of Private Collection Agencies to Improve IRS Debt Collection*, May 13, 2003: "because PCAs would work the simplest and most straightforward collection cases they would enable the IRS to

The IRS will use a variety of variables to determine overall compensation, such as business results, customer service, timeliness, efficiency, quality, taxpayer satisfaction, and employee satisfaction.[12] Thus, PCA compensation will *not* be a pure bounty system. The range of payment to PCAs is based on amount collected, but, because PCA compensation will not be based solely on the number of dollars collected, the private agents will maximize their income by balancing customer service and taxpayer rights with collection objectives. PCAs may be compensated up to 25 percent of a collection from a single taxpayer of less than $1,500; however, for some large amounts, the compensation amount would be 21 percent.[13]

Moreover, the PCA program is designed to be self-financing. The money that the PCAs collect will be placed into an IRS-maintained revolving fund, none of which can be received or processed by PCAs. The IRS will then use the money in the revolving fund to compensate PCAs. Because it is set up as a self-financing program, no appropriations will be required.

It should be noted that the use of PCAs to assist the government with its debt collection is nothing new. Since 1982, the Department of Education (DOE) has been making use of PCAs, and more and more federal agencies are beginning to employ PCAs.[14] In fiscal year 2005, the federal government referred $13.7 billion in delinquent receivables to PCAs, resulting in collections of $693.5 million, up from $351.3 million in fiscal year 2000.[15] Currently, the DOE, the Department of Treasury, and the Department of Health and Human Services all use PCAs to collect debts owed to the federal government.[16] In addition to the federal agencies, more than 40 states and many local tax agencies use PCAs to help with their tax collections.[17]

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handle more collection cases at an earlier stage in the process – before those accounts become stale and harder to collect."

[12] Congressional Research Service, *The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress*, 2006.

[13] Treasury's Budget Justification Report, February 2005.

[14] PricewaterhouseCoopers, *Value of Third Party Debt Collection to the U.S. Economy: Survey and Analysis*, June 2006, p. 4, available at http://www.acainternational.org/images/8652/finaleconomicimpactstudy.pdf.

[15] Financial Management Services, U.S. Department of Treasury, Fiscal Year 2005 Report to Congress on U.S. Government Receivables and Debt Collection Activities of the Federal Agencies.

[16] Financial Management Services, U.S. Department of Treasury, Fiscal Year 2005 Report to Congress on U.S. Government Receivables and Debt Collection Activities of the Federal Agencies. PCAs under contract with the Department of Education, the Department of Health and Human Services, and the Treasury Department's Financial Management Services collected $610 million in delinquent federal debt in fiscal year 2004, up 12 percent from $547 million in 2003. In addition, referrals totaled $18.3 billion in 2004, up 27 percent from the $14.4 billion in 2003.

[17] Mark Everson, Commissioner, Internal Revenue Service, testimony before House Ways and Means Committee, Subcommittee on Oversight, *Use of Private Collection Agencies to Improve IRS Debt Collection*, May 13, 2003. According to Alan Felton, Assistant Secretary for Examination and Collection for North Carolina's Department of Revenue, testimony in front of House Ways and Means Committee, Subcommittee on Oversight, *Use of Private Collection Agencies to Improve IRS Debt Collection*, May 13, 2003: "the use of contract collection agencies has been of great benefit to the North Carolina Department of Revenue and, more importantly, to the citizens of North Carolina. The program has received no significant opposition from the state legislature, the tax practitioner community, or the general public. A solid, comprehensive collection program that includes private collection agencies is an effective way to do business."

Examining the Opposition to PCAs

Opponents Argue that the IRS Should Hire More Collection Agents.

The most common objection to PCAs has been expressed, in particular, by union leaders of government employees, who have argued that Congress should simply increase the number of full-time IRS employees.[18] There are four reasons as to why it is doubtful this would work as well as supplementing the IRS with PCAs.

<u>First</u>, the IRS has told the GAO that it will <u>not</u> be more cost effective to hire more employees:

> [I]n March 2004, IRS provided us with projections of revenues and federal government costs for the proposed PCA program compared to projections for an alternative approach under which IRS would hire additional staff to work on the same volume for selected types of cases on which the PCAs would work. According to the analysis, PCAs would generate $4.6 in revenue for every dollar in cost and IRS employees would generate $4.1.[19]

<u>Second</u>, hiring more employees would be extremely costly – in terms of both real and hidden costs. The IRS has estimated that it would need 5,450 more collection workers to keep up with the collection enforcement tasks.[20] These workers would be in addition to the already 3,680 current IRS employees working assigned delinquent cases,[21] an increase of *over 148 percent* in the collection division alone. Thus, those employee unions urging the hiring of more IRS employees are proposing a dramatic increase in funding and bureaucracy. The GAO has also explained that "to recruit, select, and train the new staff, the IRS could need many months or more, and, if experienced staff assists in training newly hired staff, the experienced staff would not be able to handle normal workloads."[22]

<u>Third</u>, simply hiring more IRS employees would deny the IRS the flexibility it needs. Every year, the IRS fails to close the tax gap, resulting in a growing number of cases that go uncollected. To the extent the IRS fails to collect, those obligations will continue, creating the need for an indeterminable number of IRS employees. Over time, the size of the permanent staff would grow without the ability to fluctuate based on workload. If the collection workload were to decrease, the IRS would be unable to rapidly adapt and reassign the permanent workers to other areas; whereas PCAs contracts can be either renewed or cancelled. The PCA program also

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[18] Colleen Kelley, National President of the National Treasury Employees Union (NTEU) testimony in front of House Ways and Means Committee, Subcommittee on Oversight, *Use of Private Collection Agencies to Improve IRS Debt Collection*, May 13, 2003.

[19] GAO, *Tax Debt Collection: IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 2004.

[20] Charles Rossetti, "Assessment of the IRS and the Tax System." 2002 report to the IRS Oversight Board.

[21] J. Russell George, Treasury Inspector General for Tax Administration, testimony in front of Senate Finance Committee, Subcommittee on Taxation and Oversight, *A Closer Look at the Size and Sources of the Tax Gap*, July 26, 2006.

[22] GAO, *Tax Debt Collection: IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 2004.

allows the IRS to adjust employee assignments to areas in which the employee is most needed, whether it is collection, enforcement, customer service, or auditing, for example. Then, and only then, can the IRS move closer to achieving true benchmarks and meaningful collection reform.

Fourth, hiring more employees would not help with the particular types of cases that the PCAs will be handling. According to a GAO report:

> IRS officials told us that using IRS employees on these simpler cases would be less productive than assigning them to work on a different mix of collection cases. Theses officials said that the simpler cases IRS plans to assign to PCAs are generally not those cases that IRS would assign to any additional collection employees, if hired.[23]

The IRS hires professionals with specialized training and expertise suited to handle difficult tax disputes. Thus, the complex cases are the ones on which these trained employees should focus their time, while those cases that require no expertise or use of discretion should be handled by the PCAs. Hiring new employees to only work on simple cases would be an inefficient use of resources.

In addition to the above mentioned points, the IRS has promised GAO that it will conduct a study regarding the cost-effectiveness of the PCA program.[24] This study will allow the IRS to evaluate the success of the program, its cost-effectiveness, and whether changes are needed. Furthermore, the study will provide Congress with information to judge whether the use of PCAs is the optimum approach and whether their continued use is necessary.

Opponents Raise Concerns of Privacy Violations and Potential Collection Improprieties

Concerns related to privacy and collection impropriety are important, which is why the IRS plan gives critical attention to taxpayer protections. The PCAs must adhere to numerous safeguards designed to protect taxpayer rights, for example:

- The privacy of the taxpayer will be protected by providing the PCA only with limited taxpayer information, such as the taxpayer's name, contact information, the tax year, and the amount of taxes due.[25] The PCAs would have no access to such tax information as income, debts, or deductions.

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[23] GAO, *Tax Debt Collection: IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 2004.

[24] "We agree with the need to perform analysis of the PCA program, once data is readily available, to determine its effectiveness and the impact on the overall collection of delinquent taxes." Letter from Mark Everson, Commissioner of IRS, to Michael Brostek, Director, Tax Issues, GAO, dated March 14, 2004.

[25] Department of Treasury, *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, p.p. 98-99. Most of the information that is protected by the privacy rules in the Internal Revenue Code and the Taxpayer Bill of Rights is unneeded by collection firms, even unwanted by PCAs. *Transcript of Oversight Hearing on Federal Refunds, State Debts*, House Ways and Means Committee, Subcommittee on Oversight (May 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 86-28, p. 577.

- PCAs are bound by the Fair Debt Collection Practices Act, the Privacy Act, and the Fair Credit Reporting Act.[26]
- The IRS Restructuring and Reform Act of 1998 (RRA 98), which limits overzealous collection tactics by IRS agents, applies to PCAs.[27]
- PCAs must inform taxpayers of their option to receive assistance from the IRS National Taxpayer Advocate.[28]
- All PCA employees who have access to any IRS taxpayer information shall be required to undergo a background investigation conducted by the federal government prior to beginning work on the project. [29]

Moreover, the PCA's role is narrowly tailored. Under no circumstance will PCAs be given cases in which they would need to exercise discretion.[30] Discretionary cases, those that IRS agents are better equipped to handle, may include those for which there is a dispute over the interpretation of the tax code or the amount of tax assessed. At no time in the collection process shall PCAs: (1) handle actual payments because all payments are routed directly to the IRS; or (2) have any further contact with the taxpayer after they have returned the taxpayer's financial information to the IRS.[31]

Opponents Point to the Failed 1996 Pilot Program

In 1996, Congress earmarked $13 million in IRS appropriations to test the use of PCAs.[32] An additional $13 million was appropriated in 1997 for a second pilot. Under that plan, the PCAs located and contacted taxpayers to remind them of their unpaid and/or overdue tax obligations, and also informed them of payment options.[33] The PCAs received a fixed fee for their participation, regardless of any amount they actually collected. Because the PCAs were paid regardless of dollars collected, the total cost of the program exceeded the total amount collected. In 1997, because of several limitations that affected the program's success, the IRS cancelled the use of PCAs.

Comparisons to the 1996 pilot are inapt. The pilot program performance fee arrangement allowed the same payment regardless of the amount collected. The current program uses an incentive-based methodology structured around several elements: business results, customer service, timeliness, efficiency, quality, taxpayer satisfaction and employee satisfaction. The pilot program appropriated fees to pay for the PCAs. The current program uses a revolving fund subsidized by the PCAs' own collection for compensation. The pilot program encountered technology limitations, such as the inability to transfer data from one service center and to

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[26] Matthew Yuskewich, "IRS Initiative for Private Debt Collection," *Tax Advisor*, Vol. 37, No. 1, January 2005, p. 54.
[27] IRS Request for Quotation #TIRNO-05-Q-00187, p.p. 1—26.
[28] IRS Request for Quotation #TIRNO-05-Q-00187, p.p. 1—26.
[29] IRS Request for Quotation #TIRNO-05-Q-00187, p.p. 1—26.
[30] Congressional Research Service, *The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress*, Janurary 11, 2006, p. 2.
[31] Congressional Research Service, *The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress*, Janurary 11, 2006, p. 2.
[32] GAO, *Issues Affecting IRS' Collection Pilot*, GAO/GGD-97-129R, Washington, D.C.: July 1997.
[33] GAO, *Issues Affecting IRS' Collection Pilot*, GAO/GGD-97-129R, Washington, D.C.: July 1997.

transmit collection cases to PCAs.[34] The current program uses technological advances that assure proper file transfers and document sharing, while maintaining taxpayer privacy.[35]

Conclusion

Although some continue to object, the plan to use PCAs is a model that should be given a *chance*. The debt collection arena is an area begging for improvement, and the use of PCAs is a proactive, immediate step towards increasing the number of closed collection cases. Thus, the justification for PCAs is two-fold: (1) increased collection receipts and reduction of the tax gap; and (2) increased taxpayer confidence in the fairness of the tax collection system.

[34] GAO, *Issues Affecting IRS' Collection Pilot*, GAO/GGD-97-129R, Washington, D.C.: July 1997.
[35] Federal Register, Fr. Doc. E6-11400, July 19, 2006.