

**The Internal Revenue Service Protects the
Government's Interests When Taxpayers File
for Bankruptcy, but Some Controls Could Be
Improved**

July 2001

Reference Number: 2001-30-123

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.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 25, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Handwritten signature of Pamela J. Gardiner in cursive script.

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Protects the
Government's Interests When Taxpayers File for Bankruptcy, but
Some Controls Could Be Improved

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to protect the Government's interests when taxpayers file for bankruptcy. The overall objective of this audit was to determine if the IRS effectively administers its bankruptcy program to achieve its goal of protecting the Government's interests by securing maximum collections from bankruptcy proceedings.

In summary, the IRS' Insolvency Unit protects the Government's interests in bankruptcy proceedings by effectively monitoring post-petition non-compliance on businesses, timely filing claims, and accurately reflecting bankruptcy payment information on the Masterfile.¹ However, potential problems with an automated post-petition monitoring process caused by a programming error should be communicated to local management. The Insolvency Unit could also improve both the accuracy of claim filing and its monitoring of bankruptcy payment plans.

We recommended that the Commissioner, Small Business/Self-Employed (SB/SE) Division, should notify local management of possible inaccuracies in the automated process to identify business taxpayers that do not remain current on tax obligations after the bankruptcy filing. The Commissioner should also issue guidelines to ensure that proper research tools are used when technicians prepare proofs of claim. Finally, the

¹ The Masterfile is the IRS' main computer system containing taxpayer accounts.

Commissioner should reinforce requirements for timely actions on delinquent bankruptcy payments and provide specific guidance for expectations on monitoring payments for certain types of bankruptcies.

The Commissioner, SB/SE Division, agreed with and plans to take corrective actions on all of the recommendations in the report. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included in Appendix V.

Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Executive Summary

A debtor is a person or business that incurs financial liability and owes money to another person or business, which is considered the creditor. When debtors cannot meet financial obligations to their creditors, debtors can petition (file) for bankruptcy with the Federal Bankruptcy Court. During Fiscal Year (FY) 2000, approximately 1.27 million individuals and businesses filed for bankruptcy.¹ While the Internal Revenue Service (IRS) is not a creditor for each debtor filing for bankruptcy protection, a significant number of the debtors have outstanding tax liabilities. For FY 2000, IRS data show approximately 523,000² debtors entered bankruptcy status owing the IRS about \$3.1 billion in taxes, penalties, and interest.³

The Bankruptcy Code provides a structured approach for the fair distribution of the debtor's assets to the creditors. The IRS' Insolvency Unit is responsible for preparing a proof of claim, which is the creditor's assertion of a right to payment from the debtor or debtor's property. The Insolvency Unit is also responsible for monitoring payment plans approved by the Bankruptcy Court and for monitoring compliance while the taxpayer's bankruptcy case is open and under the jurisdiction of the Bankruptcy Court.

Our overall objective was to determine if the IRS effectively administers its bankruptcy program to achieve its goal of protecting the Government's interests by securing maximum collections from bankruptcy proceedings.

Results

Overall, the IRS effectively protects the Government's interests by timely filing proofs of claim and accurately reflecting bankruptcy payment information on the taxpayers' accounts on the IRS Masterfile.⁴ The IRS was effectively manually monitoring and evaluating post-petition non-compliance⁵ on businesses involved in bankruptcy

¹ Source: American Bankruptcy Institute Quarterly Non-Business Bankruptcy Filings for 1994-2001 and Quarterly Business Bankruptcy Filings for 1994-2001.

² Source: Collection Field function Time District Office (Non-ACS) Activity Report NO-5000-23.

³ Source: IMF (Individual Masterfile) Report of Bankruptcies NO-5000-31 and BMF (Business Masterfile) Report of Bankruptcies NO-5000-32.

⁴ The Masterfile is the main computer system that stores various types of taxpayer account information. This includes individual, business, and employee plans and exempt organizations data.

⁵ This includes filing and paying tax liabilities for tax periods ending after the bankruptcy petition date but prior to approval of the plan of reorganization by a bankruptcy judge.

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proceedings. However, based on our discussions with the IRS Office of Information Technology Services, they initiated a Masterfile programming change to correct an error affecting automated monitoring of non-compliance. In addition, controls in the Insolvency Unit could be improved to ensure that proofs of claim are accurate. The Insolvency Unit also needs to improve monitoring efforts to ensure that payments are sent to the IRS as required by the Bankruptcy Court's approved payment plan.

The Insolvency Unit Is Effectively Monitoring and Evaluating Post-Petition Compliance on Businesses in Bankruptcy Proceedings

The Insolvency Unit was manually monitoring most businesses to verify that the businesses were filing tax returns and paying tax liabilities as appropriate. In 36 (45 percent) of 80 cases that we sampled, taxpayers had not filed and/or paid the proper taxes that were due after the businesses filed their bankruptcy petitions. In most cases (94 percent), the Insolvency Unit had obtained payment, secured returns, filed administrative claims,⁶ or had begun these actions to protect the Government's interests.

While the Insolvency Unit's actions were effective, the three offices reviewed were not aware of a Masterfile programming error affecting the input of a code used in an automated monitoring process. The Insolvency Unit technicians input to a taxpayer's Masterfile account both a transaction code (TC 136⁷) and a code representing the tax amount on the most recently filed trust fund⁸ return, called the Employer's Quarterly Federal Tax Return (Form 941). We determined that the last return amount code was not transferred from the Integrated Data Retrieval System (IDRS)⁹ to the Masterfile after January 1, 2000, due to a programming error. We discussed this issue with the IRS Office of Information Technology Services, and they corrected the error for transactions input after March 25, 2001. As a result, Masterfile analysis may not accurately identify business taxpayers that do not remain current on tax obligations after the bankruptcy filing. This affects transactions input between January 1, 2000, and March 25, 2001.

⁶ Administrative claims are proofs of claim for debt arising after the filing of a bankruptcy petition.

⁷ The TC 136 suppresses Federal Tax Deposit (FTD) alerts and litigation transcripts. FTD alerts are used to determine an employer's compliance with employment tax deposit requirements. Litigation transcripts are computer-generated documents for accounts that are in bankruptcy status.

⁸ Trust fund taxes are income taxes that an employer is required to withhold from the pay of employees and the employees' share of social security taxes.

⁹ The IDRS is the IRS' computer system which employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Masterfile.

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The Insolvency Unit Is Not Always Filing Accurate Proofs of Claim on Bankruptcy Cases

The amount of the liability listed on the proof of claim needs to be accurate so the IRS receives the proper amount of taxes owed by the debtor. Our review of 81 proofs of claim cases found that the Insolvency Unit timely filed claims in 77 (95 percent) of the cases reviewed. However, we identified 36 (44 percent) cases which contained inaccurate amounts and/or inaccurate classification of the priority of certain items. The errors represented \$243,000 (7 percent) of the total \$3.5 million that was due on the 36 cases. Some errors were caused by technicians not properly identifying amounts due, while others were caused by technicians not using the proper IDRS research tools¹⁰ to identify the correct amount of penalty and interest amounts owed.

The Insolvency Unit Is Not Properly Monitoring Bankruptcy Payment Plans

Payments from bankruptcy cases need to be applied properly to taxpayer accounts, and receipts need to be monitored to ensure that the IRS receives all amounts provided for through the bankruptcy payment plans. Our review of 90 payments received by the Insolvency Unit found that the payment information was accurately applied to the taxpayers' accounts on the Masterfile. However, our review of cases from delinquency reports determined that the Insolvency Unit did not take timely actions during case reassignments or during the approaching retirement of an employee on 11 (24 percent) of 45 Chapter 11¹¹ cases. In addition, two of three offices reviewed were not monitoring Chapter 13¹² cases on an ongoing basis because local management relied upon the trustees to make proper distributions and take action when debtors defaulted on plan payments.

Summary of Recommendations

The Commissioner, Small Business/Self-Employed (SB/SE) Division, needs to notify local management of possible inaccuracies in the automated process to identify business taxpayers that do not remain current on tax obligations after the bankruptcy filing. He

¹⁰ This includes the use of command codes INTST and COMPA. Command Code INTST is used to calculate tax, penalty, and total interest, and command code COMPA is used to calculate interest on the penalty.

¹¹ Chapter 11 is used by businesses that want to continue to operate and repay creditors while they are reorganizing their businesses.

¹² Chapter 13 is designed for an individual debtor who has a regular source of income.

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also needs to issue guidelines to ensure that proper research tools are used when technicians prepare proofs of claim. Finally, he needs to reinforce requirements for timely actions on delinquent bankruptcy payments and provide specific guidance for expectations on monitoring payments for Chapter 13 bankruptcies.

Management's Response: SB/SE Division management agreed with all of our recommendations. They plan on issuing an advisory to the field of the programming error on TC 136 and will include instructions for alternative means of identifying cases with post-petition non-compliance. They will also work with the programmers for the Automated Insolvency System to identify cases for re-input of the TC 136.

SB/SE Division management issued a memorandum to the field on March 6, 2001, which included an instructional guide for using the new IDRS command code INTSTB to correctly compute interest and penalty on a proof of claim. The Director, Filing and Payment Compliance, will work with the Director, Compliance Services, and the Insolvency Area managers to reinforce the need for local Insolvency management to monitor Chapter 11 payment compliance with the Confirmed Plan Monitoring Report and provide specific guidance on expectations for monitoring Chapter 13 plan payments.

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Objective and Scope

The overall objective was to determine if the IRS effectively protects the Government's interests in bankruptcy proceedings.

Our overall objective was to determine if the Internal Revenue Service (IRS) effectively administers its bankruptcy program to achieve its goal of protecting the Government's interests by securing maximum collections from bankruptcy proceedings.

To accomplish our objective, we determined if proofs of claim were timely and accurately filed, evaluated the procedures for monitoring bankruptcy payment plans, and determined if the IRS properly monitored accounts of business debtors to ensure post-petition compliance.¹

Our review was conducted between October 2000 and March 2001 in the Los Angeles, CA; Nashville, TN; and New Orleans, LA; offices of the Small Business/Self-Employed (SB/SE) Division.² This audit was performed in accordance with *Government Auditing Standards*.

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

During Fiscal Year (FY) 2000, approximately 1.27 million individuals and businesses filed for bankruptcy.³ While the IRS is not a creditor for each

¹ This includes filing and paying tax liabilities for tax periods ending after the bankruptcy petition date but prior to the approval of the plan of reorganization by a bankruptcy judge.

² On October 1, 2000, the IRS dissolved its long-standing geographical structure based on districts and regions and reorganized into four main operating divisions based on types of taxpayers.

³ Source: American Bankruptcy Institute Quarterly Non-Business Bankruptcy Filings for 1994-2001 and Quarterly Business Bankruptcy Filings for 1994-2001.

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debtor filing for bankruptcy protection, a significant number of the debtors have outstanding tax liabilities. For FY 2000, IRS data show approximately 523,000⁴ debtors entered bankruptcy status owing about \$3.1 billion in taxes, penalties, and interest.⁵

The laws governing bankruptcy date back to 1898. The bankruptcy laws are based on the underlying principle that debtors, unable to pay all creditors, should have a way to pay what they can afford to pay, while receiving forgiveness for any debts that cannot be paid.

The Bankruptcy Code⁶ provides for five basic types of bankruptcy cases:

- Chapter 7 is a court-supervised procedure where a trustee collects the assets of the debtor's estate, reduces them to cash, and distributes the cash to the creditors.
- Chapter 9 is a reorganization of a municipality, which includes villages, counties, taxing districts, municipal utilities, and school districts.
- Chapter 11 is generally used by businesses that want to continue to operate and repay creditors while they are reorganizing their business.
- Chapter 12 is used by farmers with regular annual income.
- Chapter 13 is designed for an individual debtor who has a regular source of income. The debtor proposes a plan to repay creditors over time.

A debtor is a person or business that incurs financial liability and owes money to another person or business, which is considered the creditor. When debtors cannot

⁴ Source: Collection Field function Time District Office (Non-ACS) Activity Report NO-5000-23.

⁵ Source: IMF (Individual Masterfile) Report of Bankruptcies NO-5000-31 and BMF (Business Masterfile) Report of Bankruptcies NO-5000-32.

⁶ 11 U.S.C. Section 109 (1994).

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meet financial obligations to their creditors, debtors can petition (file) for bankruptcy with the Federal Bankruptcy Court. The Bankruptcy Code provides a structured approach for the fair distribution of the debtor's assets to the creditors. A proof of claim (claim) is filed with the Bankruptcy Court to participate in the distribution of assets. The claim is the creditor's assertion of a right to payment from the debtor or debtor's property.

Claims are either "secured" or "unsecured." A creditor holds a secured claim where the underlying debt is backed by a mortgage, pledge of collateral, or lien (e.g., federal tax lien⁷).

The Bankruptcy Code (11 U.S.C. Section 507) establishes an order or priority for unsecured claims, known as unsecured priority claims. These claims are paid in the order of their priority. Each priority level must be fully paid before the next level is entitled to any of the proceeds. If funds are not sufficient to pay the entire priority level, the proceeds are distributed proportionately to each creditor in that priority level.

Unsecured general claims are those that are not specified in the Bankruptcy Code as having priority. These claims are paid, if funds remain, after all the debts having priority are paid. Often, unsecured general claims receive little or no distribution.

Bankruptcies filed under Chapter 7 are administered by trustees who liquidate the debtors' non-exempted⁸ property, if any, and distribute the proceeds to the creditors. For bankruptcies filed under Chapters 11, 12, and 13, the debtors generally retain their assets and

⁷ A federal tax lien is a legal claim to property as security or payment of tax debt.

⁸ State or Federal law provides that individuals can exempt certain property (e.g., a homestead) from the bankruptcy estate. In general, the debtor can choose between exemptions provided under either State or Federal Law. Exempt property cannot be liquidated and distributed to the creditors by the trustee.

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repay creditors over time, through a plan approved by the Bankruptcy Court.

Generally, a trustee is not appointed to oversee Chapters 11 and 12 bankruptcies. In these cases, the debtor takes on the role known as the debtor-in-possession. A court-appointed trustee oversees the administration of Chapter 13 bankruptcies. A trustee:

- Is an agent of the court.
- Ensures cases are administered fairly, evenly, and economically.
- Ensures all creditors receive a fair distribution.
- Receives periodic payments from the debtor.
- Distributes periodic payments to creditors.

The Insolvency Unit is responsible for controlling and monitoring bankruptcy cases for the IRS.

The Insolvency Unit has responsibility for controlling and monitoring bankruptcy cases for the IRS. The Insolvency Unit's responsibilities include:

- Preparing and filing proofs of claim for all bankruptcy cases where the IRS is a creditor.⁹
- Monitoring bankruptcy payment plans and post-petition compliance while the bankruptcy case is open and under the jurisdiction of the Bankruptcy Court for bankruptcies filed under Chapters 11, 12, and 13.

The Insolvency Unit maintains an automated control system of cases filed under the Bankruptcy Code called the Automated Insolvency System (AIS). This is a comprehensive control and processing application for the Insolvency field offices to use when processing bankruptcy cases. Among other functions, the AIS is used to:

⁹ Bankruptcies filed under Chapter 7 are categorized as either an "asset" or "no asset" case. The IRS and other creditors will not receive distributions from a Chapter 7 "no asset" case. Therefore, a claim is not required.

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- Enter, maintain, and print proofs of claim.
- Monitor receipt of bankruptcy payments.
- Generate reports regarding bankruptcy payment plan status.

Results

Overall, the IRS' Insolvency Unit is working to protect the Government's interests in bankruptcy proceedings, but some controls could be improved.

Overall, the IRS' Insolvency Unit protects the Government's interests in bankruptcy proceedings by effectively monitoring post-petition non-compliance on businesses, timely filing claims, and accurately reflecting bankruptcy payment information on the Masterfile.¹⁰ However, potential problems with the automated post-petition monitoring process caused by a Masterfile programming error need to be communicated to local management. The Insolvency Unit also needs to improve both the accuracy of claim filing and its monitoring of bankruptcy payment plans.

The Insolvency Unit Is Effectively Monitoring and Evaluating Post-Petition Compliance on Businesses in Bankruptcy Proceedings

The Insolvency Unit is responsible for monitoring Chapter 11 business taxpayers for compliance while the taxpayer's bankruptcy case is open and under the jurisdiction of the Bankruptcy Court. Compliance monitoring must be conducted, including those cases where no proof of claim will be filed, to ensure that the taxpayers do not accumulate significant, unpaid trust fund¹¹ tax liabilities.

¹⁰ The Masterfile is the main computer system that stores various types of taxpayer account information. This includes individual, business, and employee plans and exempt organizations data.

¹¹ Trust fund taxes are income taxes that an employer is required to withhold from the pay of employees and the employees' share of social security taxes.

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Overall, the offices were monitoring accounts to identify post-petition debt or unfiled returns and acted when post-petition debt occurred.

The Insolvency Unit manually monitors taxpayers by using the Integrated Data Retrieval System (IDRS)¹² and has an automated monitoring process available. The three offices we reviewed manually monitored taxpayer accounts. However, they also input a computer transaction code to the Masterfile to initiate an automated monitoring process.

We reviewed a judgmental sample of 80 of 224¹³ Chapter 11 cases to evaluate the effectiveness of monitoring business taxpayers in bankruptcy. Overall, the offices were monitoring accounts to identify post-petition debt or unfiled returns and acted when post-petition debt occurred. However, a Masterfile programming error may impact the effectiveness of the reports generated to assist in the monitoring of taxpayer accounts.

Manual monitoring

The Insolvency Unit adequately monitored 77 (96 percent) of the 80 accounts that we reviewed. In three instances, all of which occurred in one office, the taxpayers' accounts were reviewed for post-petition debt on an annual rather than quarterly basis. These debtors had significant quarterly trust fund tax liabilities.

When post-petition non-compliance was identified, the Insolvency Unit's actions included contacting the debtor or debtor's attorney, filing administrative claims,¹⁴ and, in some instances, referring the case to IRS Office of the

¹² The IDRS is the IRS' computer system which employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Masterfile.

¹³ This includes only Business Chapter 11 cases for which a bankruptcy petition had been filed between October 1, 1998, and December 31, 1999, and that were on the AIS Open Database as of October 2000.

¹⁴ Administrative claims are proofs of claim for debt arising after the filing of a bankruptcy petition.

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Chief Counsel, for pursuit of a motion to either convert to a Chapter 7 proceeding or dismiss¹⁵ the bankruptcy.

Our review of the 80 cases identified post-petition liabilities and/or unfiled returns on 36 (45 percent) taxpayer accounts. The debtors in these cases incurred approximately \$558,000 in post-petition liabilities (i.e., taxes, penalties, and interest), including \$93,000 in estimated liabilities for unfiled returns. The post-petition liabilities or unfiled returns were identified and the Insolvency Unit had obtained payment, secured returns, filed administrative claims, or had begun these actions, in 34 (94 percent) of the 36 cases, to protect the Government's interests.

Automated monitoring

The Insolvency Unit has two automated processes available for automated monitoring. Both processes are conducted through analysis of Masterfile information. One of the automated processes is initiated when the Insolvency Unit technicians input a transaction code (TC 136)¹⁶ to the taxpayer's account on the Masterfile. When inputting the TC 136, the Insolvency Unit also inputs the Last Return Amount (LRA) code.¹⁷ The LRA code is used in this automated monitoring process to define the amount of assessed tax on the most recently filed trust fund return, called the Employer's Quarterly Federal Tax Return (Form 941).

¹⁵ A dismissal occurs when the bankruptcy proceeding is closed by the Bankruptcy Court and pre-petition debt is not forgiven. The creditors may then resume administrative collection.

¹⁶ The TC 136 suppresses Federal Tax Deposit (FTD) alerts and litigation transcripts. FTD alerts are used to determine an employer's compliance with employment tax deposit requirements. Litigation transcripts are computer-generated documents for accounts that are in bankruptcy status.

¹⁷ The other automated process, known as the Litigation Accounts Monitoring System, is an interface between the AIS and the Masterfile. This process is based on the input of the bankruptcy freeze code transaction and not TC 136 or the LRA code.

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We determined the LRA code was not input to the Masterfile for transactions input after January 1, 2000. We discussed this issue with the IRS' Office of Information Technology Services, and they determined the problem was caused by a programming error affecting the transfer of the LRA code from the IDRS to the Masterfile. They corrected the error for transactions input after March 25, 2001. However, as a result, Masterfile analysis may not accurately identify business taxpayers that do not remain current on tax obligations after the bankruptcy filing. This affects transactions input between January 1, 2000, and March 25, 2001.

The Insolvency Unit employees at the three offices reviewed were not aware of the programming error affecting the input of the LRA code.

Recommendation

1. The Commissioner, SB/SE Division, should advise local Insolvency Unit management of the programming error affecting the input of the LRA code, and determine if an automated process is available to input the LRA code for ongoing bankruptcies affected by the programming error.

Management's Response: SB/SE Division management agreed with the recommendation. They plan to issue an advisory to the field of the programming error on TC 136 and will include instructions for alternative means of identifying cases with post-petition non-compliance. They will also work with the programmers for the AIS to identify the cases they processed during that period to find the most efficient method for re-inputting TC 136 on those cases.

The Insolvency Unit Is Not Always Filing Accurate Proofs of Claim on Bankruptcy Cases

The Bankruptcy Code provides for the distribution of the debtors' assets, based on the amount and priority

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level of the claims submitted by creditors. When the IRS does not accurately record and properly classify tax, interest, and penalty amounts on claims, the equitable distribution of assets through the bankruptcy proceedings may not occur. Additionally, the Government's interests are not adequately protected when the claims do not include all amounts owed.

Currently, claim preparation is a manual process, which is prone to human error. In addition, Insolvency Unit technicians did not always use the proper IDRS research tools to separate interest on tax from interest on penalties. The Insolvency Unit is attempting to develop an application to automate the preparation of the claims. Until this process is automated, the Insolvency Unit needs to use the proper IDRS research tools¹⁸ in identifying amounts to include on tax claims. Additionally, managerial reviews to identify errors on claims filed with the Bankruptcy Court need to be improved.

We reviewed a judgmental sample of 81 open cases where the IRS filed proofs of claim on bankruptcy cases filed between October 1, 1998, and March 31, 2000. We evaluated the accuracy and timeliness of these claims for all tax periods included on the claims, where tax returns had been filed at the time of our review.

Overall, the claims were filed timely with the Bankruptcy Court. The IRS generally has 180 days from the petition date to file a claim. The Insolvency Unit timely filed claims in 77 (95 percent) of the 81 cases reviewed.

Claims were not accurately prepared in 36 of the 81 cases.

However, the claims contained inaccurate amounts, and/or inaccurate classification of the priority of certain items, in 36 (44 percent) of the 81 cases reviewed. The

¹⁸ This includes the use of command codes INTST and COMPA. Command Code INTST is used to calculate tax, penalty, and total interest, and command code COMPA is used to calculate interest on the penalty.

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errors represented \$243,000 (7 percent) of the total \$3.5 million that was due on the 36 cases.

The IRS overstated 20 proofs of claim by a total of approximately \$145,000. This includes approximately \$143,000 on secured or priority claims and \$2,000 on unsecured general claims. In addition, the IRS understated 16 proofs of claim by a total of about \$98,000. This includes approximately \$4,000 on secured or priority claims and \$94,000 on unsecured general claims. Some errors occurred when the Insolvency Unit technicians did not properly identify amounts due. These included instances where they:

- Miscalculated tax, interest, and/or penalty.
- Included penalties assessed after the bankruptcy petition date or did not include penalties assessed prior to bankruptcy petition date.
- Did not amend estimated claims after delinquent returns were received.

In addition, local procedures in two of the three offices reviewed were not adequate because they did not require Insolvency Unit technicians to use the IDRS command codes to separate interest on tax from interest on penalties. In these offices, this process resulted in all interest included on the claim having the same priority classification as the taxes. This misclassifies the interest amounts for penalties on priority tax periods¹⁹ because interest related to penalties is an unsecured general claim.

The review of the proofs of claim was not effective in identifying these errors. In one office, the Insolvency Unit technicians approved claims that they prepared. In the remaining two offices, either a specialist or the Insolvency manager approved claims filed.

¹⁹ The Bankruptcy Code, 11 U.S.C. Section 507, contains specific criteria for taxes that receive unsecured priority status. In general, an unsecured priority status is provided for tax withheld from payroll, for any excise tax collected, and for tax where the return due date is less than 3 years before the petition date.

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Recommendation

2. The Commissioner, SB/SE Division, should issue guidelines to ensure that claims are prepared using the proper IDRS research tools. These guidelines should also include local managerial review procedures to ensure that the proper IDRS research tools are used.

Management's Response: SB/SE Division management agreed with our recommendation. They issued a memorandum on March 6, 2001, to the field as an instructional guide for using the new IDRS command code INTSTB to correctly compute interest and penalty on a proof of claim. They will issue a directive for field management to ensure they review this guide with the technical employees who prepare proofs of claims. Also, they will issue instructions that field management should periodically review procedures and sample cases for the accuracy of the computations and claim determinations.

The Insolvency Unit Is Not Properly Monitoring Bankruptcy Payment Plans

The Insolvency Unit is responsible for monitoring bankruptcy payment plans.

The Insolvency Unit is responsible for monitoring bankruptcy payment plans to ensure that the debtors are making payments as required. If the debtor has defaulted on payments or the payments were not in conformance with the plan, the Insolvency Unit should determine whether additional actions may be required. This may include issuing a default notice, modifying the payment plan, dismissing the case, or converting the case to a Chapter 7 proceeding. When bankruptcy payment plans are not adequately monitored, the IRS may not receive all funds provided for in the plans.

The Insolvency Unit receives payments from trustees or from the taxpayers in Chapter 11 cases. The Insolvency Unit records the payment information on the AIS and generates payment posting instructions from the AIS for

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the IRS' teller function to use in applying the payments to the taxpayers' Masterfile accounts.

We reviewed a judgmental sample of 90 payments selected from trustee payment schedules and payment transmittal documents. All 90 payments were accurately reflected on the taxpayers' Masterfile accounts.

In addition, we obtained Confirmed Plan Delinquent Reports (delinquency reports) generated from the AIS between October 2000 and March 2001 for each of the three offices. We judgmentally sampled 92 cases to determine the effectiveness of follow-up actions taken by the Insolvency Unit on missed payments. The sample included 45 Chapter 11 cases and 47 Chapter 13 cases.

Chapter 11 payment plan monitoring

Insolvency Unit actions were not effective on 11 (24 percent) of the 45 cases reviewed. The delinquency reports showed the 11 cases as being underpaid by approximately \$390,000 (1 case accounted for about \$150,000 of this amount). In these cases, the Insolvency Unit did not take timely actions such as contacting the debtor, providing the debtor a default notice, or initiating steps to dismiss or convert the case. These conditions occurred because management oversight was not sufficient to ensure that payment monitoring continued during case reassignments and the approaching retirement of an employee.

For example, a taxpayer first appeared on a delinquency report over 2 years prior to our testing in December 2000. The AIS showed that over \$40,000 was owed on the bankruptcy payment plan. No immediate actions were taken to address the delinquency with the debtor (e.g., contacting the debtor by a telephone call or letter). Ultimately, the Insolvency Unit was unable to substantiate the IRS' position on this case, and not all amounts owed were collected.

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Chapter 13 payment plan monitoring

As previously stated, trustees oversee the administration of Chapter 13 bankruptcies. The trustees receive payments from debtors and distribute funds collected to the creditors.

In two of the three offices reviewed, the Insolvency Unit did not monitor plan compliance on an ongoing basis for Chapter 13 cases. These offices indicated that they reviewed payment information when a notice of payment plan completion or a notice of discharge²⁰ was received. These offices relied upon the trustees to make proper distributions and take action when debtors default on plan payments.

For these 2 offices, we reviewed a judgmental sample of 17 cases from the delinquency reports. The reports showed delinquencies ranging from approximately \$300 to over \$160,000. The Insolvency Unit did not take any action to determine whether all expected payments had been received or the reason why payments stopped. When these cases are not monitored on an ongoing basis, the IRS may not fully participate in the distribution of the debtor's assets.

In the remaining office, Insolvency Unit technicians periodically reviewed Chapter 13 cases. Rather than using the delinquency reports, the technicians reviewed cases on an annual or 18-month basis. Local managers indicated that this process was used because they do not usually receive payments at regularly scheduled intervals. In 29 of 30 cases we selected from the delinquency report for that office, the technicians reviewed electronic court information and/or reviewed automated trustee systems to determine the debtor's bankruptcy and payment plan status.

²⁰ A discharge is a court order relieving a debtor from liability for certain debts. The discharge operates as an injunction against any collection action to recover these debts.

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Recommendations

The Commissioner, SB/SE Division, should:

3. Reinforce the need for local Insolvency Unit managers to ensure that bankruptcy technicians use the Confirmed Plan Delinquent Reports and take timely actions on delinquent bankruptcy payments.
4. Provide specific guidance for expectations on monitoring payments for Chapter 13 bankruptcies and determine how automated trustee systems can be used to assist in evaluating potential delinquencies.

Management's Response: SB/SE Division management agreed with our recommendations. The Director, Filing and Payment Compliance, will work with the Director, Compliance Services, and the Insolvency Area managers to reinforce the need for local Insolvency management to monitor Chapter 11 payment compliance with the Confirmed Plan Monitoring Report. Also, they will establish a course of action for local offices to follow when they identify delinquent payments.

The Director, Filing and Payment Compliance, will work with the Director, Compliance Services, and the Insolvency Area managers to provide specific guidance on expectations for monitoring Chapter 13 plan payments. They will also have each office review what data sources are available with their courts and trustees to develop an effective monitoring program for each location.

The Internal Revenue Service Protects the Government's Interests When Taxpayers File for Bankruptcy, but Some Controls Could Be Improved

Conclusion

The Bankruptcy Code provides for a structured approach for the fair distribution of a debtor's assets to creditors. Overall, the Insolvency Unit is working to protect the Government's interests in bankruptcy proceedings by monitoring business taxpayers for unfiled returns or unpaid trust fund tax, by timely filing proofs of claim, and by accurately reflecting bankruptcy payment information on the Masterfile. However, the IRS needs to ensure that all claims are accurate and that bankruptcy plan payments are always monitored to fully protect the Government's interests.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if the Internal Revenue Service (IRS) effectively administers the bankruptcy program to achieve its goal of protecting the Government's interests by securing maximum collections from bankruptcy proceedings. We used judgmental sampling throughout our audit because of problems with the IRS' computer systems, which rendered us unable to identify a universe of cases from which to select statistically valid samples. To accomplish the objective, we conducted the following audit tests.

- I. Determined if the IRS protects the Government's interests by effectively preparing and filing proofs of claim.
 - A. Interviewed Insolvency Unit managers and processing clerks to identify and evaluate:
 1. Procedures for preparing, approving, and filing proofs of claim.
 2. Procedures for amending proofs of claim.
 3. Time periods for filing proofs of claim.
 4. Tolerances for filing proofs of claim.
 - B. Selected a judgmental sample of 81 cases from the Automated Insolvency System (AIS) Open Database where the IRS filed claims on bankruptcy cases filed between October 1, 1998, and March 31, 2000. The AIS showed that claims were filed for approximately 16,000 cases during this period. We selected the period October 1, 1998 to March 31, 2000, to evaluate the overall claim filing process including claim amendments and timeliness of claim filing. We determined if:
 1. Proofs of claim were timely filed.
 - a) Determined if the AIS reflected the appropriate Bar Date.¹
 - b) Compared the date on the proof of claim with the appropriate Bar Date to determine if the claim was filed with the Bankruptcy Court on or before the Bar Date.

¹ This is the date fixed by the Bankruptcy Court or by statute as the date by which a creditor must file a proof of claim.

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- c) Reviewed the proof of claim maintained in the case file to determine if the Bankruptcy Court acknowledged the claim.
- 2. Proofs of claim were accurately filed.
 - a) Reviewed Integrated Data Retrieval System (IDRS)² information to identify:
 - (1) Pre-petition balances of tax, interest and penalties.
 - (2) Pre-petition tax returns that were not filed.
 - (3) The appropriate classification of the claim for taxes (e.g., secured, unsecured priority, or unsecured general.)
 - b) Compared IDRS information to the proofs of claim to determine if the amount for each classification was correct.
 - c) Determined if the proof of claim was reviewed and properly approved before it was submitted to the Bankruptcy Court.
 - d) Reviewed the AIS for the sample cases to determine if:
 - (1) Proof of claim amounts were accurately recorded.
 - (2) Any amended proofs of claim were accurately recorded.
- II. Determined if the IRS protects the Government's interests by effectively monitoring and processing bankruptcy payment plans.
 - A. Interviewed Insolvency Unit managers and processing clerks to identify and evaluate:
 - 1. Procedures for monitoring payment plans.
 - 2. Procedures for processing bankruptcy payments.

² The IDRS is the IRS' computer system which employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Masterfile.

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- B. Reviewed a judgmental sample of 92 cases which consisted of 45 Chapter 11 cases and 47 Chapter 13 cases from the Confirmed Plan Delinquent Reports generated from the AIS between October 2000 and March 2001. These reports were obtained based on all cases which showed a delinquency. These reports contained approximately 113 Chapter 11³ cases, and approximately 4,500 Chapter 13⁴ cases. The period for this sample was chosen based on the scheduling of our on-site testing.
1. Evaluated the actions taken by the Insolvency Unit to get debtors current on plan payments.
 2. Determined if the Reports accurately identified the length of time the case had been delinquent.
- C. Selected a judgmental sample of 90 of the approximately 57,000 payments received between March 13, 2000, and September 21, 2000, from the trustee payment schedules and payment transmittal documents maintained by the Insolvency Unit. We judgmentally selected this sample from payment documentation maintained at the offices tested. The period of March 13, 2000, to September 21, 2000, represents the date range of the samples. We determined if:
1. The bankruptcy cases relating to the payments were on the AIS.
 2. Payments recorded on the AIS were under the proper taxpayer's account and for the correct amount and date.
 3. Vouchers were prepared for each payment and forwarded to the cashier's unit.
 4. Payments recorded on the Masterfile⁵ were under the proper taxpayer's account and for the correct amount and date.
- D. Reviewed 3 (1 from each office reviewed) trustee payment schedules which contained 1,492 Chapter 13 bankruptcy plan payments and determined whether:
1. The total of the payment posting vouchers agreed with the amount of the checks received from the trustees.

³ Chapter 11 is used by businesses that want to continue to operate and repay creditors while they are reorganizing their business.

⁴ Chapter 13 is designed for an individual debtor who has a regular source of income.

⁵ The Masterfile is the main computer system that stores various types of taxpayer account information. This includes individual, business, and employee plans and exempt organizations data.

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2. Trustee checks were deposited.
- III. Determined if the IRS protects the Government's interests by effectively monitoring accounts of in-business debtors in bankruptcy status to ensure post-petition compliance.
- A. Interviewed Insolvency Unit managers and processing clerks to identify and evaluate:
1. Processes and procedures to monitor post-petition compliance.
 2. Processes and procedures used when post-petition non-compliance occurs.

From the AIS Open Database as of October 2000, selected a judgmental sample of 80 of 224 Chapter 11 business cases for which a bankruptcy petition had been filed between October 1, 1998, and December 31, 1999. We selected the period October 1, 1998, to December 31, 1999, in consideration of the filing requirements of the Employer's Quarterly Federal Tax Return (Form 941) and to evaluate Insolvency Unit actions on cases with post-petition non-compliance.⁶
 3. Determined whether a Transaction Code 136⁷ was input with the appropriate Last Return Amount (LRA) code⁸ for systemic monitoring of compliance.
 4. Reviewed the IDRS to identify post-petition pre-confirmation non-compliance and reviewed cases with delinquent returns or liabilities to determine whether the Insolvency Unit took appropriate actions to bring the debtors into compliance.

⁶ This includes filing and paying tax liabilities for tax periods ending after the bankruptcy petition date but prior to approval of the plan of reorganization by a bankruptcy judge.

⁷ The TC 136 suppresses Federal Tax Deposit (FTD) alerts and litigation transcripts. FTD alerts are used to determine an employer's compliance with employment tax deposit requirements. Litigation transcripts are computer-generated documents for accounts that are in bankruptcy status.

⁸ The other automated process, known as the Litigation Accounts Monitoring System, is an interface between the AIS and the Masterfile. This process is based on the input of the bankruptcy freeze code transaction and not Transaction Code 136 or the LRA code.

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Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and
Corporate Programs)

Parker F. Pearson, Director

Amy L. Coleman, Audit Manager

Darryl J. Roth, Senior Auditor

Todd M. Anderson, Auditor

Lynn R. Rudolph, Auditor

Mildred R. Woody, Auditor

**The Internal Revenue Service Protects the Government's Interests When Taxpayers
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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Compliance Services, Small Business/Self-Employed Division S:C
Director, National Program Filing and Payment Compliance, Small Business/Self-
Employed Division S:C
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Chief Counsel CC
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Commissioner, Small Business/Self-Employed Division S:C:CP:I

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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 the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; approximately \$145,000 overstated on 20 proofs of claim filed. This includes approximately \$143,000 on secured or priority claims and \$2,000 on unsecured general claims (see page 10).

Methodology Used to Measure the Reported Benefit:

We took a judgmental sample of 81 proofs of claim with bankruptcy petition dates between October 1, 1998, and March 31, 2000, to test the accuracy of claims filed. We determined the amounts by which claims were overstated by identifying the amounts and the priority (e.g., secured, unsecured priority, and unsecured general) of claims submitted to the Bankruptcy Courts. We then compared this information with the amounts and the priority we calculated based on Integrated Data Retrieval System (IDRS)¹ research.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; approximately \$98,000 understated on 16 proofs of claim filed. This includes approximately \$4,000 on secured or priority claims and \$94,000 on unsecured general claims (see page 10).

Methodology Used to Measure the Reported Benefit:

We took a judgmental sample of 81 proofs of claim with bankruptcy petition dates between October 1, 1998, and March 31, 2000, to test the accuracy of claims filed. We determined the amounts by which claims were understated by identifying the amounts and the priority (e.g., secured, unsecured priority, and unsecured general) of claims submitted to the Bankruptcy Courts. We then compared this information with the amounts and the priority we calculated based on IDRS research.

¹ The IDRS is the IRS' computer system which employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Masterfile.

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Type and Value of Outcome Measure:

- Revenue Protection - Potential; approximately 16 taxpayers' proofs of claim were understated (see page 10).

Methodology Used to Measure the Reported Benefit:

We took a judgmental sample of 81 proofs of claim with bankruptcy petition dates between October 1, 1998, and March 31, 2000, to test the accuracy of claims filed. We determined the number of taxpayers affected by claims with understated amounts. We also determined claims with understated amounts by identifying the amounts and the priority (e.g., secured, unsecured priority, and unsecured general) of claims submitted to the Bankruptcy Courts. We then compared this information with the amounts and the priority we calculated based on IDRS research.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; approximately \$390,000 underpaid on 11 of 45 Chapter 11 cases where the bankruptcy payment plan was not appropriately or timely monitored (see page 12).

Methodology Used to Measure the Reported Benefit:

We took a judgmental sample of 45 Chapter 11 cases from the Confirmed Plan Delinquent Reports (delinquency reports) and determined if the Insolvency Unit was properly monitoring the bankruptcy payment plans. We used the amount shown as underpaid from the delinquency reports.

Type and Value of Outcome Measure:

- Revenue Protection - Potential; 11 of 45 taxpayer accounts were affected by improper monitoring of Chapter 11 bankruptcy payment plans (see page 12).

Methodology Used to Measure the Reported Benefit:

We took a judgmental sample of 45 Chapter 11 cases from the Confirmed Plan Delinquent Reports (delinquency reports) and determined if the Insolvency Unit was properly monitoring the bankruptcy payment plans. We used the number of taxpayers affected by improper monitoring of the bankruptcy payment plans.

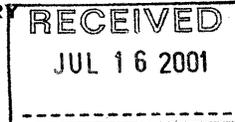
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Appendix V

Management's Response to the Draft Report



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



SMALL BUSINESS/SELF-EMPLOYED DIVISION

JUL 16 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe *Resender (Joe Kehoe)*
Commissioner, Small Business/Self-Employed

SUBJECT: Draft Audit Report - The Internal Revenue Service Protects the Government's Interests When Taxpayers File for Bankruptcy, but Some Controls Could Be Improved

Thank you for the opportunity to respond to the subject draft report. We appreciate your recognition that, overall, the IRS is effective in protecting the Government's interest in bankruptcy proceedings. The report acknowledges that the bankruptcy process involves many complex issues and the remedies for addressing non-compliance are often outside our control.

Our comments on the recommendations in this report are as follows:

IDENTITY OF RECOMMENDATION #1

The Commissioner, SB/SE Division, should advise local Insolvency Unit management of the programming error affecting the input of the LRA code, and determine if an automated process is available to input the LRA code for ongoing bankruptcies affected by the programming error.

ASSESSMENT OF CAUSE

Not posting the Last Return Amount Code for TC 136, from January 1, 2000 to March 25, 2001, was a Masterfile programming error. In offices that rely on TC 136 for monitoring post-petition compliance of in-business debtors, they may not be identified as non-compliant.

CORRECTIVE ACTION

We will issue an advisory to the field of the programming error on TC 136 and will include instructions for alternative ways to identify cases with post-petition non-compliance. In addition, we will work with the programmers for the Automated Insolvency System to identify the cases we processed during that period to find the most efficient method for re-inputting TC 136 on those cases.

IMPLEMENTATION DATE:
November 1, 2001

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RESPONSIBLE OFFICIALS

Director, Filing and Payment Compliance, Small Business/Self-Employed

CORRECTIVE ACTION MONITORING PLAN

The appropriate functional staff will advise the Director, Filing and Payment Compliance of any delay in completing the corrective action.

IDENTITY OF RECOMMENDATION #2

The Commissioner, SB/SE Division, should issue guidelines to ensure that claims are prepared using the proper IDRS research tools. These guidelines should also include local managerial review procedures to ensure that the proper IDRS research tools are used.

ASSESSMENT OF CAUSE

Under the Bankruptcy Code, we classify the various elements of a tax delinquency in different ways on a proof of claim. Interest must be broken down by the amount attributable to tax and the amount attributable to penalty. We have been working to automate the proof of claim process but until complete, we must use a manual procedure to compute the correct interest and penalty.

CORRECTIVE ACTION

We issued a memorandum, dated March 6, 2001, to the field as an instructional guide for using the new IDRS command code INTSTB to correctly compute interest and penalty on a proof of claim. We will issue a directive for field management to ensure they review this guide with the technical employees who prepare proofs of claims. We will also issue instructions that field management should periodically review procedures and to sample cases for the accuracy of the computations and claim determinations.

IMPLEMENTATION DATE:

November 1, 2001

RESPONSIBLE OFFICIALS

Director, Filing and Payment Compliance, Small Business/Self-Employed

CORRECTIVE ACTION MONITORING PLAN

The appropriate functional staff will advise the Director, Filing and Payment Compliance of any delay in completing the corrective action.

IDENTITY OF RECOMMENDATION #3

The Commissioner, SB/SE Division, should reinforce the need for local Insolvency Unit managers to ensure that bankruptcy technicians use the Confirmed Plan Delinquent Reports and take timely actions on delinquent bankruptcy payments.

The Internal Revenue Service Protects the Government's Interests When Taxpayers File for Bankruptcy, but Controls Could Be Improved

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ASSESSMENT OF CAUSE

As noted in the report, due to local court practices in the treatment of Chapter 11 debtors, as well as the involvement of outside stakeholders such as the Department of Justice, a national standard methodology for dealing with delinquent plan payments is not feasible. Local management should establish review schedules and action plans to address the issues impacting non-compliance for the caseload in that location.

CORRECTIVE ACTION

The Director of Filing and Payment Compliance will work with the Director of Compliance Services and the Insolvency Area managers to reinforce the need for local Insolvency management to monitor Chapter 11 payment compliance with the Confirmed Plan Monitoring Report. Also, we will establish a course of action for local offices to follow when they identify delinquent payments.

IMPLEMENTATION DATE:

November 1, 2001

RESPONSIBLE OFFICIALS

Director, Filing and Payment Compliance, Small Business/Self-Employed

CORRECTIVE ACTION MONITORING PLAN

The appropriate functional staff will advise the Director, Filing and Payment Compliance of any delay in completing the corrective action.

IDENTITY OF RECOMMENDATION #4

The Commissioner, SB/SE Division, should provide specific guidance for expectations on monitoring payments for Chapter 13 bankruptcies and determine how automated trustee systems can be used to assist in evaluating potential delinquencies.

ASSESSMENT OF CAUSE

As noted in the report, a trustee is responsible for ensuring payments are collected from Chapter 13 debtors and that distribution of funds is made to the creditors. Remedies for addressing delinquent payments will vary by location depending on trustee and court practices. Local management needs to establish review schedules and action plans that address the issues impacting non-compliance for the caseload in that location.

CORRECTIVE ACTION

The Director of Filing and Payment Compliance will work with the Director of Compliance Services and the Insolvency Area managers to provide specific guidance on expectations for monitoring Chapter 13 plan payments. We will also have each office review what data sources are available with their courts and trustees to develop an effective monitoring program for each location.

IMPLEMENTATION DATE:

November 1, 2001

**The Internal Revenue Service Protects the Government's Interests When Taxpayers
File for Bankruptcy, but Controls Could Be Improved**

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RESPONSIBLE OFFICIALS

Director, Filing and Payment Compliance, Small Business/Self-Employed

CORRECTIVE ACTION MONITORING PLAN

The appropriate functional staff will advise the Director, Filing and Payment Compliance of any delay in completing the corrective action.

OUTCOME MEASURES RESPONSE

We understand the methods used to determine the specific amounts noted in the report on proofs of claim and delinquent payments and will address those issues as discussed above in the corrective actions. The ultimate outcome would be determined by whether it would be paid in the circumstances of each case or by the limitations on the IRS to take action.

Please call Martha Sullivan, Deputy Director, Compliance Policy, Small Business/Self-Employed, at 202-622-5563 if you have any questions.