



*Withholding Compliance Program Results
Are Trending Favorably, but Program
Enhancements Are Needed*

March 23, 2010

Reference Number: 2010-40-030

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2(c) - Law Enforcement-Tolerance



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 23, 2010

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Withholding Compliance Program Results Are Trending Favorably, but Program Enhancements Are Needed (Audit # 200840035)

This report presents the results of our review to evaluate the effectiveness of case selection and processing in the Withholding Compliance Program (WHC). This audit was conducted as part of our Fiscal Year (FY) 2009 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

The WHC is based on the premise that by addressing underwithholding at its source, noncompliance problems can be resolved early in the process and, thereby, prevent future delinquencies that can be costly to both the Internal Revenue Service (IRS) and taxpayers. While the WHC is helping ensure individuals with underwithholding problems are meeting their obligations to pay taxes, steps are needed to ensure opportunities are not being missed to address underwithholding problems among higher wage earners and WHC actions are not unnecessarily burdening taxpayers and employers.

Synopsis

The taxes collected through the WHC are substantial and trending upward. In its FY 2008 Performance and Accountability Report,¹ the Government Accountability Office estimated the WHC resulted in the collection of \$423 million of additional income taxes for FYs 2005 and 2006 and through part of FY 2007. The Government Accountability Office further estimated the

¹ GAO Performance & Accountability Report Fiscal Year 2008 (GAO-09-1SP, dated November 2008).



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WHC generated additional tax revenues of \$309 million in the remainder of FY 2007 and much of FY 2008. Although compliance and collection data are trending favorably under the WHC, there are two steps that could be taken to enhance the operational effectiveness of the WHC.

First, a statistically valid risk-based approach needs to be explored to select problem withholding cases for possible lock-in letter² issuance. The current approach is based on the WHC's limited resources, analysis of Tax Year 2001 return characteristics, the judgment and experience of IRS personnel, and certain other risk factors that include *****2(c)*****. While the approach has successfully identified a number of underwithholding cases, it does have some limitations. The most significant limitation, perhaps, is that the *****2(c)***** in withholdings are not progressive since the withholding rate remains constant as the amount of wages increases. Consequently, the WHC may be missing opportunities to detect and address withholding problems among higher wage earners. Moreover, some in the taxpaying public might perceive that an approach using a constant factor of *****2(c)***** is not as impartial as it could be because individuals at higher wage levels can have withholding problems and avoid being selected for possible lock-in letter issuance.

Another benefit that might be realized by better ensuring withholding problems among high wage earners are detected and addressed is increased tax collections. We analyzed how various percentage reductions in the number of lower wage earner cases might affect tax collections by replacing them with higher wage earner cases and found the additional withholding taxes that could be generated over a 5-year period ranged from \$318.7 million to \$1.6 billion. This range represents the potential revenue depending on what percent of lower dollar cases are replaced by higher dollar ones (1–5 percent).

The second step that could be taken to enhance the WHC involves ensuring lock-in letter issuance is not unnecessarily burdening employers and taxpayers. During the course of our review, WHC officials acknowledged that more could have been done to complete and document a comprehensive review of existing computer programs that affect the issuance of lock-in letters and to identify instances in which the computer programs are not functioning in accordance with the intent of IRS policies and procedures.

Recommendations

We recommended that the Director, Compliance, Wage and Investment Division, should develop and implement a statistically valid plan to study the underwithholding compliance risk throughout all segments of the wage-earner population and use the results to adjust, if necessary, the case selection methods in the WHC. The Director, Compliance, Wage and Investment

² The lock-in letter directs the employer to withhold taxes for a specific employee at the specified rate. The lock-in letter to the taxpayer informs them of the instructions provided to his/her employer.



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Division, should also ensure actions are taken to correct the computer programs that initiate lock-in letters and research the employers we identified that may have been incorrectly issued lock-in letters to determine if they are overwithholding for any employees and, if necessary, correct the withholding.

Response

IRS management agreed, in general, with our recommendations and has or will take actions in response to those recommendations. The IRS will perform a statistically valid study of WHC cases to formulate a risk-based decision for case creation and, if necessary, use the results to adjust the selection methods for WHC cases. The IRS will also continue to pursue programming changes to correct computer programs that initiate lock-in letters and will research employers we identified in this audit to determine if they are overwithholding for employees and make necessary corrections. In addition, as recommended, the IRS considered expanding this research but chose not to, stating it would be cost prohibitive from a resource allocation standpoint. The IRS also concurred that their corrective actions in response to our recommendations, along with other planned WHC improvements, will result in significant revenue from additional withholding. However, the full realization of the outcome measures in Appendix IV is dependent upon IRS resources and may be negatively impacted by the recent economic downturn. The IRS did express concern with the methodology used to determine if lock-in letters were issued incorrectly; however, there was no specific disagreement with the number of affected employers and taxpayers reported in Appendix IV. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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Abbreviations

| | |
|-------|---|
| FY | Fiscal Year |
| GAO | Government Accountability Office |
| IRS | Internal Revenue Service |
| TIGTA | Treasury Inspector General for Tax Administration |
| TY | Tax Year |
| WHC | Withholding Compliance Program |



Withholding Compliance Program Results Are Trending Favorably, but Program Enhancements Are Needed

Background

The Internal Revenue Code¹ generally requires employers to withhold taxes from employees' (taxpayers') pay so that taxes withheld can be paid to the Department of the Treasury on a ratable basis throughout the year. Proper withholding helps to ensure that taxpayers do not file returns at the end of the year owing a substantial amount of tax. In Fiscal Year (FY) 2008, about \$970.7 billion (more than one-third of total tax revenues for the year) were collected through income tax withholding. Because of income tax withholding, tax payment compliance is generally very high among those who have a sufficient amount of taxes withheld from their pay.

In FY 2008, more than one-third of total tax revenues were collected through income tax withholding.

The Internal Revenue Service (IRS) established the Withholding Compliance Program (WHC) in FY 2005 to identify and address taxpayers with withholding problems so they can be brought into compliance with Federal income tax withholding requirements. The WHC uses information from Wage and Tax Statements (Form W-2) to identify taxpayers with insufficient withholdings. Once identified, the WHC strives to increase the amount of tax withheld so the individuals are better positioned to meet their tax obligations.

For most WHC cases, lock-in letters,² used to correct withholding, are automatically generated and mailed by the IRS to both the employer (Letter 2800C) and the employee (Letter 2801C). The Letter 2800C directs the employer to withhold taxes at a specified rate. The Letter 2801C informs the taxpayer of the instructions provided to his/her employer. However, there are conditions that may require manual review of the cases before issuing the lock-in letters. These conditions include, among others, cases in disaster relief areas and some cases with mismatching taxpayer identification numbers and names.

This review was performed at the Withholding Compliance function in Lowell, Massachusetts, and the WHC Headquarters Office in Atlanta, Georgia, during the period August 2008 through September 2009. 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 objectives. Detailed

¹ 26 U.S.C. Section 3402.

² The lock-in letter directs the employer to withhold taxes for a specific employee at the specified rate. The lock-in letter to the taxpayer informs them of the instructions provided to his/her employer.



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information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



Withholding Compliance Program Results Are Trending Favorably, but Program Enhancements Are Needed

Results of Review

The IRS considers the WHC an important part of its overall approach to increasing voluntary compliance. The WHC is based on the premise that by addressing underwithholding at its source, potential compliance problems can be resolved early in the process and, thereby, prevent future delinquencies that can be costly to both the IRS and taxpayers.

Since its inception, the WHC has identified numerous underwithholding cases and taken action to help ensure the individuals involved are meeting their obligations to pay taxes. These actions, in turn, have contributed to WHC results that are trending favorably in terms of enhancing compliance and increasing tax collections. As the WHC grows, there are at least two steps that could be taken to enhance its operational effectiveness. First, a statistically valid risk-based approach needs to be explored to select problem withholding cases for possible lock-in letter issuance. Second, management controls need strengthening to better ensure WHC actions are not unnecessarily burdening taxpayers and employers.

Withholding Compliance Program Results Are Enhancing Voluntary Compliance and Increasing Tax Collections

Prior to implementing the WHC, the IRS Questionable Form W-4³ Program looked at problem withholding cases that were identified, in large part, from information submitted by employers. However, in November 2003, the Government Accountability Office (GAO) recommended that the IRS assess the value of the Questionable Form W-4 Program and determine whether it should be continued.⁴ In response to the GAO recommendation, the IRS evaluated the Questionable Form W-4 Program and ultimately replaced it with the WHC after concluding operational changes were needed.

Among other changes implemented, the WHC no longer relies on employers to identify taxpayers who may have insufficient withholding. Instead, computer programs have been implemented to take advantage of information reported on Forms W-2 to identify taxpayers who may not have enough Federal income taxes withheld from their wages. Once identified, additional criteria are applied based on such factors as whether a return was filed and if a substantial amount of taxes were owed after it was filed.

³ A Form W-4 is a tax form prepared by an employee for an employer indicating the employee's exemptions and Social Security Number and enabling the employer to determine the amount of taxes to be withheld for the employee.

⁴ *IRS's Use of Information on Taxpayers Claiming Many Allowances or Exemption From Federal Income Tax Withholding* (Letter Report GAO-04-79R, dated November 2003).



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Under the WHC, statistics show a significant volume of withholding problems have been identified as reflected in the number of lock-in letters issued to employees. For Tax Year (TY) 2006, lock-in letters were issued to 141,332 employees who the WHC identified as having withholding problems. According to WHC tracking data, this is a significant increase from the 29,865 lock-in letters issued for TY 2003 and is important because the lock-in letters appear to be having a positive impact on withholding and payment compliance. For example, WHC data show the amount of taxes withheld from the wages of taxpayers who were issued lock-in letters for TY 2003 increased from 2 percent to 14 percent between TY 2003 and TY 2007. The number of balance due returns filed by these taxpayers also dropped from 78 percent to 32 percent during the same time period, which indicates the taxes they owe are being paid on a more ratable basis throughout the year.

Besides enhancing compliance, the taxes collected through the WHC are substantial and trending upward. In its FY 2008 Performance and Accountability Report,⁵ the GAO estimated the WHC resulted in the collection of \$423 million of additional income taxes for FY 2005 through part of FY 2007. The GAO further estimated the WHC generated additional tax revenues of \$309 million for the remainder of FY 2007 through much of FY 2008. While the compliance and collection trends indicate the IRS is making notable progress to overcome shortcomings noted in the Questionable Form W-4 Program, additional steps could be taken to enhance the operational effectiveness of the WHC.

A Statistically Valid Risk-Based Approach Needs to Be Explored to Select Problem Withholding Compliance Cases

Risk-based approaches are well recognized and used throughout the Federal Government and in private industry as effective strategies for deciding how to best allocate limited resources to achieve desired results. For example, the Treasury Inspector General for Tax Administration (TIGTA) and the GAO have reported on and endorsed the risk-based approach the IRS has long used to select individual and other types of returns for examination. From a reporting compliance perspective, the risk-based approach the IRS developed and uses is critical because the IRS has limited resources to examine returns filed each year. At a basic level, the IRS approach involves statistically validating various risk factors by examining a small but representative sample of returns. Once validated, the risk factors are used to identify and select returns for audit from the entire population filed each year.

Unlike the methodology used to select returns for audit, the approach for selecting problem withholding cases in the WHC has not been statistically validated. Instead, the process is based on the WHC's limited resources, analysis of TY 2001 return characteristics, the judgment and experience of IRS personnel, and certain other risk factors that include *****2(c)*****

⁵ GAO Performance & Accountability Report Fiscal Year 2008 (GAO-09-1SP, dated November 2008).



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*****2(c)*****. Although the process has successfully identified a significant number of underwithholding cases, it does have some limitations.

The WHC may be missing opportunities to address problem withholding cases among high wage earners

The most significant limitations, perhaps, are that the risk factors of *****2(c)***** are not progressive since the withholding remains constant as the wages increase and that the risk factors have not been statistically validated against a representative sample of all underwithholding problem cases. As a result, the WHC may be missing opportunities to detect and address underwithholding problems among higher wage earners. Moreover, some in the taxpaying public might perceive that an approach that uses a constant *****2(c)***** is not as impartial as it could be since individuals at higher wage levels can have underwithholding problems and avoid being selected for possible lock-in letter issuance actions.

*****2(c)*****

To illustrate further, we used wage amounts and withholding percentages to stratify 139,766 individuals that, according to IRS data files,⁷ *****2(c)***** in TY 2006 and filed a TY 2006 balance due return owing taxes *****2(c)*****. Because each of the 139,766 individuals in our population had *****2(c)***** none were identified as having a withholding problem by the WHC even though all were underwithheld based on the 2006 (*Circular E*), *Employer’s Tax Guide* (Publication 15) issued by the IRS. We next analyzed a statistically valid sample of 125 of the 139,766 individuals in our population by comparing their withholdings to the withholdings from a statistically valid sample of 100 of 29,681 individuals who were included in the WHC after filing a TY 2006 balance due return.

Figure 1 summarizes our projected results and indicates the WHC is identifying a significant number of individuals with underwithholding problems. However, Figure 1 also shows that 18,590 higher wage earners (those earning \$200,000 or more) were not identified as potential problem cases even though their average underwithholding was 4 times higher than that of lower wage earners selected by the WHC for possible lock-in letter issuance.

*****2(c)*****

⁷ The files included information from the Wage and Tax Statements (Form W-2) and the Master File. The Master File is the IRS database that maintains transactions or records of individual tax accounts.



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Figure 1: Comparison of Individuals That Filed a Balance Due Return and Had a Potential Withholding Problem for TY 2006

| Wages Earned | Individuals Included in the WHC | | | Individuals Not Included in the WHC | | |
|--------------------------|---------------------------------|-----------------------|-------------------------------------|-------------------------------------|-----------------------|-------------------------------------|
| | Withholding Percentage | Number of Individuals | Projected Average Under Withholding | Withholding Percentage | Number of Individuals | Projected Average Under Withholding |
| ***2(c)*****to \$199,999 | ***2(c)**** | 28,712 | ***2(c)*** | ****2(c)**** | 121,176 | ***2(c)*** |
| \$200,000 or More | ***2(c)**** | 969 | ***2(c)**** | ***2(c)**** | 18,590 | ***2(c)*** |
| Total | | 29,681 | | | 139,766 | |

Source: IRS provided TY 2006 WHC System Extract and Form W-2 File and TIGTA analysis of sampled TY 2006 Individual Master File data.

We also analyzed the underwithholding problem of individuals who did not file their TY 2006 returns (nonfilers). We used the wages and withholding percentages to stratify 89,627 individuals that, according to IRS data files, ***2(c)***** in TY 2006 but were nonfilers. Because each of the 89,627 individuals had ***2(c)***** none were identified as having withholding problems by the WHC. We next analyzed a statistically valid sample of 125 of the 89,627 individuals in our population by comparing their withholding to the withholdings from a statistically valid sample of 100 of 98,210 nonfilers who were included in the WHC.

Figure 2 summarizes our projected results and indicates the WHC is identifying a significant number of nonfilers with underwithholding problems. However, Figure 2 also shows that 4,784 higher wage earners (those earning \$200,000 or more) were not identified as potential problem cases even though their average underwithholding was more than 5 times higher than that of lower wage earners selected by the WHC for possible lock-in letter issuance.



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Figure 2: Comparison of Nonfilers That Had a Potential Withholding Problem for TY 2006

| Wages Earned | Individuals Included in the WHC | | | Individuals Not Included in the WHC | | |
|-------------------------|---------------------------------|-----------------------|-------------------------------------|-------------------------------------|-----------------------|-------------------------------------|
| | Withholding Percentage | Number of Individuals | Projected Average Under Withholding | Withholding Percentage | Number of Individuals | Projected Average Under Withholding |
| ***2(c)*** \$199,999 | ***2(c)*** | 94,766 | ***2(c)*** | ***2(c)*** | 84,843 | ***2(c)*** |
| \$200,000 or more | ***2(c)*** | 3,444 | ***2(c)*** | ***2(c)*** | 4,784 | ***2(c)*** |
| Total | | 98,210 | | | 89,627 | |

Source: IRS provided TY 2006 WHC System Extract and Form W-2 File and TIGTA analysis of sampled TY 2006 Individual Master File data.

Another benefit that might be realized by better ensuring underwithholding problems among higher wage earners are detected and addressed is increased tax collections. To demonstrate the potential revenue effect, we analyzed how various percentage reductions in the number of lower wage earner cases might affect tax collections by replacing them with higher wage earner cases. The estimates begin in Calendar Year 2011⁸ and are based on the difference between the projected average underwithholding for lower wage earners (those earning between ***2(c)*** and \$199,999 in wages) and the higher wage earners (those earning \$200,000 or more). Appendix IV contains our complete analysis and shows that when using Calendar Year 2006 constant dollars, the additional withholding taxes that could be generated over a 5-year period⁹ (Calendar Years 2011–2015) ranged from \$318.7 million to \$1.6 billion. This range represents the combined potential revenue for both filers and nonfilers, depending on what percent of lower dollar cases are replaced by higher dollar ones (1 to 5 percent).

Recommendations

The Director, Compliance, Wage and Investment Division, should:

Recommendation 1: Develop and implement a statistically valid study to assess the underwithholding compliance risk throughout all segments of the taxpayer population.

⁸ The estimates start in Calendar Year 2011 to give the IRS time to react to our report and its recommendations.

⁹ This projection assumes all conditions, such as the withholding rates, that existed at the time of our review will remain the same over the 5-year period.



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Management's Response: IRS management agreed with our recommendation and will analyze a statistically valid sample in order to make a risk-based decision for WHC case creation.

Recommendation 2: Use the results of the risk factor validation study to adjust, if necessary, the selection methods that identify and prioritize the taxpayers with underwithholding problems for lock-in letter issuance.

Management's Response: IRS management agreed with our recommendation. If the results of the statistically valid sample study warrant, adjustments will be made to the WHC case selection methodology to improve the identification and selection of taxpayers requiring lock-in letters.

Management Needs to Better Ensure Accurate Computer Programming to Avoid Unnecessarily Burdening Taxpayers and Employers

The GAO *Standards for Internal Control in the Federal Government* requires agencies to establish controls that ensure operations are carried out in a manner that adheres to management policies and procedural requirements. During the course of our review, WHC officials acknowledged that more could have been done to complete and document a comprehensive review of existing computer programs that affect the issuance of lock-in letters and to identify any instances in which computer programs are not functioning in accordance with the intent of IRS policies and procedures. As a result, thousands of taxpayers and their employers are at risk of having to incur the time and expense (i.e., burden) of dealing with lock-in letters that they should not have received.

Computer program flaws can cause lock-in letters to be initiated against compliant taxpayers

Under the Internal Revenue Code,¹⁰ the IRS has authority to bring taxpayers who have underwithholding problems into compliance with Federal income tax withholding requirements. This is accomplished through an automated process that issues two computer-generated lock-in letters. One letter (Letter 2800C) directs the employer to begin withholding taxes at a new higher rate that the IRS determines and specifies in the letter. The second letter (Letter 2801C) advises the taxpayer of the actions being taken and steps that can be taken to request a change of the determination. For employers who do not follow IRS directions, the consequences can be severe. According to the Internal Revenue Code, employers who fail to increase withholding, as directed, can be held liable for the additional taxes specified in the lock-in letter.

¹⁰ 26 U.S.C. Sections 3402 and 3403.



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We tested a statistical sample of 200 of 127,891 taxpayers selected by the WHC because of a TY 2006 underwithholding problem. We found 28 of the 200 taxpayers had 45 lock-in letters incorrectly issued to their employers. In each case, the taxpayer had annual earnings that were less than the \$2,650 threshold for withholding Federal income taxes according to the 2006 (*Circular E*), *Employer's Tax Guide* (Publication 15) issued by the IRS. When projected to the population from which we selected our sample, we estimate 35,530 employers were unnecessarily issued lock-in letters when their employees' TY 2006 annual earnings were below the \$2,650 threshold.

To determine whether other computer programming problems may exist, we expanded our testing and found three other areas in which unnecessary computer-generated lock-in letters were issued. Although we used statistically valid sampling techniques in only the first of the three areas discussed below, our results clearly indicate that controls over computer programs need strengthening to better ensure they function in accordance with the intent of IRS policies and procedures.

The first area involved taxpayers who were selected by the WHC after they were incorrectly identified as nonfilers with an underwithholding problem. Our computer analysis of IRS tax accounts for the 98,210 nonfiler cases that were selected by the WHC for TY 2006 showed 1,257 taxpayers had, in fact, filed TY 2006 tax returns under a secondary identification number. Moreover, our review of a statistical sample of 70 of the 1,257 cases found that 61 not only filed a TY 2006 return, but also had sufficient withholdings. When projected into the population from which we selected our sample, we estimate 1,095 taxpayers were unnecessarily issued lock-in letters.

The second area involved 11 employers who, according to WHC records, were issued lock-in letters for the same employee within a 12-month period. According to WHC procedures, a second lock-in letter should not be issued until at least a year has elapsed from the issuance of the initial letter. Since the purpose for the 12-month rule is to allow the employer and employee sufficient time to correct the problem, the second letter may not be necessary if the employer and employee are correcting the problem by increasing the amount of withholding. During our discussions on a draft of this report, IRS officials stated that steps to correct the programming error were implemented in March 2009. Since the programming change fell outside the time period from which we selected our sample cases for review, we did not assess the effectiveness of this corrective action.

The final area involves issuing multiple lock-in letters in an attempt to address underwithholding cases that have mismatched taxpayer names and identification numbers on Forms W-2. Mismatched taxpayer names and identification numbers can occur for a variety of reasons. For example, an employee could inadvertently provide an employer with a wrong identification number or an employer could make an error when recording an otherwise valid identification number on the document. It is also reasonable to assume that some employees who may want to hide their identities and not pay taxes that they may otherwise owe would provide incorrect



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identification numbers to those that hire them. Nevertheless, several studies,¹¹ including those that the TIGTA, the IRS, and the GAO have completed, suggested legislative or regulatory changes are needed to hold employers more accountable for obtaining accurate identification numbers from the employees they hire.

Until such changes are implemented to address the root causes that largely account for the mismatched names and identification numbers, computer programming routines need to be enhanced to better resolve mismatched names and identification numbers before issuing lock-in letters. For example, we found an instance where lock-in letters were sent to 13 employers after computer programming routines mistakenly attributed 13 Forms W-2 with the same taxpayer identification number to 1 employee name, even though the statements were originally submitted under several different employee names. As a result, it is likely that 12 of the 13 employers spent time dealing with a lock-in letter associated with an employee's name that did not match any of the employee names on the Forms W-2 they submitted to the IRS.

Recommendations

The Director, Compliance, Wage and Investment Division, should ensure that actions are taken to:

Recommendation 3: Correct the computer programs so that lock-in letters are issued in accordance with the intent of IRS policies and procedures.

Management's Response: IRS management agreed with our recommendation and will continue to pursue necessary programming changes, which will be contingent on available resources and funding. Programming to determine if a lock-in letter has been issued in the prior 12 months was implemented in March 2009. In addition, programming changes to correct problems with mismatched taxpayer name and identification numbers, as well as with verification of Federal tax compliance based on a cross-referenced identification numbers, have already been submitted.

Recommendation 4: Research each of the employers in our samples that may have been affected by the programming errors to determine whether they are overwithholding any employees. If employers are overwithholding, correct the withholdings as needed and consider expanding the research to identify and correct additional instances where employers may be affected by the programming errors and are overwithholding employees.

¹¹ *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Reference Number 2001-30-132, dated August 24, 2001), TAX ADMINISTRATION: *IRS Needs to Consider Options for Revising Regulations to Increase the Accuracy of Social Security Numbers on Wage Statements* (GAO-04-712, dated August 2004), and *The IRS' Large and Mid-Size Division: The Form W-2 SSN/Name Mismatch Project*, dated April 2003.



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Management's Response: IRS management partially agreed with our recommendation. The IRS agreed to research employers identified in this audit and take corrective actions, if necessary. However, due to resource constraints, the research will not be expanded. The IRS stated that, as instructed in the lock-in letter, taxpayers may contact the WHC at any time to request a lock-in be released or modified, and on average approximately 85 percent of the taxpayers issued lock-in letters request some type of modification.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the effectiveness of case selection and processing in the IRS WHC. We validated the reliability of computer-processed data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, to ensure accuracy, we traced a judgmental sample of each data set to IRS source files by using the Integrated Data Retrieval System¹ and Individual Master File.² Unless otherwise noted, our limited tests of the reliability of data obtained from the IRS systems did not identify any errors.

To accomplish the overall audit objective, we:

- I. Reviewed a significant amount of source material to gain an understanding of the WHC and the rules, procedures, and processes governing Federal income tax withholding. These sources included the Internal Revenue Code, publications and guidance issued by the IRS, the Internal Revenue Manual, and published TIGTA and GAO reports.
- II. Interviewed WHC management and computer programmers to assist in identifying and evaluating the procedures and processes in place to ensure the WHC is selecting taxpayers with underwithholding problems.
- III. Used the GAO *Standards for Internal Control in the Federal Government* to assess the policies, procedures, and practices the IRS had established for ensuring the WHC is selecting taxpayers with underwithholding problems.
- IV. Determined how many, if any, higher wage earners with underwithholding problems were not detected and addressed by the WHC by reviewing the following four sets of statistically valid samples from TY 2006.
 - A. Evaluated a statistically valid stratified sample of 100 of 29,681 cases selected by the WHC that involved taxpayers who filed a TY 2006 balance due return. We used a 95 percent confidence level, an expected dollar error of 7 percent, and a precision factor of ± 5 percent to select a sample from a population stratified by wages ranging between \$50,000 to \$199,999; \$200,000 to \$999,999; \$1,000,000 to \$3,999,999; and \$4 million or more.
 - B. Evaluated a statistically valid stratified sample of 125 of 139,766 taxpayers who filed a TY 2006 balance due return owing \$2,500 and reported wages of ***2(c)*****

¹ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

² The IRS database that maintains transactions or records of individual tax accounts.



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- *****2(c)*****. Before selecting our sample, we refined the population down from 443,128 by stratifying it by wages and withholding ranging between ***2(c)*** to \$99,999 and 10 percent or less in withholdings; \$100,000 to \$199,999 and 15 percent or less in withholdings; \$200,000 to \$499,999 and 20 percent or less in withholding; \$500,000 or more with 25 percent or less in withholdings. The stratified sample was based on a 95 percent confidence level, an expected dollar error of 9 percent, and a precision factor of ± 5 percent.
- C. Evaluated a statistically valid stratified sample of 100 of 98,210 cases selected by the WHC that involved individuals the IRS determined did not file a TY 2006 return (nonfilers). In selecting the stratified sample, we used a 95 percent confidence level, an expected dollar error of 7 percent, and a precision factor of ± 5 percent. The population and resulting sample were stratified by wages ranging between**2(c)** to \$199,999; \$200,000 to \$999,999; \$1,000,000 to \$9,999,999; and \$10 million or more.
- D. Evaluated a statistically valid stratified sample of 125 of the 89,627 individuals that the IRS determined were nonfilers but were not selected by the WHC. The population consisted of individuals with *****2(c)*****. Before selecting a sample, we refined the population down from 443,128 taxpayers by stratifying it according to wages and withholdings ranging between ***2(c)***** to \$99,999 and 10 percent or less in withholdings; \$100,000 to \$199,999 and 15 percent or less in withholdings; \$200,000 to \$499,999 and 20 percent or less in withholding; and \$500,000 or more with 25 percent or less in withholdings. The stratified sample was selected based on a 95 percent confidence level, an expected dollar error of 9 percent, and a precision factor of ± 5 percent.
- V. Assessed the automated process in the WHC for issuing lock-in letters to ensure computer programs were designed or functioned in accordance with the intent of established policies and procedures.
- A. Evaluated a statistical sample of 200 of 127,891 cases selected by the WHC for TY 2006 to determine the number of cases, if any, that involved taxpayers whose annual earnings were less than the \$2,650 threshold for withholding Federal income taxes. In selecting the sample, we used a 95 percent confidence level, an expected dollar error of 7 percent, and a precision factor of ± 5 percent.
- B. Analyzed the IRS Master File³ accounts for the 98,210 nonfiler cases selected by the WHC for TY 2006 to determine if any of the individuals involved had, in fact, filed a TY 2006 return.

³ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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- C. Used the results from analyzing IRS Master File accounts for the 98,210 nonfiler cases selected by the WHC for TY 2006 and evaluated a statistical sample of 70 of the 1,257 accounts that showed a TY 2006 return was filed to determine if any of the 70 taxpayers had sufficient withholdings. The sample size was determined based on a 95 percent confidence level, an expected error rate of 5 percent, and ± 7.67 percent precision factor.
- D. Reviewed the Withholding Compliance System⁴ database to identify instances where lock-in letters were issued for the same employee within a 12-month period or to multiple employers for the same employee.

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 the following internal controls were relevant to our audit objective: the WHC's policies, procedures, and practices for selecting and processing individuals with underwithholding problems. We evaluated these controls by reviewing source materials, interviewing management, analyzing taxpayers' wages and withholding data, and researching the Withholding Compliance System.

⁴ A database designed to provide a means to monitor and control information related to the cases in WHC inventory.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Audit Liaison: Commissioner, Wage and Investment Division SE:W



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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; \$83.7 million in additional tax withholding over a 5-year period.¹ The outcome is based on replacing 2 percent of the lower wage earners selected by the WHC who filed TY 2006 balance due returns with higher wage earners who filed balance due returns owing \$2,500 or more in taxes for TY 2006 but were not selected by the WHC (see page 4).

Methodology Used to Measure the Reported Benefit:

To estimate the increased revenue, we analyzed how various percentage reductions in the number of low wage earner cases and replacing them with higher wage earner cases might affect the amount of additional tax withholding over 5 years (Calendar Years 2011–2015). In estimating the additional withholdings each year, we analyzed two statistically valid stratified samples of TY 2006 underwithheld taxpayers.

The first sample was comprised of 100 of the 29,681 individuals who were included in the WHC after filing a TY 2006 balance return and reporting wages of *****2(c)*****. The second sample involved 125 of the 139,766 individuals who were not included in the WHC after filing a TY 2006 return owing *****2(c)*****.

Next, we computed the difference in average underwithholding between the 2 samples, which resulted in the higher wage earners (those earning \$200,000 or more) showing their average underwithholding was \$25,825 greater than that of the lower wage earners (those earning less than \$200,000). We then added the \$25,825 difference to 1, 2, 3, 4, and 5 percent of the lower wage earners' underwithholdings and multiplied the sums by the Consumer Price Index inflation conversion factors to determine the value of Calendar Year 2006 dollars in Calendar Years 2011 through 2015. Figure 1 shows the amount of additional tax withholding that could be generated over a 5-year period (Calendar Years 2011–2015) ranged from \$41.9 million to \$209.5 million,

¹ This projection assumes all conditions, such as the withholding rates, that existed at the time of our review will remain the same over the 5-year period.



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depending on how many lower wage earner cases were replaced by higher wage earner cases (1–5 percent). However, we conservatively limited the benefit to the additional tax withholding that could be generated with a 2 percent reduction in lower wage earner cases.

Figure 1: Increased Tax Collections by Replacing a Percentage of Lower Wage Earner Cases With Higher Wage Earner Cases Among Those Who Filed a Return and Had a Potential Underwithholding Problem for TY 2006

| Percentage Reduction (Dollars in Million) | | | | | |
|--|------------------|------------------|------------------|------------------|------------------|
| Calendar Year | 1 Percent | 2 Percent | 3 Percent | 4 Percent | 5 Percent |
| 2011 | \$8.1 | \$16.2 | \$24.3 | \$32.4 | \$40.5 |
| 2012 | \$8.2 | \$16.5 | \$24.7 | \$32.9 | \$41.2 |
| 2013 | \$8.4 | \$16.7 | \$25.1 | \$33.5 | \$41.9 |
| 2014 | \$8.5 | \$17.0 | \$25.5 | \$34.0 | \$42.6 |
| 2015 | \$8.6 | \$17.3 | \$25.9 | \$34.6 | \$43.3 |
| 5-Year Total* | \$41.9 | \$83.7 | \$125.6 | \$167.4 | \$209.5 |

*Total may be off due to rounding.

Source: TIGTA analysis of IRS Individual Master File² and IRS-provided Wage and Tax Statement (Form W-2) file for the sampled taxpayers.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$553.4 million in additional tax withholding over a 5-year period.³ The outcome is based on replacing 2 percent of the lower wage earners selected by the WHC who, according to WHC records, did not file TY 2006 returns (nonfilers) with higher wage earners who, according to IRS records, were TY 2006 nonfilers and underwithheld but were not selected by the WHC (see page 4).

Methodology Used to Measure the Reported Benefit:

To estimate the increased revenue, we analyzed how various percentage reductions in the number of low wage earner cases and replacing them with high wage earner cases might affect the amount of additional tax withholding over 5 years (Calendar Years 2011–2015). In estimating the additional withholdings each year, we analyzed two statistically valid stratified samples of TY 2006 underwithheld nonfiler taxpayers.

² The IRS database that maintains transactions or records of individual tax accounts.

³ This projection assumes all conditions, such as the withholding rates, that existed at the time of our review will remain the same over the 5-year period.



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The first sample was comprised of 100 of the 98,210 individuals who were included in the WHC as nonfilers earning wages *****2(c)*****. The second sample involved 125 of the 89,627 nonfilers who were not included in the WHC with wages of *****2(c)*****.

Next, we computed the difference in average underwithholding between the 2 samples, which resulted in the higher wage earners (those earning \$200,000 or more) showing their average underwithholding was \$51,705 greater than that of the lower wage earners (those earning less than \$200,000). In calculating the underwithholding, to be consistent with IRS practices, we assumed filing status of single with no exemptions. The actual underwithholding could be reduced if the taxpayer ultimately has tax deductions and/or credits.

We then added the \$51,705 difference to 1, 2, 3, 4, and 5 percent of the lower wage earners underwithholdings and multiplied the sums by the Consumer Price Index inflation conversion factors to determine the value of 2006 dollars in Calendar Years 2011 through 2015. Figure 2 shows that the amount of additional tax withholding that could be generated over a 5-year period (Calendar Years 2011–2015) ranged from \$276.8 million to \$1.4 billion, depending on how many lower wage earner cases were replaced by higher wage earner cases (1–5 percent). However, we conservatively limited the benefit to the additional tax withholding that could be generated with a 2 percent reduction in lower wage earner cases.

Figure 2: Increased Tax Collections by Replacing a Percentage of Lower Wage Earner Cases With Higher Wage Earner Cases Among Those Who Did Not File a TY 2006 Return and Had a Potential Underwithholding Problem

| Percentage Reduction (Dollars in Million) | | | | | |
|--|------------------|------------------|------------------|------------------|------------------|
| Calendar Year | 1 Percent | 2 Percent | 3 Percent | 4 Percent | 5 Percent |
| 2011 | \$53.6 | \$107.1 | \$160.7 | \$214.2 | \$267.8 |
| 2012 | \$54.5 | \$108.9 | \$163.3 | \$217.8 | \$272.2 |
| 2013 | \$55.3 | \$110.6 | \$166.0 | \$221.3 | \$276.6 |
| 2014 | \$56.3 | \$112.3 | \$168.8 | \$225.0 | \$281.2 |
| 2015 | \$57.2 | \$114.3 | \$171.5 | \$228.7 | \$285.9 |
| 5-Year Total* | \$276.8 | \$553.4 | \$830.2 | \$1,107.1 | \$1,383.6 |

*Total may be off due to rounding.

Source: TIGTA analysis of IRS Individual Master File and IRS-provided Form W-2 file for the sampled taxpayers.



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Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 183,125 taxpayers and employers over a 5-year period⁴ who may be forced to incur the time and expense (i.e., burden) of dealing with lock-in letters that they should not have received. The taxpayers either had annual earnings less than the \$2,650 threshold for withholding Federal income taxes or were incorrectly identified as a nonfiler with insufficient withholdings (see page 8).

Methodology Used to Measure the Reported Benefit:

We tested a statistical sample of 200 of 127,891 taxpayers selected by the WHC because of TY 2006 underwithholding problems and found 28 of the 200 taxpayers had 45 lock-in letters incorrectly issued to their employers. In each case, the taxpayer had annual earnings that were less than the \$2,650 threshold for withholding Federal income taxes according to the 2006 (*Circular E*), *Employer's Tax Guide* (Publication 15) issued by the IRS. When projected into the population from which we selected our sample, we estimate lock-in letters were unnecessarily issued to 35,530 employers whose employees' annual earning were below the \$2,650 threshold.

In addition, we computer analyzed the IRS tax accounts for the 98,210 nonfiler cases that were selected by the WHC for TY 2006 and identified 1,257 taxpayers had, in fact, filed 2006 tax returns under a secondary identification number. We then reviewed a statistical sample of 70 of the 1,257 cases and found 61 that not only filed a 2006 return but also had sufficient withholdings. When projected into the population from which we selected our sample, we estimate lock-in letters were unnecessarily issued to 1,095 taxpayers. To estimate the number of taxpayers and employers potentially impacted over a 5-year period, we added the 35,530 potential employers impacted annually to the 1,095 potential taxpayers impacted annually and multiplied the sum by 5 years.

⁴ This projection assumes all conditions, such as the withholding rates, that existed at the time of our review will remain the same over the 5-year period.



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Appendix V

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
MAR 05 2010

BY: *Richard Byrd, Jr.*

FEB 18 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. *Richard Byrd, Jr.*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Withholding Compliance Program Results
Are Trending Favorably but Program Enhancements Are Needed
(Audit # 200840035)

I reviewed your draft report and agree, in general, with your conclusions. I am pleased you found the Withholding Compliance Program (WHC) is continuing to help ensure individuals with underwithholding problems are meeting their obligations to pay taxes. During Fiscal Year (FY) 2009, we brought in over 150,000 taxpayers to the WHC, a 6.7 percent increase from FY 2008. Furthermore, since the program began in FY 2005, the WHC has brought in additional withholding of over \$730 million, effectively reducing the tax gap by increasing revenue into the Treasury. Taxpayers who have been included in the WHC have shown dramatic improvements in compliance with Federal tax regulations, with an average increase in withholding of nearly 10 percent and a decrease of almost 50 percent in the number of returns filed with a balance due. A recent review shows these positive trends continuing, despite the adverse economic indicators over the past several years.

We agree that additional improvements can be made to enhance various aspects of the WHC, particularly in the case creation process. In fact, programming has already been completed to improve the lock-in letter process. The programming has reduced the number of erroneous lock-in letters issued, in instances where an employer has already received a letter in the past twelve months. We will continue to work with the Modernization and Information Technology Services (MITS) organization to ensure that additional programming improvements are completed as quickly as possible, but this is often difficult given MITS limited resources and competing priorities.

While we agree that additional improvements are needed, we disagree with the methodology used to determine if lock-in letters were issued incorrectly. The auditors based their determination for an incorrect lock-in letter on a threshold of \$2,650, which represents the minimum wage amount subject to Federal tax withholding based on an



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annual payroll period. However, since there is no way to determine if the reported wages are based on an annual payroll period, the WHC aggregates all reported wages to determine case creation parameters and subsequent issuance of lock-in letters to all employers.

We reviewed the methodology you used to formulate the outcome measures cited in Appendix IV of your report. We agree the corrective actions in our response to your recommendations, along with other planned program improvements, will result in significant revenue from additional withholding. However, realization of the full revenue cited is dependent on the availability of MITS resources and may be negatively impacted by the recent economic downturn.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Denice Vaughan, Director, Filing and Payment Compliance, Wage and Investment Division, at (404) 338-9116.

Attachment



Withholding Compliance Program Results Are Trending Favorably, but Program Enhancements Are Needed

Attachment

The Director, Compliance, Wage and Investment Division, should:

RECOMMENDATION 1

Develop and implement a statistically valid study to assess the underwithholding compliance risk throughout all segments of the taxpayer population.

CORRECTIVE ACTION

We agree with this recommendation. We will continue to work with the Modernization and Information Technology Services (MITS) organization in an effort to retrieve the data necessary to select and analyze a statistically valid sample. The stratification of the data will be completed by MITS, based on the same parameters used by Treasury Inspector General for Tax Administration during the audit. Once the data is provided by MITS, we will analyze the data in order to make a risk based decision for Withholding Compliance Program (WHC) case creation. The Unified Work Request (UWR) was submitted in October 2009.

IMPLEMENTATION DATE

September 15, 2010

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 2

Use the results of the risk factor validation study to adjust, if necessary, the selection methods that identify and prioritize the taxpayers with underwithholding problems for lock-in letter issuance.

CORRECTIVE ACTION

We agree with this recommendation. If the results of the analysis described in the corrective action to Recommendation #1 warrant, adjustments will be made to the WHC selection methodology, to improve the identification and selection of taxpayers requiring lock-in letters.

IMPLEMENTATION DATE

September 15, 2011

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division



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CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

The Director, Compliance, Wage and Investment Division, should ensure that actions are taken to:

RECOMMENDATION 3

Correct the computer programs so that lock-in letters are issued in accordance with the intent of IRS policies and procedures.

CORRECTIVE ACTION

We agree with this recommendation. We agree to continue to pursue programming changes, which will be contingent on MITS resources and funding. Programming to determine if a lock-in letter has been issued in the prior twelve months was implemented in March 2009. The UWR was submitted in October 2009 for programming to correct problems with name and Social Security Number (SSN) mismatches, and Federal tax compliance based on a cross referenced SSN.

IMPLEMENTATION DATE

September 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 4

Research each of the employers in our samples that may have been affected by the programming errors to determine whether they are overwithholding any employees. If employers are overwithholding, correct the withholdings as needed and consider expanding the research to identify and correct additional instances where employers may be affected by the programming errors and are overwithholding employees.

CORRECTIVE ACTION

We partially agree with this recommendation. We agree to research the employers identified in this audit and take corrective action, if necessary. However, we disagree with expanding this research, since it would be cost prohibitive from a resource allocation standpoint. Additional MITS resources would be required in order to expand the research on employers. Currently, the available MITS resources are devoted 100



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percent to maintenance of the WHC program. Additionally, as instructed in the Letter 2801, WHC lock-in letter, the taxpayer may contact WHC at anytime after the lock-in letter has been issued to request that the lock-in be released or modified, thus eliminating any potential impact to the taxpayer's Federal income tax situation. On average, approximately 85 percent of the taxpayers issued lock-in letters request some type of modification.

IMPLEMENTATION DATE

March 15, 2011 (for the employers identified in this audit only)

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control process.