



Highlights of [GAO-04-95](#), a report to congressional requesters

## FINANCIAL MANAGEMENT

# Some DOD Contractors Abuse the Federal Tax System with Little Consequence

### Why GAO Did This Study

GAO was asked to determine (1) the magnitude of unpaid federal taxes owed by Department of Defense (DOD) contractors, (2) whether indications exist of abuse or criminal activity by DOD contractors related to the federal tax system, (3) whether DOD and the Internal Revenue Service (IRS) have effective processes and controls in place to use the Treasury Offset Program (TOP) in collecting unpaid federal taxes from DOD contractors, and (4) whether DOD contractors with unpaid federal taxes are prohibited by law from receiving contracts from the federal government.

### What GAO Recommends

GAO makes recommendations to DOD for complying with statutory guidance and supporting IRS efforts in collecting unpaid taxes, to IRS for improving the effectiveness of collection activities, and to the Office of Management and Budget (OMB) to develop options for prohibiting federal contract awards to businesses and individuals that abuse the federal tax system. DOD and IRS partially agreed; OMB did not agree. DOD and OMB also did not agree with GAO's matters for congressional consideration that DOD report on its collections through TOP and OMB report on policy options developed and actions taken against contractors that abuse the federal tax system. GAO reiterated support for its recommendations as well as for its suggestions to Congress.

[www.gao.gov/cgi-bin/getrpt?GAO-04-95](http://www.gao.gov/cgi-bin/getrpt?GAO-04-95)

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gregory D. Kutz at (202) 512-9095 or [kutzg@gao.gov](mailto:kutzg@gao.gov), or Steven J. Sebastian at (202) 512-3406.

### What GAO Found

DOD and IRS records showed that over 27,000 contractors owed about \$3 billion in unpaid taxes as of September 30, 2002. DOD has not fully implemented provisions of the Debt Collection Improvement Act of 1996 that would assist IRS in levying up to 15 percent of each contract payment to offset a DOD contractor's federal tax debt. We estimate that DOD could have collected at least \$100 million in fiscal year 2002 had it and IRS fully utilized the levy process authorized by the Taxpayer Relief Act of 1997. As of September 2003, DOD had collected only about \$687,000 in part because DOD provides contractor payment information from only 1 of its 16 payment systems to TOP. DOD had no formal plans at the completion of our work to provide payment information from its other 15 payment systems to TOP.

Furthermore, we found abusive or potentially criminal activity related to the federal tax system through our audit and investigation of 47 DOD contractors. The 47 contractors provided a variety of goods and services, including parts or support for weapons and other sensitive military programs. The businesses in these case studies owed primarily payroll taxes with some dating back to the early 1990s. These payroll taxes included amounts withheld from employee wages for Social Security, Medicare, and individual income taxes. However, rather than fulfill their role as "trustees" and forward these amounts to IRS, these DOD contractors diverted the money for personal gain or to fund the business.

For example, owners of two businesses each borrowed nearly \$1 million from their companies and, at about the same time, did not remit millions of dollars in payroll taxes. One owner bought a boat, several cars, and a home outside the United States. The other paid over \$1 million for a furnished home. Both contractors received DOD payments during fiscal year 2002, but one went out of business in 2003. The business, however, transferred its employees to a relative's company (also with unpaid taxes) and recently received DOD payments on a previous contract.

IRS's continuing challenges in collecting unpaid federal taxes also contributed to the problem. In several case studies, IRS was not pursuing DOD contractors due to resource and workload management constraints. For other cases, control breakdowns resulted in IRS freezing collection activity for reasons that were no longer applicable. Federal law does not prohibit contractors with unpaid federal taxes from receiving federal contracts. OMB is responsible for providing overall direction to governmentwide procurement policies, regulations, and procedures, and is in the best position to develop policy options for prohibiting federal government contract awards to businesses and individuals that abuse the tax system.