The IRS Did Not Have Adequate Support For Its Administrative Charges To The Unemployment Trust Fund For Fiscal Years 1999 - 2002

Office of Inspector General
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ABBREVIATIONS

BPD	Bureau of Public Debt
CFR	Code of Federal Regulations
DOL	Department of Labor
ETA	Employment and Training Administration
FUTA	Federal Unemployment Tax Act
FY	Fiscal Year
GAO	General Accounting Office
IRS	Internal Revenue Service
MIS	Management Information System
OIG	Office of Inspector General
PL	Public Law
SSA	Social Security Act
TD	Treasury Directive
TIGTA	Treasury Inspector General for Tax Administration
UTF	Unemployment Trust Fund

EXECUTIVE SUMMARY

Over the last 15 years the U.S. Department of Labor (DOL), Office of Inspector General (OIG), has repeatedly reported problems with the amount of costs the Internal Revenue Service (IRS) charges the Unemployment Trust Fund (UTF) for:

- collecting employers' monthly Federal Unemployment Tax Act (FUTA) payments,
- processing the annual FUTA reporting returns (IRS Form 940), and
- investigating and collecting any unpaid FUTA taxes.

Historically, the IRS has been unable to support its charges. In a September 21, 1999, audit report, the DOL-OIG reported that the IRS did not have a cost accounting system to capture actual costs for its UTF-related processes and had overcharged the UTF by $48 million for Fiscal Years (FY) 1996 through 1998 (October 1, 1995, through September 30, 1998). In addition to recommending that the IRS refund the overcharge to the UTF, the DOL-OIG recommended that DOL's Employment and Training Administration (ETA)– the Federal agency responsible for managing the unemployment insurance program – establish a team to negotiate with IRS to establish an acceptable method for IRS to charge its costs to the UTF.

ETA was unable to get the IRS to resolve the issues regarding its UTF charging process, so the DOL-OIG conducted another audit of IRS' process for identifying administrative costs charged to the UTF. The audit found that during FYs 1999 though 2002 (October 1, 1998, through September 30, 2002), the IRS charged almost $300 million to the UTF for its administrative costs with inadequate support for its charges.

It is the IRS' responsibility to develop an acceptable, supportable cost compilation methodology to recover its UTF administrative costs. According to Federal cost accounting standards, basing costs on outcomes when actual cost data are not available, or are not economically feasible to obtain, is the next option for allocating costs. We suggested the IRS use a percent-of-revenue received/outcome-based allocation approach as an alternative to collecting actual costs (which currently cannot be done with a reasonable degree of accuracy).

If the recommended percent-of-revenue received method was used to estimate IRS' cost to administer the UTF for FYs 1999 through 2002, the IRS would have charged the UTF approximately $174 million less than IRS actually charged based on its previous unsupported estimated amounts. In the first quarter of FY 2003, the IRS used the percent-of-revenue received method to estimate the IRS' FY 2002 costs to administer the UTF and determined the costs to be $32 million. IRS submitted these revised cost amounts to the Bureau of Public Debt (BPD). In the second quarter of FY 2003, the BPD credited back to the UTF $56 million of FY 2002 overcharges; i.e., the initially charged $88 million (unsupported) for FY 2002 was reduced to $32 million based on the percent-of-revenue received method.

The IRS is currently working on an alternative cost recovery methodology for all trust funds it administers and began using it as of FY 2003. This methodology uses the percent of revenue received as its basis, including a complexity factor to account for the difference in difficulty in the laws involved with each trust fund. The IRS submitted this proposed methodology to us for comment, and we posed questions with the complexity factor. However, it is the IRS' responsibility to develop its cost recovery systems.

Recommendations

We recommend the Assistant Secretary for Employment and Training:

- Negotiate with the IRS to adopt an acceptable alternative methodology – such as percent-of-revenue received -- as a supportable basis for charging the UTF for the allocable administrative costs.

- Develop a Memorandum of Agreement with the IRS to ensure consistent application of the agreed-upon method for allocating IRS administrative costs to the UTF.

- Request the IRS to reimburse the UTF $118 million ($174 million minus $56 million already recovered) in previously unsupported cost estimates charged.

The ETA's Response to Our Draft Report

The ETA concurred with our recommendations.

OIG's Conclusion

We consider the recommendations resolved, but the report will remain open until ETA has completed its course of action.

BACKGROUND

Title IX of the Social Security Act (SSA) instructs the Secretary of the Treasury to charge the Unemployment Trust Fund (UTF) for the Treasury Department's costs of collecting and maintaining the UTF. The IRS historically has collected from the UTF its costs for collecting the employers' monthly Federal Unemployment Tax Act (FUTA) payments, processing the annual FUTA reporting returns (IRS Form 940), and investigating and collecting any unpaid FUTA taxes. The Bureau of Public Debt (BPD) maintains the UTF. The BPD charges its administrative costs to the UTF directly through an intergovernmental charging account. However, according to statute, the IRS administrative charges are taken from the UTF and placed in Treasury's General Fund. Only IRS' costs are the subject of this audit.

On three prior occasions, the DOL-OIG has audited IRS' administrative charges to the UTF and on each occasion identified problems:

- In 1986 the DOL-OIG issued an audit report that questioned almost $25 million because of an IRS overcharge in its computation for collecting delinquent FUTA taxes for FYs 1984-1986. This report also identified issues with inaccurate cost rates and management information systems that did not provide adequate detail related to the FUTA operations. Additionally, the IRS had not adjusted to actual costs at the end of each fiscal year. The $25 million was credited back to the UTF.

- In 1990 the DOL-OIG issued another audit report that questioned almost $18 million because of various over- and undercharges to the UTF, based on errors found in IRS cost allocation methodologies for certain cost units (covering FYs 1986-1988). The $18 million was also credited back to the UTF.

- In 1999 the DOL-OIG issued its third audit report that questioned almost $48 million in overcharges for FYs 1996 through 1998. The OIG reported that the IRS charges were largely based on an outdated unit cost rate. The audit also found the IRS' method of calculating the costs was based on a fragmented, ad hoc spreadsheet account approach. The process involved a variety of estimates and data from at least 10 individual management information systems which were largely unaudited. The IRS' accounting systems were not integrated or configured to accommodate recently required Federal cost accounting standards. The $48 million overcharge was credited to the UTF in the fourth quarter of 1999 as part of an overall $67 million credit. We also recommended that the ETA establish a team to negotiate with IRS an alternative method of charging the IRS administrative costs, since the current method was fragmented, cumbersome, and unreliable.

In March 2001, the DOL Inspector General sent a letter to the IRS Commissioner (with a copy to the Treasury IG and the IG for Tax Administration) explaining that the IRS had not responded adequately to ETA's attempts to meet and discuss its cost collection techniques to help resolve this recurring issue. The IRS CFO's office met with ETA and the DOL OIG in October 2001, where they agreed to assign a staff cost accountant to explore this issue. ETA, the DOL-OIG, and the assigned IRS accountant consulted informally on the proper basis for allocating the costs involved in the FUTA process with no resolution.

The current audit was initiated to formally follow up on the status of IRS' resolution of our September 1999 audit recommendations. The audit work involved visiting the BPD to obtain the supporting cost documentation for the IRS charges and interviewing IRS staff to determine how the current costs are being compiled.

During this followup, the DOL OIG learned that the Treasury Inspector General for Tax Administration (TIGTA) had also initiated an audit as a result of the DOL Inspector General's March 2001 letter to the IRS Commissioner on this issue. The TIGTA auditors have discussed the current cost compilation process with the IRS and concluded the IRS routinely increased previously reported estimates with no actual cost basis. TIGTA auditors also arranged to meet with each of the IRS cost components to determine whether it is currently possible to collect and accurately report the direct costs involved with collecting and reporting taxes for the UTF and other trust funds. Their audit report will be issued in the spring of 2003.

OBJECTIVE, SCOPE, AND METHODOLOGY

Audit Objective:

Our audit objective was to answer the following questions:

- Can IRS support the UTF administrative costs it reports to the Bureau of Public Debt?

- How has the IRS been identifying and reporting its UTF administrative costs?

- If there has not been a sound basis for IRS' UTF administrative costs, would an alternative allocation/compilation methodology be more appropriate?

Audit Scope and Methodology:

Our audit period covered IRS administrative charges to the UTF from October 1, 1998, through September 30, 2002 (FYs 1999 through 2002). Our audit scope consisted solely of following up with the IRS regarding whether its administrative cost compilation and reporting process was supported and/or had changed since our last audit. We neither examined the IRS process for collecting and reporting FUTA taxes, nor compiled any cost center documentation that would be relevant to determining the appropriateness of charges to the UTF since our prior audit. We obtained from the BPD the supporting documentation that the IRS submitted and the BPD used as the basis for charges to the UTF.

We then contacted the IRS directly to inquire about the documents IRS submitted to the BPD. We learned that TIGTA was already performing an audit following up on our September 1999 audit report. We obtained verbal confirmation from the IRS regarding the lack of supporting cost documents that could be provided to us. The TIGTA auditors, who had already interviewed the IRS and obtained the only documentation available, confirmed our understanding that IRS did not have any cost documentation. The documentation TIGTA obtained consisted of cost estimates submitted to BPD to support the UTF charges. The TIGTA auditors shared this documentation with us. We did not duplicate these efforts with the IRS. We contacted the IRS and BPD prior to issuing this draft report to obtain the latest cost information and included the information in the "Subsequent Events" section of this report.

We performed sufficient work on the management controls and laws and regulations over the Treasury charges to the UTF to gain an understanding of the deficiencies in IRS' cost allocation and reporting process for FYs 1999 through 2002.

Our financial-related audit was performed in accordance with generally accepted government auditing standards.

SUBSEQUENT EVENTS

Since we initiated this audit, the IRS has been developing an alternative method for calculating its costs for administering the various trust funds it administers. IRS proposed a method which included using the percent-of-revenue received (as suggested in finding 2) but included a complexity factor to adjust these costs based on how difficult the laws were for each of the funds involved. The IRS began using this method for its FY 2003 cost reports submitted to the BPD, although the method has not yet been finalized as official IRS policy.

Subsequent to the end of our fieldwork (December 31, 2002), the IRS adjusted its FY 2002 administrative charges to the UTF. Initially, IRS charged the UTF $88,185,474 (unsupported) and subsequently (in the first quarter of FY 2003) submitted documentation to the BPD showing administrative costs of $32,006,920 based on using the percent-of-revenue received method discussed in this audit report and adopted by the IRS beginning in FY 2003. Consequently, the BPD credited the UTF for $56,178,554 in the second quarter of FY 2003 to adjust the initially charged amount using the percent-of-revenue basis.

No adjustments have been made for the other fiscal years included in our audit (FYs 1999 through 2001).

AUDIT RESULTS

1. The IRS Did Not Have Adequate Support for Its Charges to the Unemployment Trust Fund.

The IRS has not had a reasonable basis for its UTF charges since our prior audit report was issued in September 1999. Not only had there not been any improvement in the process since our prior audit, rather the basis for charging IRS costs to the UTF had deteriorated; i.e., IRS made no attempt to document costs.

The IRS staff responding to our inquiries regarding IRS' current system to document costs did not have any prior information or instructions on how IRS' costs for collecting and reporting FUTA revenue had been compiled in the past. These IRS staff stated they had used the amounts reported in our prior audit report for 1998, adjusted for annual increases in the number of returns, as the basis for the charges to the UTF for FYs 1999 through 2002. However, we were unable to validate that this was the method used.

The IRS staff submitting the estimated costs to the BPD had no direct contact with any of the individual IRS cost components in order to update their estimate, based on either direct traceable costs or any other allocation basis. In summary, IRS did not have any supportable basis for the estimated IRS charges other than what we had reported in our prior audit report.

The IRS should have a reasonable and supportable process of accounting for the estimated charges, as required by Title IX of the Social Security Act (SSA), which it admittedly has not had since our prior audit. Title IX, Section 901 of the SSA states:

> (2) The Secretary of the Treasury is directed to pay from the employment security administration account into the Treasury as miscellaneous receipts the amount estimated by him which will be expended during a three-month period by the Treasury Department for the performance of its functions under
>
> (A) this title and titles III and XII of this Act, including the expenses of banks for servicing unemployment benefit payment and clearing accounts which are offset by the maintenance of balances of Treasury funds with such banks,
> (B) the Federal Unemployment Tax Act, and
> (C) any Federal unemployment compensation law with respect to which responsibility for administration is vested in the Secretary of Labor.

> If it subsequently appears that the estimates under this paragraph in any particular period were too high or too low, appropriate adjustments shall be made by the Secretary of the Treasury in future payments.

As the above criteria provides, the SSA instructs the Treasury to charge the UTF estimated costs quarterly. In our opinion, any estimates should have a reasonable basis. Furthermore, the SSA requires subsequent adjustments to the estimates if the amounts initially charged are found to have been too high or too low, implying that IRS should be recovering actual costs.

The Secretary of the Treasury provided additional guidance through Treasury Directive (TD) 32-06, which established reporting requirements for administrative expenses incurred by Treasury bureaus in servicing particular trust fund accounts, including the UTF. Quarterly reports setting out estimates of administrative expenses to be incurred for the current quarter, adjusted by actual expenses incurred in the previous quarter; and, a fiscal year-end report to summarize and adjust estimated administrative expenses to actual expenses are required to be submitted to the BPD, Trust Fund Management Branch, to support the charges made to the individual trust funds. This directive also specifically states:

> In the event the basis used in compiling the estimates for quarterly reports is changed, the first quarterly estimate in which the new basis is applied should be accompanied by an explanation of the new basis.

Prior to our starting this audit of IRS' charges to the UTF, IRS had not assigned any priority to ensuring that it could support its charges. However, it now appears that the IRS is attempting to implement a charging system that is supportable.

2. One Alternative Cost Allocation Option to Support Charging IRS Costs to the UTF Is the Percent-of-Revenue Received.

The IRS does not have the cost accounting systems in place to adequately collect and report either the direct costs or an appropriate allocation of indirect costs for the individual cost centers responsible for collecting and reporting FUTA taxes. The FUTA tax collection process is complex and involves many different cost centers, making it difficult for the IRS to be able to collect the allocable expenses by cost center with the reasonable assurance necessary to direct charge these services to the UTF.

The Managerial Cost Accounting Standards required for Federal agencies (SFFAS #4) are aimed at providing reliable and timely information on the full cost of programs. For costing methodologies, the SFFAS #4 provides:

> The **cost assignments** should be performed using the following methods **listed in the order of preference:** (a) directly tracing costs wherever feasible and economically practicable, (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis. [Emphasis added.]

Discussions with IRS management and staff as well as the IRS' own internal reports (Publication 3349 dated January 2000) evidence that the cost accounting systems lack the detail needed for direct charging administrative costs to the UTF. This fact, along with recurring DOL-OIG audit reports that the IRS does not have adequate cost accounting systems to efficiently collect the necessary cost information, in our opinion, supports the fact that option (a) above – directly tracing costs – is not "feasible or economically practicable."

Option (b) is more applicable, as using a percent-of-revenue received allocation basis could be interpreted as a "cause-and-effect" basis. The main purpose (or "cause") of the IRS service is to collect these trust fund dollars for the respective agencies. The "effect" or ultimate output can be measured as the amount of trust revenues collected for these agencies.

It is the IRS' responsibility to develop and implement its own methodology to collect the costs and support its administrative charges to the trust funds. However, in our opinion, using the percent-of-revenue received as a basis to allocate the pool of all IRS administrative costs to the UTF would be an acceptable alternative; i.e., it is appropriate, defensible, simple, and "reasonable and consistent" (option (c)).

Because the pool of costs for allocable functions (i.e., cost centers) are not consistently reported from year-to-year in the IRS financial statements, we believe it is appropriate for UTF to share in all IRS costs, based on an allocation using the percent-of-revenue received in the UTF compared to the total of all taxes collected by the IRS. This allocation basis would be reasonably easy to apply in an economical, consistent, and equitable manner.

Because the IRS agrees that there has not been an adequate basis for the administrative charges to the UTF since our last audit report was issued in September 1999, we question the reasonableness of charges to the UTF. On the other hand, we agree that there were significant costs incurred by the IRS for collecting and processing FUTA tax payments and returns. The problem has been the IRS' inability to fairly determine the allocable costs.

Using the percent-of-revenue received cost allocation approach as an alternative costing methodology and the total IRS costs reported in its financial statements for the past few years (as detailed in exhibit 2), the UTF's share of the IRS' total costs amounts to $123,218,969 for the period October 1, 1998, through September 30, 2002. The UTF was charged a total of $297,577,888 for the same timeframe. Applying the recommended methodology (in lieu of any other supportable basis), the UTF was overcharged $174,358,919 for the period October 1, 1998, through September 30, 2002.

However, in the first quarter of FY 2003, the IRS used the percent-of-revenue received method to estimate the IRS' FY 2002 costs to administer the UTF and determined the costs to be $32 million. IRS submitted these revised cost amounts to the BPD. In the second quarter of FY 2003, the BPD credited back to the UTF $56 million for FY 2002 overcharges; i.e., the initially charged $88 million (unsupported) for FY 2002 was reduced to $32 million based on the percent-of-revenue received method.

RECOMMENDATIONS

We recommend the Assistant Secretary for Employment and Training:

- Negotiate with the IRS to adopt an acceptable alternative methodology – such as percent-of-revenue received -- as a supportable basis for charging the UTF for the allocable administrative costs.

- Develop a Memorandum of Agreement with the IRS to ensure consistent application of the agreed-upon method for allocating IRS administrative costs to the UTF.

- Request the IRS to reimburse the UTF $118 million ($174 million minus $56 million already recovered) in previously unsupported cost estimates charged.

The ETA's Response to Our Draft Report

The ETA concurred with our recommendations. See page 14 for the complete text of ETA's response.

OIG's Conclusion

We consider the recommendations resolved, but the report will remain open until ETA has completed its course of action.

Exhibit 1
Schedule of Estimated Overcharge

Fiscal Year	UTF Share of IRS Costs[1]	Costs Charged to the UTF	Overcharges to the UTF
1999	$30,356,691	$33,694,439	$ 3,337,748
2000	$29,118,264	$87,731,361	$58,613,097
2001	$29,830,820	$87,966,614	$58,135,794
2002	$33,913,194	$88,185,474[2]	$54,272,280
Totals	***$123,218,969***	***$297,577,888***	***$174,358,919***

[1] See exhibit 2.
[2] FY 2002 costs were adjusted in the second quarter of FY 2003 to $32,006,920. See Subsequent Events section of this report.

Exhibit 2
Calculation of FUTA Share of IRS Costs Using the Percent-of-Revenue Received Cost Allocation Methodology

FY	(1) Total FUTA Revenue	(2) Total IRS Revenue	(3) (1)/(2) % of Revenue Collected[3]	(4) Total IRS Costs	(5) (3*4) FUTA Share of IRS Costs
1999	$7,000,000,000	$1,898,000,000,000	0.3688%	$8,231,000,000	$30,356,691
2000	$7,000,000,000	$2,097,000,000,000	0.3338%	$8,723,000,000	$29,118,264
2001	$7,000,000,000	$2,122,000,000,000	0.3299%	$9,043,000,000	$29,830,820
2002	$7,000,000,000	$2,016,000,000,000	0.3472%	$9,767,000,000	$33,913,194
				FY Totals	***$123,218,969***

The above schedule outlines the methodology for calculating the UTF's portion of the IRS' total administrative costs based on the recommended percent-of-revenue received cost allocation methodology.

This method involves taking the following steps (the item numbers correspond to the columns on the above schedule):

(1) Identify the total FUTA revenue from the Statement of Custodial Activity from the audited IRS Financial Statements for the appropriate fiscal year.

(2) Identify the total IRS revenue from the Statement of Custodial Activity from the audited IRS Financial Statements for the appropriate fiscal year.

(3) Calculate the percentage FUTA tax revenue is of total IRS revenues collected (column 1 divided by column 2).

(4) Identify the total IRS costs from the Statement of Changes in Net Position in the IRS financial statements. For FYs 1999 and 2000 we used total IRS costs, as all cost categories appeared to apply to trust fund activities. The IRS changed its reporting presentation starting in FY 2001. As a result, for FYs 2001 and 2002, the Administration of the Earned Income Tax Credit cost category reported in these more current years obviously does not apply to administration of the trust funds, thus is not included in the total IRS costs to be allocated. This agrees with the method the IRS has proposed and is currently using.

(5) Multiply the percentage calculated at (3) times the total IRS costs at (4) to determine the share of total costs chargeable to the UTF as IRS FUTA administrative costs.

[3] Percentage was rounded to four decimal places for table presentation. Actual unrounded percentage was used for computation.

U.S. Department of Labor

Assistant Secretary for
Employment and Training
Washington, D.C. 20210

MAR 3 1 2003

MEMORANDUM FOR: ELLIOT P. LEWIS
Assistant Inspector General for Audit

FROM: EMILY STOVER DEROCCO *Emily Stover DeRocco*

SUBJECT: Response to Draft Audit Report No. 06-03-005-03-315

The Employment and Training Administration concurs with the recommendations in the referenced audit report. We will proceed with negotiations with the Internal Revenue Service (IRS) to adopt a methodology for allocating administrative costs to the Unemployment Trust Fund and to develop a Memorandum of Agreement documenting that methodology. We will also request reimbursement for past overcharges. It would be very helpful if you would provide us with the appropriate contacts at IRS.

If you have any questions regarding this response, please contact Ron Wilus at 202-693-2931.

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