INTERNAL REVENUE SERVICE

WRITTEN TESTIMONY
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BEFORE THE
SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
MEDICAID PROVIDERS WHO CHEAT ON THEIR TAXES AND WHAT SHOULD BE DONE ABOUT IT

NOVEMBER 14, 2007

Good afternoon Chairman Levin, Ranking Member Coleman and members of the Permanent Subcommittee on Investigations. I am pleased to appear before you to discuss Medicaid payments made to providers who may be delinquent on their Federal tax obligations and the IRS' ability to claim what is owed through the Federal Payment Levy Program (FPLP).

While this is my first opportunity to testify before the Subcommittee, the IRS has discussed issues related to FPLP with the Subcommittee on several occasions. We first appeared in 2004 to respond to the Government Accountability Office (GAO) report on 47 Department of Defense (DoD) contractors who were delinquent on their taxes. In 2005 we appeared to discuss 50 civilian contractors that the GAO had identified as also being delinquent as well as the 25 cases from the General Services Administration (GSA). At that time, we pointed out the progress that the IRS had made working with the Financial Management Service (FMS), the GSA, DoD, the Office of Management and Budget (OMB), and the Department of Justice (DOJ). Together these agencies formed the Federal Contractor Tax Compliance (FCTC) Task Force in 2004.

Last year, the IRS testified about the continued progress we are making with the FCTC task force, and discussed actions we were taking independently of the task force as well as the status of the contractor cases cited by the GAO. Last March, we updated the Subcommittee on our continued progress and addressed the possibility of including Medicare payments made to providers by the Center for Medicare and Medicaid Services (CMS) in the FPLP.

Today, I want to update you on the progress we have made in each of these areas since the Subcommittee's hearing last March as well as to discuss the issue that is the focus of this hearing – the possibility of including Medicaid providers in the continuous levy program.

I also want to thank this Subcommittee for its continued interest in the broad issue of using the FPLP as a means of collecting tax debt. Much of the progress we have made in the past four years has been the direct result of the interest and support of the Subcommittee Members and its staff.

Progress Report

Perhaps the best indicator of the progress made since the creation of the FCTC task force has been the increase in the amount of tax debts that are available to the FMS' Treasury Offset Program (TOP). On January 31, 2004, there was only $73 billion in tax debt referred to FMS. As of October 2007, that number had grown to $127 billion, a 57-percent increase.

Corresponding to this increase in tax debt referred to FMS has been the decline in the number of tax debts that are excluded from the FPLP. In FY 2004, $195 billion had been excluded. By October 2007, that number fell to $160 billion.

As the Subcommittee knows, there are both statutory and operational exclusions to tax debt being referred to the FPLP. While the statutory exclusions have actually increased between FY 2004 and October 2007, from $61 billion to $83 billion, the operational exclusions have declined from $106 billion to $77 billion.

This increase in the overall level of tax debt referred to the FPLP and the decline in the operational exclusions has been the result of a number of actions by the IRS over the last several years. These include:

- Elimination of the one-year waiting period for deferred and queue cases for selection into the FPLP.

- The addition of all field Revenue Officer cases, more Automated Collection System cases, and certain Criminal Investigation cases into the FPLP.

- The addition of the secondary TIN on joint income tax and sole proprietor tax liability accounts.

- The addition of historical business names to improve matching with FMS.

- Adding additional defaulted installment agreements due to programming fixes.

- Adding adjustment claims, pending installment agreements with existing levies, and certain Collection Statute Expiration Date accounts.

In March 2007, the IRS began identifying Federal contractors in its Master file database by using information on recently awarded Federal contracts provided by GSA through FMS. This Federal contractor account indicator will assist the IRS in developing overall collection strategy and prioritization on all corporate inventory accounts.

Total revenue collected through the FPLP has also increased substantially. In FY 2003, there was $89 million in revenue from the FPLP. This had risen to approximately $345 million by FY 2007.

Looking at the subset of contractors, revenue collected from all contractors showed similar growth, rising from $7 million in FY 2003 to $48 million in FY 2007. Defense contractor revenue has gone from $5 million to $25 million over the same period. Since the start of the FPLP in FY 2000, the FPLP has collected over $1.1 billion in Federal payments through FY 2007, of which $195 million was from contractor payments.

Not all of the tax debt referred to the FPLP, however, can be immediately levied due to the notice and review process that is legally required prior to the activation of the levy. Of the $127 billion in tax debt referred to the FPLP inventory, $63 billion, or approximately half, is not currently available for levy. We continue our efforts to accelerate the notice process so that the debts can be levied as soon as legally possible.

We are also making some changes in the IRS case criteria for purposes of the FPLP. These include:

- Levying additional Federal employee salary payments beginning in June 2008.

- Keeping taxpayers who subsequently request an installment agreement (IA) or adjustment claim in the FPLP until a formal IA is established or the adjustment claim remains in a balance due status. This change started in January 2007, and thus far we have been able to keep $454 million in the FPLP.

- Retaining accounts in the FPLP until 30 days prior to the collection statute expiration date (CSED). Prior to this change, these accounts were removed 90 days prior to the CSED.

- Adding a greater number of defaulted installment agreements to the FPLP. This has resulted in 105,000 additional accounts being eligible for the FPLP.

Update on Cases Referred By the GAO

Since 2004, the GAO has referred a number of cases to the IRS that it had identified as having evidence of abusive and/or potentially criminal activity related to the Federal tax system.

Specifically, in 2004 and 2005, GAO referred 47 cases involving defense contractors, 50 cases involving civilian contractors, and 25 cases involving GSA contractors. Since we have received the referrals, the IRS has worked diligently to ensure that all appropriate cases are included in the Federal Payment Levy Program.

Of the total of 122 cases that were referred in 2004 and 2005, 62 cases, or 51 percent, are closed. Of these, 23 cases were full pay closures, and it was determined that the remaining 39 cases were currently not collectible. These non-collectible cases involve defunct corporations or other taxpayers where it is judged that there is no potential now or in the future for collection.

Another 43 of the 122 cases are not currently in an active collection status for the following reasons:

- Six (6) are reported as currently not collectible. This would include hardship cases or cases where we have been unable to contact the taxpayer. Though currently inactive, these cases are subject to periodic review because the circumstances of the taxpayer may change and he/she might be able to pay;
- Nine (9) are in some form of bankruptcy (Chapter 7, 11 or 13);
- Seventeen (17) have an Installment Agreement (IA) or are in Collection Due Process Appeals;
- Three (3) are part of an Offer In Compromise Investigation; and
- Eight (8) have been referred for criminal investigation.

The remaining 17 cases (14 percent) are in active collection status, and investigations to determine collectibility are ongoing. Making the collectibility determination involves working with the taxpayer and using other available resources to verify information obtained from the taxpayer. If the taxpayer is uncooperative, the investigation can be more cumbersome as the taxpayer's assets and liabilities must be researched. The determinations could also involve:

- Permitting the taxpayer a reasonable amount of time to supply financial information;
- Considering a taxpayer's request for an installment agreement by reviewing and requesting verification of the taxpayer's income and expenses as well as assets and liabilities;
- Following up on any notices of levy that have been issued;
- Investigating a lien issue;
- Investigating responsibility and willfulness for the Trust Fund Recovery Penalty;
- Waiting for an appeal period to expire; or
- Conducting a fraud investigation.

To promote compliance, the IRS will continue to take a variety of enforcement actions to ensure that all types of taxpayers are current on their filing and payment requirements. These enforcement actions are often complex and investigation of such issues can be very time-consuming. Several of the audit cases involve complex issues including related entities, bankruptcy, fraud suits, and civil injunctions.

Medicare Cases

During the Subcommittee's hearing on March 20, 2007, the GAO identified an additional 40 cases with evidence that certain Medicare providers may be guilty of abusive or potentially criminal activity relative to Federal income and/or employment taxes. The GAO referred all 40 case studies to the IRS for criminal investigation and collection of any taxes owed.

At that hearing, we explained that we had determined that payments to Medicare providers were indeed Federal payments for purposes of the FPLP and that we were beginning to work with the Center for Medicare and Medicaid Services (CMS) and the FMS to determine how to bring these providers under the continuous levy program.

That work has been overseen by a subgroup of the FCTC task force. CMS joined the FCTC in order to develop a pilot program to incorporate CMS Medicare provider payments (under part A and B) into the FPLP. Currently, CMS Medicare payments are levied through the IRS' regular paper levy collection process.

The FCTC subgroup meets on a regular basis, and after exploring various options, began focusing on developing a pilot program that is tentatively scheduled to go into operation in October 2008. This pilot program would be the same as the process used for levying

Department of Defense payments, known as the Non-Treasury Disbursing Office, or the NTDO process.

Through the pilot program, we would levy Medicare payments disbursed through CMS' centralized Healthcare Integrated General Ledger Accounting System (HIGLAS). This is a systemic process whereby FMS would match information about CMS' payments, on a daily basis, against the tax debts included in the FPLP. FMS would provide information back to CMS when there was a match and CMS would levy the payments.

On October 3, 2007, personnel from FMS and CMS successfully conducted a simulated NTDO pilot program. We are moving ahead with the design and are on track to implement the NTDO process in 2008 for contractors that are currently utilizing the HIGLAS system. We anticipate full implementation during FY 2011.

In addition to exploring the NTDO and TDO systemic processes, we are currently working with CMS to develop a centralized and efficient paper levy process.

We have also done a review of the 40 Medicare cases that the GAO referred. Of the 40 cases, 6 cases (15 percent) are closed because they are either in full pay closure or currently reported as being out of business.

Twenty-three (23) of the 40 cases (58%) are not currently in an active collection status for the following reasons:

- Four (4) are reported as currently not collectible (hardship and unable to contact);
- Six (6) are in bankruptcy (chapter 7, 11 or 13);
- Six (6) have an Installment Agreement;
- Three (3) are Criminal Investigation referrals; and
- Four (4) are under Offer in Compromise investigation.

The remaining 11 cases (27 percent) are in active collection status, and investigations to determine collectibility are on going.

As we pointed out at the March hearing, one of the difficulties of including Medicare providers in the FPLP is that many Medicare physicians operate their practices through limited liability companies (LLCs) which are disregarded for tax purposes under IRS "check-the-box" regulations. In such cases, the individual physicians are personally liable for the tax, but the Medicare payments are legally the property of the LLC, and cannot be directly levied by the IRS. Unless an individual service provider has treated a professional corporation or LLC as an alter ego or mere nominee, the IRS cannot levy on a payment to the entity to collect a tax delinquency of the individual provider.

Under the former "check the box" regulations, if a single-member LLC elected to be treated as a "disregarded entity," the member was liable for all Federal taxes arising from his medical services business (income tax, employment tax, etc.) because the LLC was

disregarded or treated as though it did not exist for tax purposes. The various state laws, however, treated payments to the LLC as the property of and belonging to the LLC – not the individual member. Thus, the IRS generally could not collect the member's Federal tax liabilities by levying or otherwise collecting on payments made to the LLC.

Going forward, the problem of pursuing collection activities for an individual doctor's tax liabilities from payments to single-member "disregarded" LLCs has been addressed, in part, by recently issued Treasury regulations. The IRS and Treasury Department issued final regulations in August 2007 that, once applicable, will "regard" an otherwise disregarded LLC for employment and excise tax purposes. In other words, under the rules in the final regulations, the IRS will be able to collect employment and excise tax liabilities of such an LLC by levying on the income or property of the LLC, because the LLC will be liable for those taxes.

This "entity problem," however, is not limited to disregarded LLCs. Medicare payments for professional medical services could be made to professional corporations through which individual physicians provide services. A levy may not be used to collect the tax liabilities of an individual doctor from Medicare payments for the doctor's services when the Medicare payee is the professional medical corporation that furnished the doctor's services. As with a single-member LLC, under the various state laws such a Medicare payment is the property of the professional corporation rather than of the individual doctor.

Similarly, although the IRS may seize an individual partner's partnership interest to satisfy the partner's tax liability, where the Medicare payments are the property of the partnership, the payments may not be levied upon or seized to satisfy the individual tax liability of the partner.

The challenge presented where the taxpayer is an entity separate from the entity receiving payment is not easily remedied. "Piercing the corporate veil" is a judicial tool available in certain limited circumstances, if the owners or principals of a corporation ignore the legal existence of the separate corporate identity to the detriment of creditors of the business. In those cases, a creditor may ask a court to "pierce the corporate veil" and hold an individual shareholder or principal liable for the debts of the corporation.

In "reverse piercing of the corporate veil," the corporation may be held liable for the debts of an individual shareholder. However, these remedies are available only in egregious situations, typically requiring litigation. In addition, they are expensive to pursue and would not assist in a systemic program such as the FPLP.

Including Medicaid Payments in the FPLP

Last summer, as the GAO was conducting its audit of funds transmitted through the Medicaid program and received by persons delinquent in the payment of Federal taxes, the FCTC task force sought to determine ways in which Medicaid payments might be included in the FPLP. The first step in the process was for the IRS Office of Chief

Counsel to determine whether such payments were like payments to Medicare providers and thus subject to continuous levy. Counsel concluded that the FPLP, as currently structured, is not a tool that can be used for this purpose.

Section 6331(h) of the Internal Revenue Code, the statutory basis for the FPLP, authorizes the IRS to serve a continuous levy on certain specified payments. Specified payments include several statutorily identified disbursements (not including Medicaid payments), as well as a more general category of "Federal payments." Use of the FPLP to levy on Medicaid proceeds depends on whether such disbursements constitute "Federal payments" under section 6331(h)(2)(A).

After careful analysis and consultation with Counsel, the FCTC task force concluded that Medicaid disbursements flowing from the Federal government to state Medicaid agencies do not qualify as Federal payments for purpose of continuous levy under section 6331(h).

In reaching this conclusion, the FCTC weighed various factors relating to the structure and operation of the Medicaid programs. The most pertinent considerations include the actual flow of Medicaid funds, the relationship between the Federal disbursing agency and the recipient state agency, and whether the state or Federal agency faces legal responsibility to providers in the case of non-payment. Each of these considerations suggests that Medicaid disbursements are more in the nature of a state entitlement than a Federal payment includable in the FPLP.

The Medicaid cycle begins with delivery of medical services by a provider. Providers submit claims for reimbursement to the state agency, which, in the vast bulk of cases, pays claims within 30 days. Payment is made with funds representing an aggregate of state and Federal money. Following the payment of claims, the state submits an accounting to CMS of the monies actually paid for a given period. Discrepancies between the advance previously transmitted and the Federal government's obligation to share costs are reconciled in the following quarter's advance.

CMS-provided funds often flow first into a state's general fund before subsequent redirection to the state Medicaid agency or agencies. Once transmitted to the state, there is generally no segregation of the Federal funds based upon actual or intended recipients.

The monies disbursed by CMS under the Medicaid program are monies to which the state Medicaid agency is entitled and over which the state agency exercises control. If a state fulfills the established criteria for participation in the program, CMS cannot withhold Federal funds from the state. The state agency is also granted wide latitude in the use of Federal funds transmitted to it, including discretion to create eligibility standards for enrollment of providers and to establish criteria for disbursement of funds. Furthermore, in the instance of non-payment to a provider, suits may be filed by providers against the state as the legally responsible party. The Federal disbursing agency generally bears no responsibility for non-payment to providers by the state agency.

The Medicaid program is structured so that states, and not Medicaid providers, possess an entitlement to the Federal funds transmitted by CMS. Furthermore, the flow of funds from the Federal government to the state Medicaid agencies, the operational discretion exercised by the state Medicaid agencies, and the state agencies' responsibility for non-payment reflect that state agencies are not mere agents of the Federal government for transmission of funds to medical service providers but, instead, are the actual recipients of such funds. These factors prevent Medicaid payments from qualifying under section 6331(h)(2)(A) of the Internal Revenue Code as "Federal payments," foreclosing the FPLP as currently structured as a means of recovering tax delinquencies of medical service providers.

As we pointed out in our March testimony, the fact that Medicare providers were not yet part of the FPLP did not mean that we were taking no enforcement actions against delinquent providers. The same is true for Medicaid providers. We are utilizing alternative collection means to pursue these delinquent taxpayers.

The GAO has referred the 25 egregious cases it discovered in its audit, and we will take appropriate action on each case. However, I would note that a cursory review of these 25 cases, based on the information provided in the draft GAO report, confirms that the IRS has sought enforcement actions against virtually all of the 25 providers. In some cases, that action involved a lien against the provider or an effort to apply the Trust Fund Recovery Penalty (TFRP). In some cases, the provider was part of the FPLP levy, although not for Medicaid payments.

Summary

Mr. Chairman, working collectively with FMS, GSA, DoD, CMS, and DoJ, and with the support of this Subcommittee, we have made considerable progress in expanding the amount of tax debt that is referred to the FPLP and the total collections that have resulted from those referrals. Taxpayers have every right to expect that anyone receiving Federal payments is current on their tax payments.

We continue to look at ways to expand even further the amount of tax debt that might be referred.

One improvement would be the enactment of a technical correction to the Internal Revenue Code that would allow us to levy up to 100% of all federal vendor payments. This authority was generally granted in 2005 but has not been fully implemented because of a technical deficiency in the statutory language.

Again, I thank the Members of the Subcommittee and your staff for your continued interest in the FPLP program, and I would be happy to respond to any questions that you may have.