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The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress

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Summary

Under the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), the Internal Revenue Service (IRS) has acquired for the second time in its history the legal authority to hire private debt collection agencies (PCAs) to assist in the collection of certain individual tax debt. The grant of authority grew out of a proposal made by the Bush Administration in its budget request for the IRS in both FY2004 and FY2005.

This report focuses on IRS's current plan for hiring PCAs to collect delinquent individual taxes and the policy issues it raises. It begins with an examination of the scope of IRS's authority to use PCAs under the AJCA and concludes with a discussion of the main issues for Congress as it oversees IRS's efforts to implement and manage the private tax debt collection initiative. The report will be updated to reflect significant legislative action and new developments related to the initiative.

Under section 6303 of the Internal Revenue Code (IRC), the IRS is authorized to hire PCAs to assist in the collection of certain delinquent individual tax debt under rules intended to protect the rights of taxpayers and the confidentiality of taxpayer information. Basically, the IRS may use PCAs only to locate and contact taxpayers with an unpaid tax liability who have no outstanding disputes with the agency over the amount of taxes owed, and to arrange for the payment of those taxes. PCAs awarded collection contracts are required to follow a narrowly prescribed procedure in contacting the delinquent taxpayers assigned to them.

The Bush Administration's proposal to allow the IRS to hire PCAs provoked a heated debate in the 108th Congress over whether or not the proposal served the public interest, a debate that continues to simmer. Proponents argue that a large and growing inventory of delinquent individual tax debt undermines the public's confidence in the fairness of the tax system and encourages honest taxpayers to engage in tax evasion. In their view, since Congress has not provided the IRS with the resources required to shrink this inventory, it makes sense to authorize the IRS to hire private firms to collect this tax debt in a manner that protects taxpayer rights. Critics retort that the collection of taxes should not be outsourced because such a task is inherently governmental, and that it would be more cost effective to give the IRS the resources needed to pursue readily collectible individual tax debt than to hire PCAs to do the task, and that PCAs cannot be trusted to protect taxpayer rights.

Although critics arguably lost the first round of the debate, they have not ceased their efforts to derail the IRS's private tax debt collection initiative. In the current Congress, H.R. 1583 and H.R. 1621 would repeal the IRS's authority to enter into contracts with PCAs. Although the prospects in the current Congress for enactment of such a measure appear less than promising, the fundamental concerns underlying the two bills may lead Congress to pay close attention to critical aspects of the initiative as it unfolds and to re-examine periodically the question of whether it is promoting the public interest.

Contents

IRS's Statutory Authority to Use Private Debt Collection Agencies	2
Current Law	2
Previous Law	4
Legislative History of IRS's Current Authority	5
Steps Taken by the IRS to Implement the Private Tax Debt Collection Initiative	7
Main Arguments For and Against the Use of Private Debt Collection Agencies by the IRS	10
Pro	11
Con	13
Legislative Initiatives in the 109 th Congress to Modify the IRS's Existing Authority to Hire Private Debt Collection Agencies	15
Issues for Congress	16

The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress

Many Americans evidently see the collection of taxes as an inherently governmental function.¹ According to this view, collecting the federal taxes owed by individual and business taxpayers should be the primary and exclusive responsibility of a federal agency like the Internal Revenue Service (IRS). This view has been shared by the IRS and the President's Office of Management and Budget, both of whom have regarded the collection of taxes as a task that should be performed by government employees.²

Yet under the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), the IRS has acquired for only the second time in its history the legal authority to hire private debt collection agencies (PCAs) to assist in the collection of certain overdue or delinquent individual taxes.³ The grant of authority represented the culmination of a debate in Congress over the best way to shrink a large and growing inventory of potentially collectible federal tax debt against a backdrop of sizable federal budget deficits. It grew out of a proposal first unveiled by the Bush Administration in its budget request for FY2004. Though the proposal garnered enough support in the 108th Congress to be adopted, it also engendered a heated controversy — one that continues to reverberate in the current Congress. IRS's initial experience with the use of PCAs to assist in the collection of overdue individual taxes came in the form of a pilot project — known as the Contracting Out Collection Activities Project — authorized by the Treasury, Postal Service, and General Government Appropriations

¹ According to the results of a national poll conducted by the Global Strategy Group in October 2003, 66% of respondents opposed a plan unveiled earlier that year by the Bush Administration to use private debt collection agencies to assist the IRS in the collection of delinquent federal individual income tax debt; the margin of error was plus or minus four percentage points. See Amy Hamilton, "The 'Fight' Over the IRS Hiring Private Debt Collectors," *Tax Notes*, Oct. 20, 2003, p. 321.

² U.S. General Accounting Office, *Internal Revenue Service: Issues Affecting IRS's Private Debt Collection Pilot*, GAO/GGD-97-129R (Washington: July 18, 1997), p. 2.

³ The first well-documented case of the federal government outsourcing the collection of taxes occurred in 1872, when Congress granted the IRS's predecessor, the Bureau of Internal Revenue, the authority to hire no more than three individuals to assist in "discovering and collecting any money belonging to the United States." The program was ended two years later in the wake of an investigation conducted by the House Ways and Means Committee. The investigators concluded that such contracts served no useful purpose and undermined the existing apparatus of federal tax administration. For more information on this program, see Joseph J. Thorndike, "The Unhappy History of Private Tax Collection," *Tax Notes*, Sept. 20, 2004, pp. 1346-1349.

Act, 1996 (P.L. 104-52); the project lasted about one year before the IRS ended it under pressure from some Members of Congress and senior officials in the Clinton Administration.

This report focuses on IRS's current plan for hiring PCAs to collect delinquent individual taxes and the policy issues it raises. More specifically, it examines the scope of IRS's statutory authority to use PCAs under the AJCA, describes the steps taken so far by the IRS to implement this authority, elucidates the main arguments raised for and against the use of PCAs to collect overdue and unpaid individual taxes, and identifies legislative proposals in the 109th Congress that would affect IRS's use of PCAs. The report concludes with a brief discussion of the main issues for Congress as it oversees the IRS's nascent private debt collection initiative. It will be updated to reflect both significant legislative action affecting IRS's private tax debt collection initiative and noteworthy new developments related to its implementation.

IRS's Statutory Authority to Use Private Debt Collection Agencies

Current Law

The AJCA added section 6306 to the Internal Revenue Code (IRC). Under this section, the IRS has the authority to hire PCAs to assist with the collection of delinquent individual taxes in a manner that protects taxpayer rights. An individual taxpayer is considered delinquent if he or she fails to pay his or her taxes by the date they are due after having been notified by the IRS of the amount owed.

IRC section 6306 also sets forth a set of restrictive guidelines to govern IRS's use of PCAs. First and foremost, the IRS may use PCAs only to locate and contact taxpayers with an unpaid tax liability who have no unresolved disputes with the IRS over the amount of taxes owed, and to arrange for payment of those taxes. Most of these taxpayers are expected to belong to one of two categories: (1) those who have filed a return indicating an amount due but have failed to pay the balance in full, and (2) those who have been assessed an additional tax by the IRS in its review of their returns and made several payments but failed to pay the balance due in full. No cases whose resolution requires the exercise of discretion by the IRS — such as disputes over the interpretation of the tax code or the amount of tax assessed by the IRS — are to be handled by PCAs.

In addition, PCAs awarded tax collection contracts are required to follow a narrowly prescribed procedure when contacting the delinquent taxpayers assigned to them. Their initial contact has to be in the form of a letter reminding the individual of an unpaid and overdue tax liability. If his or her last known address is incorrect, the PCA is authorized to track down the correct address. If the letter does not lead to a prompt payment of the tax debt, a PCA may try to reach the taxpayer by telephone and request that he or she pay the balance immediately. If a taxpayer responds that he or she cannot do so, the PCA can offer the taxpayer the option of erasing the tax debt by making installment payments over a period of up to five years. If the taxpayer does not agree to such a payment plan, the PCA is authorized to

obtain certain financial information about the taxpayer and turn it over to the IRS for further action. Once a PCA has gathered this information, it is barred from having further contact with the taxpayer.

Employees of PCAs are expected to adhere to the same high standards for collection practices that apply to IRS employees. Nevertheless, if a taxpayer who is contacted by a PCA accuses it of acting unlawfully or abusively and sues for civil damages, the IRS may not be held legally liable for the actions of the PCA. And if the IRS determines that a PCA has engaged in an unauthorized collection activity under section 1203 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA98), it may impose a number of penalties, including revoking the firm's tax collection contract and barring it from bidding on such contracts in the future.

PCAs awarded tax collection contracts must also heed a set of rules intended to safeguard the rights of individual taxpayers with outstanding tax debts. Specifically, the employees of PCAs assigned to work on the contracts must know and abide by the provisions of the Fair Debt Collection Practices Act of 1996 (FDCPA), which proscribes collection practices deemed in the act to be unreasonably intrusive or abusive to debtors.⁴ The same employees are also bound by the same legal protections of taxpayer rights and privacy that IRS employees are required to observe. As a result, PCA employees are subject to civil and criminal penalties for the unlawful disclosure of taxpayer information to the same extent as IRS employees under IRC section 6103. Additionally, PCAs must inform the taxpayers they contact of their right to seek assistance from the IRS National Taxpayer Advocate, whose taxpayer assistance orders under IRC section 7811 are to apply to PCAs and the IRS with the same force. In the view of one analyst, IRC section 6306 confers on taxpayers the same rights and protections in dealing with PCAs that they enjoy when the IRS collects taxes, as well as the added protections found in the FDCPA.⁵

In addition, a PCA may not use subcontractors to contact taxpayers, provide quality assurance services, or write debt collection notices. If a PCA wishes to hire a subcontractor for some other purpose, it must obtain the prior approval of the IRS.

All revenue collected through the efforts of PCAs is to go into a revolving fund. But none of this revenue can be received or processed by PCAs; only the IRS can do so. The IRS may use up to 25% of the money in the fund to compensate PCAs for their services. It remains unclear what criteria the IRS will use in determining exactly how much compensation to offer a PCA for the specific services it provides; IRC section 6306 offers no guidance on this matter. In addition, the IRS is permitted to transfer up to 25% of the amount in the revolving fund to its budget for tax law enforcement in a fiscal year. How much revenue is likely to be collected through the use of PCAs in accordance with the guidelines set forth in the AJCA is also a matter of some uncertainty. The congressional Joint Committee on Taxation has estimated that the use of PCAs under the conditions set forth in the AJCA should lead to the

⁴ For example, PCAs would not be allowed to communicate with taxpayers at unusual or inconvenient times or places and would be barred from harassing or threatening taxpayers.

⁵ Mark T. Resnick, "Outsourcing Federal Tax Collection," *Houston Business and Tax Law Journal*, vol V, 2005, p. 25.

collection of \$1.356 billion in revenue from FY2005 through FY2014.⁶ By contrast, the IRS maintains that PCAs will bring in about \$7.2 billion in overdue taxes during the same period.⁷

IRS's current statutory authority to use PCAs comes with at least one notable string attached: periodic congressional review of the results of the private tax debt collection initiative. Under the AJCA, the IRS is obligated to report every other year — beginning in 2005 — to the House Ways and Means and Senate Finance Committees on various aspects of the initiative, including a comparison of its overall costs and benefits; its impact on IRS enforcement staffing levels; its impact on the inventory of unpaid tax assessments; the amount of revenue collected; an evaluation of the performance of contractors; and an assessment of whether any collection techniques used by contractors have proved successful and, if so, whether those techniques should be adopted by the IRS.⁸

Previous Law

Before the enactment of the AJCA, the IRS lacked the legal authority to hire private companies to assist in the collection of delinquent taxes — with one notable but short-lived exception, which is described below. Since 1954, the federal tax code has implied that only the IRS is authorized to collect taxes: under IRC Section 6301, only officers, employees, and agencies of the Treasury Department may collect “taxes imposed by the internal revenue laws.” This limitation on the exercise of tax collection authority was included in the Debt Collection Improvement Act of 1996 (DCIA, P.L. 104-134), which permits all federal agencies except the IRS to enter into contracts with PCAs to collect overdue non-tax debts owed to the federal government. Bolstering the legal barriers to the outsourcing of federal tax collection were several provisions of the Federal Activities Inventory Reform Act of 1998 (FAIR), which bars federal agencies from using the private sector to conduct activities regarded as inherently governmental. According to Section 5 of the act, an activity is considered inherently governmental if “it is so intimately related to the public interest as to require performance by Federal Government employees,” and if it entails the “exercise of discretion” in applying governmental authority or the “making of value judgments relating to monetary transactions and entitlements.”⁹

The short-lived exception occurred in 1996 and 1997, when Congress gave the IRS the authority to establish and manage a pilot project involving the use of PCAs. In the appropriations bills covering the Treasury Department and its bureaus enacted

⁶ U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 4520, the “American Jobs Creation Act of 2004,”* JCX-69-04 (Washington: Oct. 7, 2004), p. 9.

⁷ Warren Rojas, “IRS Works to Lay Foundation for Private Collection Agencies,” *Tax Notes*, April 4, 2005, p. 23.

⁸ The initial report on events in 2005 is due to be submitted to the committees in January 2006. Floyd Williams of the IRS said in an e-mail message sent on January 9, 2006, that the report is likely to be released near the end of that month.

⁹ 31 U.S.C. 501.

for both FY1996 and FY1997, Congress authorized the IRS to spend up to \$13 million each year to test the use of PCAs in the collection of delinquent individual taxes. In response, the IRS set up a program under which the PCAs it hired assisted IRS collection personnel by locating and contacting individual taxpayers to remind them of their unpaid and overdue tax liabilities and inform them of payment options. Taxpayers who agreed to a payment plan were referred to someone in IRS's collection division to arrange a payment schedule. Under the program, only IRS employees could collect funds to settle delinquent accounts. Participating PCAs received a fixed fee for their services, regardless of the amount of overdue taxes collected as a result.

Deep disappointment with the results of the program in Congress and the Clinton Administration led the IRS to cancel it in 1997. These results and the main factors contributing to them were examined in a report issued by the General Accounting Office (GAO) in July 1997.¹⁰ According to the report, through the end of January 1997, PCAs had contacted 14,000 out of 153,000 targeted taxpayers and collected \$3.1 million in overdue taxes. More important, the total cost of the program exceeded the total amount collected: through January 1997, expenditures for the design, start-up, and administration of the program came to \$3.1 million; a total of about \$1.0 million had been paid to PCAs for their services; and the estimated opportunity cost of using IRS collection staff to assist with the pilot program was \$17 million. The GAO blamed the failure of the program to live up to initial expectations on several factors, including limitations on the work PCAs were allowed to undertake, the number and types of cases referred to PCAs, and problems that arose in using IRS's computer system to identify, select, and transmit collection cases to PCAs.

Legislative History of IRS's Current Authority

IRS's current authority to hire PCAs has its origins in the Bush Administration's budget request for the IRS in both FY2004 and FY2005. Each request included a proposal to allow the IRS to hire PCAs under a set of restrictive guidelines to help the agency reduce the swelling inventory of overdue and unpaid individual taxes.¹¹

According to the proposal, the use of PCAs would be limited to locating individual taxpayers with unpaid and overdue tax liabilities who are not contesting their tax assessments, contacting them to request full payment of their tax debts, offering the option of paying in installments over three years if full payment could not be made immediately, and obtaining certain financial information about the taxpayer and transmitting it to the IRS for further action if no such agreement could be reached. PCAs would be assigned cases that were likely to be resolved with one or two phone calls and required no exercise of discretion by the IRS. Most of these cases would focus on taxpayers who had filed tax returns showing that taxes were owed but not paid, or who made three or more voluntary payments to cover a tax

¹⁰ U.S. General Accounting Office, *Issues Affecting IRS' Collection Pilot*, GGD-97-129R (Washington: July 18, 1997).

¹¹ For a summary of the Administration's proposal, see Amy Hamilton, "Bush Proposes Private Agencies Collect Know Tax Delinquencies," *Tax Notes*, Feb. 10, 2003, pp. 885-887.

assessment by the IRS in its review of the returns but had stopped the payments short of paying off the balance due. All revenue collected through the activities of PCAs would go into a revolving fund, from which they would be compensated for their services. Compensation would be based on a number of factors, including the quality of service provided, taxpayer satisfaction, and case resolution. Employees of PCAs would be subject to the same rules regarding the protection of taxpayer rights and the confidentiality of taxpayer information that apply to IRS employees. Taxpayers who believe their rights were violated by the actions of a PCA would be allowed to sue the company for civil damages. But the federal government could not be held liable for any unauthorized act committed by a PCA.

Clearly, there are numerous parallels between the Administration's proposal and the provision in the AJCA granting the IRS the authority to hire PCAs.

In asking Congress to grant the IRS the legal authority to use PCAs, the Bush Administration was addressing several pressing policy issues. Perhaps the paramount issue was the rising amount of delinquent individual income tax debt and its disturbing potential to encourage more and more law-abiding taxpayers to engage in tax evasion. In testimony delivered at a hearing held by the House Ways and Means Subcommittee on Oversight on May 13, 2003, IRS Commissioner Mark W. Everson noted that from early 2000 to March 2003, the amount of individual income tax debt deemed uncollectible by the IRS because of shifting enforcement priorities increased from about \$7 billion to over \$13 billion. Another issue was the continuing inability of the IRS to gain the resources necessary to reduce the growing inventory of delinquent individual tax debt. From FY1996 through FY2003, the number of revenue officers assigned to handle delinquent accounts fell from about 5,500 to about 3,500, a decrease of 36%. IRS officials have attributed the decline to an increase in workload in other essential operations (e.g., processing returns, issuing refunds, and responding to mail from taxpayers); a stronger emphasis on taxpayer service and support; increases in operating costs (e.g., rent, mail, and wages) not covered by appropriated funds; and a reluctance on the part of Congress to endorse the Bush Administration's repeated requests for larger budgets for tax collection.¹² The decline in collection staff contributed to an expanding gap between the number of cases assigned for collection and the number of cases closed each year; by May 2003, the IRS was deferring action on one of every three collection cases.¹³ In the face of these trends, senior IRS officials came to the conclusion that the only feasible option for shrinking the growing inventory of delinquent individual tax debt was to outsource some of the collection work to the private sector.

Several legislative initiatives in the 108th Congress sought to implement the main elements of the Administration's proposal. Specifically, H.R. 1169, H.R. 2896, S. 2, and S. 1637 all contained provisions that would have given the IRS the legal authority to hire PCAs to assist with the collection of individual tax debt under a set of restrictive guidelines. The AJCA is the product of the conference agreement on

¹² U.S. General Accounting Office, *Tax Debt Collection: IRS Is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492 (Washington: May 2004), p. 5.

¹³ *Ibid.*, p. 5.

H.R. 4520 approved by the House and Senate. On the issue of allowing the IRS to enter into tax collection contracts with private firms, the agreement (H.Rept. 108-755) combined elements from the House-passed version of the bill (which incorporated the provision on PCAs from H.R. 2896), and the Senate-passed version (which included the provision on PCAs from S. 1637).

Steps Taken by the IRS to Implement the Private Tax Debt Collection Initiative

The IRS evidently began to lay the foundation for a viable plan to use PCAs in the collection of delinquent individual tax debt in late 2001, about three years before the enactment of the AJCA. A key objective of the planning effort was to come up with an approach that would collect a substantial amount of overdue and unpaid individual taxes while avoiding the key mistakes that led to the termination of the 1996 pilot project.

A PCA project team was formed within the IRS in October 2001. One of its first activities was to meet with representatives from the revenue agencies of five state governments and two federal agencies with experience in administering debt collection programs that rely on the use of private contractors.¹⁴ Among the issues explored by the team were the structure and management of contracts for the private collection of public debts, data security, and the protection of taxpayer rights. The team also met five times with representatives from three PCAs between May and October 2002 to discuss a variety of issues related to collection case management, including case screening criteria, electronic data sharing capabilities, data security requirements, and potential compensation schemes.

In a sign that the IRS was making significant progress in assembling a plan for a tax debt collection involving the use of PCAs, the agency issued a so-called Request for Quotation (RFQ) in February 2003 that focused on its emerging plan to hire PCAs.¹⁵ The RFQ's primary purpose was to promote awareness among prospective contractors of the IRS's growing interest in the use of PCAs and to solicit useful feedback from PCAs on what requirements should be included in collection contracts.

¹⁴ Department of the Treasury, Treasury Inspector General for Tax Administration, *Efforts to Develop a Successful Collection Contract Support Program Could Be Enhanced*, Audit Report 2003-30-075 (Washington: March 2003), p. 2.

¹⁵ Generally, a Request for Quotation (RFQ) is a method used by federal agencies to describe to prospective contractors the products and services that may be purchased and the terms and conditions that would apply. RFQs serve the useful purpose of informing the private sector about the procurement needs of federal agencies and informing federal agencies about the depth of interest in the private sector in bidding on specific contracts. A response by a prospective contractor to a RFQ is not considered an offer and thus cannot be accepted by a federal agency as a binding contract. Each RFQ has a unique identifying number; the RFQ issued by the IRS in February 2003 was TIRNO-03-H-0001.

In May 2004, the GAO released a report assessing IRS's readiness to implement a plan for using PCAs similar to the Bush Administration's proposal. GAO made the assessment largely on the basis of what it called the "five broad factors that are critical to the success of a proposed program for contracting with PCAs to collect tax debt."¹⁶ One factor concerned the goals for the program; a second addressed the resources needed by the IRS to achieve those goals; a third focused on the nature of the work that would be assigned to PCAs; a fourth dealt with the protection of taxpayer rights and privacy; and the fifth stressed the importance of monitoring the performance of PCAs and periodically comparing the results and costs of the program with its main goals. The report concluded that though the IRS had taken a number of steps to address each of the factors, considerable work needed to be done before the agency could begin to assign collection cases to PCAs.

With the enactment of the AJCA, the IRS shifted its focus from devising a plan to outsource the collection of certain individual tax debt to implementing a specific plan (i.e., the one contained in the act) with a set of deadlines. On April 27, 2005, the agency issued a second RFQ (TIRNO-05-Q-00050) soliciting bids for contracts to assist with the collection of delinquent tax debt. In the document, the IRS announced that it would implement its private tax debt collection initiative in two stages: "a limited implementation in FY2005, (followed by) a full implementation in FY2007." In the first stage, the IRS would enter into contracts with "approximately three" PCAs. To be eligible to bid on a contract, a firm had to be registered as a debt collection agency with the General Services Administration (GSA) and be a current supplier of debt collection services to a federal agency "under GSA Schedule 520-4." Only 23 of the 87 PCAs authorized by the GSA to perform debt collection for federal agencies as of early 2005 were qualified to bid for the IRS contracts under these terms. In addition, all contractor and subcontractor employees had to be U.S. citizens or permanent resident aliens. Each of the contracts would last 12 months and could be extended up to six months a total of three times. Firms interested in bidding for a contract had to provide the IRS with extensive details on their past performance, pricing, licenses, and bonding. Applications were due by 12:30 p.m. on June 1, 2005. In late May, the deadline was pushed ahead to June 7, 2005. At the time, the IRS said it intended to award the contracts by the end of July and to start the initial phase of the collection work in January 2006.

The RFQ offered myriad details about the guidelines that would govern the collection work to be done by PCAs and the terms of their compensation. Basically, they would be assigned collection cases involving individual taxpayers who filed tax forms 1040, 1040A, or 1040EZ, owed a balance of \$25,000 or less on the assessed tax, and were not contesting their tax liabilities. The RFQ noted that as of December 2004, the IRS had classified \$7.7 billion in delinquent tax debt as "potentially available for the limited implementation of private debt collection," and that about \$5.5 billion of this amount was considered "low-priority work load that would likely be eligible for placement with PCAs." In addition, PCAs' contacts with taxpayers would be strictly monitored. For example, all letters they intend to send to taxpayers would have to be approved by the IRS before they could be mailed, and the IRS would have the right to monitor phone conversations between contractors and

¹⁶ U.S. General Accounting Office, report GAO-04-492, p. 9.

taxpayers. To insure that contractors are complying with the terms of the contract, they would have to give the IRS “full, free, and uninhibited access” to all facilities owned by the contractors so that the agency can verify that contractors were taking all necessary and appropriate steps to safeguard the “security, integrity, and confidentiality” of taxpayer information. Contractors that are the target of repeated complaints could lose some or all of the compensation they are owed. The RFQ also explained how contractors would be paid for their services: PCAs would be paid 24% of a collection from a single taxpayer of less than \$1,500; the percentage would be smaller for larger amounts, falling to 21% for collections of more than \$10,000.

The solicitation of bids under the RFQ came to a sudden halt when a PCA based in Houston, Texas — Universal Fidelity LP — filed a lawsuit in the U.S. Court of Federal Claims on June 6, 2005, challenging the legality and fairness of the procedure being used by the IRS to award the first round of contracts for the private tax debt collection initiative.¹⁷ At the time, Universal Fidelity was one of the 87 contractors approved by the GSA for debt collection under Schedule 520-4, but it was ineligible to bid for a contract because the company was not performing debt collection for a federal agency under a current work order. The lawsuit (*Universal Fidelity LP v. United States*, Fed. Cl., No. 05-602C) alleged that the IRS’s solicitation of bids violated the Competition in Contracting Act of 1984 by setting conditions that were “arbitrary, capricious, and unduly restrictive” and by unfairly excluding firms that could meet the agency’s minimum requirements. It asked the court to issue temporary and permanent injunctions to prevent the IRS from awarding contracts under the RFQ. In its formal response to the lawsuit, the IRS argued that hiring contractors with active work orders would minimize the time needed to begin the first phase of the debt collection initiative, greatly lessen the risk of problems arising because contractors are unfamiliar with the laws and regulations governing the use of PCAs in the public sector and the information systems used by the contractors are incompatible with those used by the IRS, and increase the IRS’s prospects of reaching its short-term goal of collecting a minimum of \$4 million in revenue in FY2006 from the collection activities of PCAs — 25% of which would be transferred to the IRS’s budget for enforcement activities.

The judge presiding over the case issued a temporary ruling on July 25 which stated that the IRS could not proceed with its original plan for bid solicitation, and that it had to open the bidding to all 87 contractors approved by the GSA for debt collection work.¹⁸ In his ruling, the judge noted that excluding contractors without current work orders “irrespective of their experience or ability is arbitrary and capricious in the circumstances presented.” He also maintained that the IRS could achieve its aims “more fairly and efficiently by other means, including other mandatory minimum requirements.” The ruling was not made final because the judge wanted to give the IRS “an opportunity to make alternative plans and to take appropriate actions in a prompt and efficient manner.” On July 29, the IRS agreed

¹⁷ Alison Bennett, “Universal Fidelity Sues IRS Over Debt Collection Initiative,” *Daily Report for Executives*, Bureau of National Affairs, July 18, 2005, p. G-10.

¹⁸ Diane Freda, “Federal Judge Says He Will Stop Debt Collection Initiative as Planned,” *Daily Report for Executives*, Bureau of National Affairs, July 28, 2005, p. G-11.

to abide by the judge's ruling in a report it filed with the court, and on August 4, it cancelled the RFQ that provoked the lawsuit.

About two weeks later, the IRS asked the judge to dismiss Universal Fidelity's lawsuit on the grounds that it no longer was valid in light of the agency's decision to change its bid solicitation to bring it into compliance with the judge's ruling. In another ruling issued on September 28, the judge concurred with the IRS and dismissed the case. In his view, the controversy underlying it had been resolved.¹⁹ At the same time, he said that Universal Fidelity could file a motion to re-open the case if it were to find that the revised solicitation for bids issued by the IRS poses the same problems as the earlier one.

Delivering on its pledge, the IRS released a new RFQ dealing with the first phase of its debt collection initiative on October 14. In it, the IRS reiterated its intention to hire three PCAs to assist in the collection of delinquent individual tax debt in 2006. The IRS also said it planned to award the contracts in February 2006 and to launch the first phase of the collection program in June 2006, assuming no major problems arise. All firms approved by the GSA to undertake debt collection work for federal agencies under Federal Supply Schedule 520-4 are eligible to submit bids; a firm's eligibility no longer would hinge on whether or not it has a current work order with a federal agency for debt collection. The contracts are to cover one year, with an option to extend them another year. A key consideration in determining which bidders win contracts is their "relevant" experience in performing debt collection work. To quote from the RFQ: "vendors' experience should demonstrate a wide variety of collection experience, on a nationwide basis, and should also demonstrate a level of accomplishment in a competitive environment."²⁰ Most of the remaining terms of the solicitation were identical to those of the one issued in April, including the proposed compensation plan for contractors. If no problems arise, the initiative could be expanded in January 2008 to as many as 12 contractors. (Additional details on the RFQ can be obtained through the IRS's website at [<http://www.irs.gov/opportunities/procurement>].)

Main Arguments For and Against the Use of Private Debt Collection Agencies by the IRS

The Bush Administration's proposal to give the IRS the legal authority to hire PCAs provoked a heated and protracted controversy over whether or not such a step would promote the public interest. Proponents and opponents of the private tax debt collection initiative forcefully stated their cases in several congressional hearings

¹⁹ Diane Freda, "Judge Dismisses Universal Fidelity Lawsuit Challenging IRS Debt Collection Procurement," *Daily Report for Executives*, Bureau of National Affairs, Oct. 7, 2005, p. G-6.

²⁰ Diane Freda, "IRS Issues New Request for Quotes In Private Debt Collection Initiative," *Daily Report for Executives*, Bureau of National Affairs, Oct. 7, 2005, p. G-16.

held in recent years.²¹ While it can be argued that proponents prevailed in that the 108th Congress authorized the use of PCAs by the IRS through the passage of the AJCA, the controversy persists, kept alive mainly by the continuing efforts of lawmakers opposed to the initiative to derail it or block or delay its implementation. Among other things, lingering opposition to the initiative means that Congress is likely to re-visit the issue of whether or not it serves the public interest in the not-too-distant future. For this reason alone, it is useful for lawmakers to have a firm grasp of the main arguments for and against the initiative. They are discussed below.

Pro

The main arguments in favor of allowing the IRS to use PCAs in the collection of delinquent federal individual tax debt are rooted in recent trends in the federal budget, the inventory of overdue and uncollected federal individual income taxes and IRS's resources for enforcement. Those who have backed the private tax debt collection initiative, led by IRS Commissioner Mark Everson, cite the recent growth in this inventory and decline in the IRS workforce engaged in enforcement activities against a backdrop of a large and growing federal budget deficit as the primary justification for their support. As of September 2005, \$13.5 billion in individual income tax debt (including accrued interest and penalties) was considered uncollectible because the IRS lacked sufficient resources to work on the delinquent accounts; five years earlier, the total amount was about \$9.0 billion.²² A key factor behind this expansion was a significant rise in the workload of the average IRS enforcement agent in recent years, one driven largely by a 26% decline in the IRS workforce engaged in enforcement activities and a 12% increase in the volume of individual tax returns from 1996 to 2003. From FY2001 to FY2005, the federal budget shifted from a surplus of \$128 billion to a deficit of \$319 billion. In its latest baseline outlook for the federal budget, the Congressional Budget Office projected a budget deficit of \$314 billion in FY2006 and \$324 billion in FY2007.²³

In a bid to counter these trends, the Bush Administration has repeatedly sought to channel more resources into enforcing compliance with the tax laws in the hope of gradually collecting a large share of the delinquent tax debt, but Congress has shown what might be described as a steadfast reluctance to provide the requested funding. For instance, the Administration asked Congress to appropriate \$3.881 billion for tax compliance services in FY2003 so that the IRS could expand its workforce for that purpose to a full-time equivalent (FTE) of 45,959; Congress eventually approved a budget for tax compliance services of \$3.623 billion, which meant that the IRS filled 1,569 fewer FTE positions in compliance services than it had intended.

²¹ See, for example, a hearing held May 13, 2003, by the House Ways and Means Subcommittee on Oversight on the topic of using private collection agencies to improve the collection of delinquent federal tax debt.

²² Based on data obtained in an e-mail message from Floyd Williams of the IRS on Dec. 14, 2005.

²³ U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington: August 2005), p. x.

Proponents of the use of PCAs to assist in the collection of delinquent individual tax debt contend that the expanding backlog of cases involving individual taxpayers — who are aware of their tax liabilities but have not paid them in the belief that the IRS is unlikely to pursue them because it lacks the enforcement staff — gives rise to some serious concerns.

First and foremost, in their view, is that the expanding backlog of cases is eroding the public's confidence in the fairness and integrity of the federal income tax system and encouraging honest and law-abiding taxpayers to shirk their legal obligations under the tax code.

Another major concern of proponents stems from the previous one: if enough honest and law-abiding taxpayers were to stop paying the taxes they legally owe in the belief that they will not be caught by the IRS, the gap between the amount of federal taxes owed and the amount paid could worsen dramatically. This gap, which is often referred to as the tax gap, is largely a product of tax evasion by individual and business taxpayers. According to proponents, an increasing tax gap driven by a surge in tax evasion would raise several difficult policy issues for lawmakers at a time of large and growing federal budget deficits. Not only would federal revenues be smaller than they should be, but the economic costs arising from tax evasion would also become more of a problem. Foremost among those costs are unequal tax burdens among individuals with similar incomes, higher effective tax rates for honest and law-abiding taxpayers, and a reallocation of resources to activities where tax evasion has a relatively high chance of success.²⁴

In light of these concerns, proponents maintain that if Congress is unwilling to give the IRS the resources it needs to pursue the delinquent individual tax debt considered readily collectible — the so-called low-hanging fruit on the tax-evasion tree — then a simple, feasible, and cost-effective solution would be to permit the IRS to hire PCAs to do the work under a set of stringent rules governing their dealings with taxpayers. At a minimum, the rules should seek to protect the privacy of taxpayers and the confidentiality of their tax information and to prohibit abusive or unreasonably intrusive collection practices. These aims, according to proponents, could be achieved through a combination of new statutory amendments, explicit contractual provisions, and aggressive IRS oversight.

In addition, proponents argue that the use of PCAs would allow the IRS to focus its limited enforcement resources on more complex and challenging cases with potentially greater revenue gains.

They also insist that any initiative to use PCAs could be designed so that it does not violate or contradict any federal statutes declaring the collection of taxes to be an inherently governmental function. One workable option, in their view, would be to allow PCAs to handle cases that do not entail the exercise of discretion over the enforcement of tax law. Such an approach implies that PCAs would not be assigned

²⁴ For more details on these costs, see Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes*, 3rd edition (Cambridge, MA: MIT Press, 2004), pp. 176-180.

cases involving disputes between taxpayers and the IRS over the interpretation of the tax code or the amount of assessed tax.

Con

Opposition to the IRS's private tax debt collection initiative — led by the National Treasury Employees Union (NTEU), the Tax Executives Institute, and certain consumer advocacy groups — is motivated by a different set of concerns.

A primary concern is that the collection of taxes is an inherent function of government and thus cannot be delegated under any circumstances to private entities. Opponents claim this view rests on a solid foundation of legal precedent. Of particular importance, in their view, are IRC section 6301 and the relevant provisions of DCIA and FAIR, all of which limit the exercise of the power to collect taxes to a federal agency such as the IRS.

Another major concern is that the initiative is likely to prove needlessly costly. In testimony delivered before the House Ways and Means Subcommittee on Oversight in May 2003, Colleen Kelley, the National President of the NTEU, said that hiring PCAs to collect delinquent individual tax debt under the Bush Administration's proposal would eventually yield \$3 in revenue for each dollar paid to PCAs for their services, but that hiring a sufficient number of IRS enforcement agents for the same purpose would eventually yield \$31 in revenue for each dollar spent on wages and benefits for the new staff.²⁵ Her calculations were based on a comparison of a proposal made in 2002 by then IRS Commissioner Charles Rossotti to allow the IRS to hire an additional 5,450 employees to focus on collecting unpaid tax debts with the Administration's proposal to hire PCAs for the same purpose.²⁶

Opponents also warn that the initiative carries an unacceptably large risk that the rights of many taxpayers will be violated and the identities of many taxpayers will be stolen. Some of this concern springs from a widespread expectation among critics that the IRS will lack the needed resources and competence to supervise PCAs and monitor their compliance with contractual provisions aimed at safeguarding taxpayer rights. In support of this belief, critics cite numerous alleged violations of the FDCPA by some of the PCAs participating in the pilot tax debt collection initiative launched by the IRS in 1996 and terminated in 1997 and the failure of the IRS to cancel the contracts of the firms found to violate the act, even though it had the

²⁵ U.S. Congress, House Ways and Means Committee, Subcommittee on Oversight, *Use of Private Collection Agencies to Improve IRS Debt Collection*, 108th Cong., 1st sess., May 13, 2003 (Washington: GPO, 2004), p. 29.

²⁶ Under the most optimistic projection, the Administration's plan to use PCAs would eventually result in the collection of \$13 billion in delinquent individual tax debt at a cost of \$3.25 billion, assuming PCAs receive 25% of the total amount collected as compensation for their services. By contrast, Rossotti estimated in 2002 that the IRS could eventually collect \$9.47 billion in collectible tax debt at a cost of \$296.4 million by adding 5,450 full-time employees to its enforcement staff.

authority to do so.²⁷ They also point to the findings of a 2004 report on IRS's oversight of its contractors by the Treasury Inspector General for Tax Administration (TIGTA). The report has not been released to the general public because of concerns that its findings could compromise the security of IRS's computer operations. It concluded that the IRS was vulnerable to the unauthorized disclosure of taxpayer information and the spread of computer viruses in its information systems because of the access to its computer systems that the agency granted four private contractors in 2003. The report also recommended that the IRS tighten its supervision of contractors in the future to limit its vulnerability to such problems.²⁸ Beyond any concerns about the IRS's ability to oversee PCAs, critics say the initiative is likely to lead to many instances of wrongful disclosure of taxpayer information. The statute granting the IRS the authority to hire PCAs (IRC section 6306) places no restrictions on what taxpayer information may be released to PCAs. The wrongful disclosure of confidential taxpayer information, they maintain, would increase the likelihood of identity theft and the significant economic losses it can entail. According to critics, the best way to avoid the twin risks of taxpayer identity theft and violation of taxpayer rights while collecting substantial amounts of delinquent individual tax debt is to hire and train additional IRS enforcement agents for that purpose.

Lastly, critics of the initiative say it should be scrapped because it opens the way to the use of illegal and abusive collection practices by PCAs. In their view, paying PCAs a certain percentage of the revenues collected through their contacts with taxpayers — in effect, paying them a commission for the overdue revenue they collect — is likely to encourage them to resort to harassment and other overly aggressive collection practices in an effort to maximize their earnings from the contracts. Critics also contend that such a compensation scheme is blatantly inconsistent with section 1204 of the RRA98, which effectively bars IRS management from linking the compensation paid to enforcement staff to how much they collect from delinquent taxpayers.²⁹ Moreover, critics say the recent conduct of PCAs suggests they are very likely to resort to overly aggressive collection techniques: the Federal Trade Commission has received more consumer complaints about PCAs than any other specific industry in recent years.³⁰

²⁷ According to Colleen M. Kelley of the NTEU, “contractors (for the 1996 pilot project in using PCAs managed by the IRS) violated the FDCPA and did not protect the security of sensitive taxpayer information.” She also has said that “an IRS internal audit report found that contractors made hundreds of calls to taxpayers outside of the time restrictions of the FDCPA, and calls were placed as early as 4:19 a.m.” See House Ways and Means Subcommittee on Oversight, *Use of Private Collection Agencies To Improve IRS Debt Collection*, p. 30.

²⁸ Allen Kenney, “IRS Needs Tighter Control of Contractors, TIGTA Finds,” *Tax Notes*, June 28, 2004, p. 1579.

²⁹ Section 1204(a) of RRA98 states that “the Internal Revenue Service shall not use records of tax enforcement results (1) to evaluate employees; or (2) to impose or suggest production quotas or goals with respect to such employees.”

³⁰ According to a recent report by the Federal Trade Commission, “the number of consumer complaints filed in 2004 against third-party (debt) collectors (58,687) was higher than the (continued...) ”

Legislative Initiatives in the 109th Congress to Modify the IRS's Existing Authority to Hire Private Debt Collection Agencies

Congressional opponents of the IRS's private tax debt collection initiative are continuing their efforts to derail it, even as the initiative is in the initial stages of implementation. Two bills to repeal the IRS's authority to enter into contracts with PCAs have been introduced in the House: H.R. 1583 (sponsored by Representative Chris Van Hollen) and H.R. 1621 (sponsored by Representative Rob Simmons). The latter has attracted at least 65 cosponsors from both parties. Lacking support from the Republican leadership in the House, both bills have languished in the Ways and Means Committee. No similar legislation has emerged in the Senate.

In addition, during the floor debate in the House on H.R. 3058, a measure to provide appropriations in FY2006 for the Treasury Department and certain other federal agencies, Representatives Simmons and Van Hollen introduced an amendment (H.Amdt. 418) that would prevent the IRS from using any appropriated funds to enter into, implement, or manage contracts with PCAs in FY2006. They withdrew the amendment when they realized a point of order would be raised against it if they persisted in their attempt to thwart the initiative. A similar amendment did not surface during the Senate's consideration of its version of H.R. 3058.

A provision in the tax reconciliation bill (S. 2020) passed by the Senate on November 18, 2005, would reserve no less than 10% of tax debt collection contracts awarded by the IRS under IRC section 6306 after April 1, 2006, for firms meeting certain standards for employing disabled persons. The provision began as an amendment (S.A. 2625) introduced on the floor of the Senate by Senator E. Benjamin Nelson on November 17; the Senate agreed to it by unanimous consent. To be eligible for this preferential treatment, a firm not only must meet the general eligibility requirements for bidding on the contracts, but it also must employ at least 50 persons in its U.S. operations who are severely disabled at the time the contracts are awarded; the disability requirement could also be satisfied if at least 30% of the firm's domestic workforce is considered severely disabled when the contracts are awarded, or if the firm were to agree that severely disabled individuals will make up at least 35% of the individuals hired to work on the contract. The provision defines a severely disabled person as a war veteran with a disability of "50% or greater" or someone considered a disabled beneficiary under section 1148(k)(2) of the Social Security Act. A similar provision is not included in the version of the tax reconciliation bill (H.R. 4297) passed by the House on December 8. At present, it is unclear if there is sufficient support in the House for such a provision to likely be part of any conference agreement on tax reconciliation legislation that might emerge.

³⁰ (...continued)

number of consumer complaints filed against any other specific industry last year." Complaints about the collectors accounted for 17% of all consumer complaints in 2004, up from 12.6% in 2003. See Federal Trade Commission, *Annual Report 2005: Fair Debt Collection Practices Act* (Washington: July 2005), pp. 2-4.

Issues for Congress

While the proponents of allowing the IRS to hire PCAs to collect certain delinquent individual tax debt have prevailed for the time being, there is no certainty that their triumph will last indefinitely. Some of the concerns raised by critics remain unresolved or untested in the crucible of actual experience. In addition, Congress is likely to exercise its oversight authority to monitor and assess various aspects of the private tax debt collection initiative as it unfolds. Those aspects include IRS's management of the initiative (including its oversight of PCAs and the data it collects on the results of the initiative), the performance of PCAs in fulfilling the terms of their contracts, the cost-effectiveness of the initiative, and its impact on taxpayer rights.

What are the key issues for Congress as it oversees the efforts of the IRS to implement and manage a plan for the use of PCAs based on the authority granted by the AJCA? Nine seem paramount, all of which can be expressed as questions that Congress may wish to address:

- Can the plan be justified on economic grounds or would the public interest be better served if Congress were to give the IRS enough resources to undertake the collection initiative on its own?
- What opportunity costs does the plan entail, and what is their magnitude?
- Are taxpayers adequately informed of their rights and protections under the plan?
- Does it offer sufficient incentives for PCAs to avoid engaging in unlawful collection practices?
- Are PCAs adequately informed of their rights and responsibilities under the contracts and the penalties they would face for failing to uphold them?
- Does the IRS have adequate resources to oversee the performance of PCAs?
- Does the compensation package offered to PCAs promote the lawful and equitable treatment of taxpayers while giving a sufficient incentive to contact delinquent taxpayers?
- Are the PCAs engaging in activities that should be regarded as inherently governmental functions?
- How does the plan fit into the larger framework of IRS collection and enforcement activities?