Analysis&Perspective

The Internal Control Most Large Corporations Fail to Consider

Corporations exert significant effort to maintain adequate internal controls and satisfy requirements of independent auditors and Sarbanes-Oxley. At the same time, the organizations remit billions of dollars to the IRS annually while failing to reconcile their IRS account balances to determine whether the funds have been properly applied.

BY W. SCOTT ROGERS, ESQ.

The Overlooked Control

In the wake of the Sarbanes-Oxley Act, corporations are committing more resources than ever to developing and maintaining adequate internal controls. However, one important control is routinely ignored by most large corporations.

Before describing the control, however, here is an example of the financial impact overlooking this control can have. Assume that XYZ Corporation (Company), a Fortune 500 Company, establishes multiple direct deposit accounts with the Third National Bank (Bank). The overall relationship includes the accounts set forth in Table 1, each of which is established separately to fund a specific financial obligation type (Types 1-6).

Table 1 – Example Accounts

	Total Annual Obligations	Total Number of Open Accounts	Total Deposits in All Accounts
Type 1	4	17	$ 2,040,000,000
Type 2	1	15	4,400,000,000
Type 3	4	17	732,000
Type 4	1	4	7,020,000
Type 5	1	3	210,000
Type 6	1	4	164,000
Totals	12	60	$ 6,448,126,000

As shown in Table 1, Company enters into 12 separate financial obligations each year covering six different types of liability. Because the obligations often do not settle until several years after the funds are deposited, Company is actively maintaining 60 separate accounts as of the date on which Table 1 is assembled.

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The cumulative total amount Company has deposited in the accounts is nearly $6.5 billion.

In our example, Bank is free to move funds between Company's 60 accounts, often doing so without notifying Company of the movements. Also, should real or perceived delays occur with respect to settling the amounts due, Bank is free to penalize Company for the delays, even if the delays are the result of Bank-generated errors.

Finally, in a departure from normal banking procedures, Bank does not send periodic account statements to Company for purposes of reconciliation. In addition, Company does not make an attempt to reconcile the accounts using its own internal records.

When Company prepares its annual financial statements and its external auditors examine Company's financial records and internal controls, neither party makes any attempt to reconcile the accounts used in our example. Thus, nearly $6.5 billion that was placed under the exclusive care of Bank is completely omitted from consideration when the annual report is distributed with the blessing of both the external auditors and Company's senior management.

Overlooked Control: Federal Tax Deposit Accounts

The accounts described in Table 1 are the federal tax deposit accounts maintained with the IRS by the typical large corporation. The numbers set forth in Table 1 are actual amounts extracted from IRS records (hereinafter, transcripts) with respect to an actual Fortune 500 corporation. While the numbers may vary between account types and corporations, the totals above are by no means out of the ordinary for a large organization.

An analysis of federal tax account transcripts for large corporations over the past two decades by principals of Interest & Penalty Recovery Group has often lead to the recovery of funds erroneously captured by the IRS. IRS errors encountered can be categorized as computational errors (usually with respect to interest and penalty matters), erroneous penalty assessments, offsets of funds between different accounts without a taxpayer's awareness, and the failure to refund overpayments from taxpayers' accounts.

Although we have analyzed IRS transcripts for hundreds of Fortune 500 companies and their subsidiaries, as well as many smaller companies, we have rarely spoken with a corporate tax executive whose company conducts at least an annual reconciliation of all of its IRS transcripts, nor have we encountered an external audit firm that considers such a review to be an important internal control.

Before suggesting why that might be the case, this article offers some examples of actual IRS actions about which clients were unaware because of the lack of an annual transcript review. These examples represent a small sampling of the many IRS errors uncovered.

Example 1: the Advance Payment That Disappeared

For ABC Company (ABC), an analysis was performed of transcripts of all federal tax types. The review discovered nearly $1 million of late deposit penalties posted to three of ABC's Form 941 (payroll) accounts. ABC was unaware of the penalty assessments because the IRS had paid the penalties by offsetting advance payments from a Form 1120 account to the respective Form 941 accounts. To determine why the IRS had assessed the penalties, copies of Forms 941 were obtained. It was found that ABC had simply failed to check a box indicating that payroll liabilities had been deposited using the ''Safe Harbor'' provision, which allows an employer to deposit less than the total amount of a wage withholding liability by the prescribed due date provided that the employer makes up the shortfall by a specified later date. (Note that the Safe Harbor check-box was removed from Form 941 a few years later.) We corrected the errors on the Form 941 and filed claims seeking abatement of the penalties. The IRS abated the penalties in full, and the advance payments were returned to the proper Form 1120 accounts. Had ABC not taken action, the statute of limitations within which to have the payroll penalties abated would have expired. Consequently, ABC would have been required to make new advance payments with respect to the anticipated Form 1120 deficiencies.

Example 2: 'Our Payroll and Excise Accounts Are in Perfect Order'

XYZ Company (XYZ) engaged one of our principals in the early 1990s to analyze all federal tax accounts. Before work began, XYZ's payroll and excise tax managers advised that no errors in the payroll and excise tax transcripts would be found. However, it was discovered that the IRS employee charged with monitoring XYZ accounts had input a freeze code to prevent the IRS's computer system from refunding any overpayments from the company's accounts. The IRS employee said she had grown frustrated with XYZ's apparent inability to explain to her why they had grossly overdeposited their reported payroll and excise tax liabilities and had thus frozen the accounts pending further investigation.

XYZ's managers were shocked and unable to provide an adequate explanation as to why the overpayments existed. XYZ received payroll and excise tax refunds, plus interest, in excess of $15 million.

Example 3: XYZ Revisited and the Specter of 'Excess Collections'

XYZ engaged our principal again in the late 1990s to undertake another analysis of its complete federal tax transcripts. Findings in the second engagement were nearly identical in both amount and cause as the overpayments we recovered for the client in the first engagement. The IRS liaison for the project was the same employee we had worked with to secure the recoveries discovered in our prior analysis. However, there was an important variation with respect to the statute of limitations applicable to the amounts we were seeking to recover. The IRS liaison advocated for the client, but the Statute Control Unit at the Service Center initially argued that the company's claims were statute barred. The company ultimately prevailed, once again obtaining refunds in excess of $15 million.

A computer-generated series of transactions nearly prevented identification and recovery of the overpayments that were refunded pursuant to the second XYZ engagement. The IRS's computer system is programmed to offset any overpayment that remains unclaimed in a taxpayer's account for a specified period of time to a special collections account. In short, once the IRS freezes a corporate overpayment balance in an account for approximately 60 months, the overpayment may be swept from the account into excess collections. Effectively, the taxpayer's money is simply captured by the government's account as a voluntary payment of unassessed tax. Shortly after the overpayment is removed from the taxpayer's tax account, the account from which it was taken is removed from the IRS's active account system. Unfortunately, the active account system is used to select the transcripts that the IRS sends out for purposes of analysis.

In our example, had XYZ delayed in reviewing its account by a few months, the accounts containing the overpayment balances would have been emptied and removed from the IRS active account system before anyone could request account transcripts. While it is possible to identify IRS transactions offsetting overpayments to excess collections when a transcript is still active, once the IRS archives the transcripts the opportunity may be lost.

To underscore, the excess collections program may cost a company substantial cash flow opportunities in the absence of an annual transcript analysis and reconciliation.

Why Has This Control Been Disregarded?

The prevailing corporate organizational structure has a detrimental impact on attempts to convince companies that IRS transcript reconciliations are a necessary function that should be performed if annual financial statements are to be accurately stated and control deficiencies avoided.

When we approach a client, our primary point of entry is normally the vice president of tax or the tax director. We choose this approach because we find the largest concentration of IRS posting errors in the Form 1120 accounts. However, sometimes this approach is frustrated because of organizational issues.

For example, the typical Fortune 500 Company settles a federal income tax examination approximately every three years. The IRS normally examines income tax returns in groups of three, thus the three-year settlement cycle. The federal income tax executive is responsible for and concerned with the income tax examination process, but normally has no responsibility as relates to payroll, excise, or other federal tax types. These executives normally engage consultants to analyze the federal income tax transcripts after an examination has settled. Income tax executives often say they are not authorized to contract for analysis of non-income tax related federal tax accounts, and suggest that the payroll and excise tax managers are responsible.

The federal income tax executive tends to have an appreciation for the complexities involved in analyzing interest on an income tax settlement, and welcomes a review of those transactions. However, the typical payroll and/or excise tax manager is generally not aware of the numerous mistakes that the IRS makes behind the scenes. Often, they consider a proposal to audit the transactions as an effort to uncover mistakes for which they may be held accountable. Very few managers of these tax functions understand that such a review may correct hidden IRS errors, rather than report the managers' own errors to their superiors.

The ideal executive with whom to discuss performing an annual transcript analysis is the executive under whose authority all federal tax responsibilities converge. We have found that the audit committee member, chief financial officer, or controller is typically an executive who is both empowered to make the engagement decision and to be in a position in which he or she has no need to fear for his or her security.

Be Careful With Internal Review

A company's complete federal tax account transcripts should be analyzed annually. Companies should consider carefully before considering assigning the reconciliation duties to an employee or to external auditors, however. One issue is that IRS transcripts are highly coded and complex. In addition, a knowledgeable authority can obtain more detailed information from the IRS. Consider the following example.

Example 4: What Do the Numbers Mean?

DEF Inc. (DEF) assigns Jane, an assistant manager in the payroll department, with the task of analyzing all IRS transcripts of DEF's federal tax accounts each December. Jane orders transcripts from the IRS, which sends her the type of transcripts normally sent to company employees who request the information. In the course of analyzing the Form 720 Excise Tax return for the first quarter of 2003, Jane discovers the following transaction (an approximation of the typical format used by IRS in publicly-disclosed transcripts follows):

840	REFUND	11-30-2005	$12,000,000.00

Jane may get excited because she notices that the IRS failed to include any interest in the $12 million refund. However, the excise tax refunded was a type of excise tax on which refund interest is not allowed. Professional practitioners would have received a more detailed, but less user friendly, IRS transcript on which specific excise tax categories are designated by a special series of codes. The practitioner would have known that the IRS properly refunded that particular excise tax overpayment without interest.

Undeterred, Jane continues with her analysis of DEF's IRS transcripts. Next, she discovers a large overpayment that was offset (removed) from the third quarter, 1999 Form 941 account. The transaction on Jane's transcript is shown as follows:

820	OVERPAYMENT CREDIT TRANSFERRED 9-06-2005	$1,000,000.00

Jane reads this transaction to simply mean that an overpayment was moved from one account to another. However, the more detailed reports received by a professional practitioner would show the following:

820	9/06/2005	$1,000,000.00	20053608	07148-650-00001-4 01 9999

The transaction analyzed by the practitioner indicates that the IRS has offset the $1 million overpayment to excess collections. The practitioner will now seek to have the overpayment restored and refunded to DEF.

Example 5: the Worst Case Scenario

As in Example 4 above, DEF assigns an assistant payroll manager with the task of reviewing all federal tax account transcripts on an annual basis. Snidely, however, has taken a payroll position at DEF for the sole purpose of finding some way to abscond to parts unknown with a bundle of DEF's cash. While analyzing DEF's accounts, Snidely discovers an overpayment of $25 million frozen in DEF's 1998 income tax account. DEF deposited the $25 million as an advance payment in anticipation of an examination settlement at some point in the next 18 months. Snidely knows that DEF owns subsidiary LMN, a small subsidiary that pays a handful of employees and files Form 941 each quarter. DEF assists in LMN's payroll recordkeeping and Snidely has access to all important LMN payroll information. Snidely forges signatures on the appropriate powers of attorney for DEF and LMN and sends a letter to the IRS advising it to move the $25 million advance payment from DEF's federal income tax account to the tax year 2005 Form 945 Backup Withholding account of LMN. Snidely next files an amended Form 945 return for LMN's 2005 tax year on which the $25 million is added to both total deposits and total backup withholding liabilities for the year. Subsequently, Snidely issues a Form 1099 to himself from LMN on which he reports $25 million of back-up withholding. Finally, Snidely files Form 1040 for 2005, reporting his W-2 income from DEF and adding a fraudulent Schedule C in which he reports taxable net income from self-employment of about $35 million. Under this scenario, Snidely may expect to receive a refund of about half of the $25 million he reported as backup withholding ($12.5 million). While the IRS may ultimately uncover Snidely's scam, he may be resting on a beach in a non-extradition country and someone at DEF will have a lot of explaining to do as to why adequate controls were not in place to prevent Snidely's crime.

Conclusion

Finally, we return briefly to Table 1, in which Bank manages a company's numerous deposit accounts. Imagine those same funds being managed by the IRS. That fact, more than any other, should motivate the audit committee member, CFO, or controller to seek an annual transcript review.