



*Millions of Dollars in Potentially
Improper Self-Employed Retirement
Plan Deductions Are Allowed*

March 20, 2014

Reference Number: 2014-10-008

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

2 = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

MILLIONS OF DOLLARS IN POTENTIALLY IMPROPER SELF-EMPLOYED RETIREMENT PLAN DEDUCTIONS ARE ALLOWED

Highlights

Final Report issued on March 20, 2014

Highlights of Reference Number: 2014-10-008 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

Self-employed taxpayers may deduct contributions that are made to their own Simplified Employee Pension (SEP) or other qualified retirement plan account on line 28 of their individual tax return under certain circumstances.

WHY TIGTA DID THE AUDIT

The overall objective was to determine whether the IRS's controls and third-party data are adequate to identify improper deductions for contributions made by self-employed taxpayers to their own SEP plan retirement account.

WHAT TIGTA FOUND

This could be verified using information provided by taxpayers when individual tax returns are filed. If the IRS improves controls, it could prevent improper deductions and potentially protect \$71 million in revenue over five years.

In addition, TIGTA found that the IRS could better use third-party data to detect potentially

improper SEP deductions. For example, to be able to claim a SEP deduction on line 28 of Form 1040, self-employed taxpayers must show net earnings on a self-employed business.

If the IRS improves controls, it could detect improper deductions and potentially realize \$29 million in revenue over five years.

While using third-party data could assist the IRS in detecting improper SEP deductions,

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS enhance controls to prevent and detect improper claims on line 28 and assess the need for additional third-party data to verify line 28 deductions.

In their response, IRS management disagreed with TIGTA's conclusion that, but they agreed that certain actions can be taken to improve existing processes.

TIGTA does not believe that the IRS's corrective actions are sufficient. This audit identified millions of dollars in potentially improper or fraudulent claims. TIGTA continues to believe that the IRS should consider additional controls to prevent or detect potentially improper retirement plan deductions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 20, 2014

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael E. McKenney

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed
(Audit # 201210031)

This report presents the results of our review to determine whether the Internal Revenue Service's (IRS) controls and third-party data are adequate to identify improper deductions for contributions made by self-employed taxpayers to their own Simplified Employee Pension (SEP) plan retirement account. This review is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations).



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

Table of Contents

Background Page 1

Results of Review Page 3

*****2*****
*****2*****
*****2***** Page 3

Recommendation 1: Page 5

Recommendation 2: Page 6

*****2*****
*****2*****
*****2***** Page 7

Recommendation 3: Page 9

*****2*****
*****2*****
*****2***** Page 10

Recommendation 4: Page 11

Appendices

 Appendix I – Detailed Objective, Scope, and Methodology Page 12

 Appendix II – Major Contributors to This Report Page 14

 Appendix III – Report Distribution List Page 15

 Appendix IV – Outcome Measures Page 16

 Appendix V – Management’s Response to the Draft Report Page 20



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

Abbreviations

AUR	Automated Underreporter
IRA	Individual Retirement Arrangement
IRS	Internal Revenue Service
SEP	Simplified Employee Pension
SIMPLE	Savings Incentive Match Plan for Employees
W&I	Wage and Investment



*Millions of Dollars in Potentially Improper
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Background

A Simplified Employee Pension (SEP) is a retirement plan that allows self-employed taxpayers to make contributions toward their own and their employees' retirement without getting involved in a more complex qualified plan. Under a SEP, self-employed taxpayers make contributions to a traditional Individual Retirement Arrangement (IRA) established for each eligible employee (employees own and control their SEP IRA). Employers create SEPs by executing a formal written agreement that provides benefits to all eligible employees and can satisfy this requirement by adopting an Internal Revenue Service (IRS) model SEP using Form 5305-SEP, *Simplified Employee Pension – Individual Retirement Accounts Contribution Agreement*. Use of Form 5305-SEP does not require prior IRS approval.

***Simplified employee pensions
provide a means for
self-employed taxpayers to
save for their retirement.***



SEP IRAs are managed by financial institutions (or entities approved by the IRS) serving as third-party trustees. These institutions annually notify employers, employees, and the IRS of contributions made to SEP IRAs via Form 5498, *IRA Contribution Information*. An analysis of Forms 5498 for Tax Year 2011 revealed that more than 207,000 taxpayers had SEP contributions totaling \$1.7 billion.

Self-employed taxpayers may claim deductions for contributions to their SEP, Savings Incentive Match Plan for Employees (SIMPLE), or other qualified retirement plans on line 28 of Form 1040, *U.S. Individual Income Tax Return*. To be eligible for a deduction for contributions to their own retirement plans, taxpayers must be self-employed. A self-employed taxpayer's compensation (hereafter referred to as net earnings)¹ should be reported on a Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, Schedule E, *Supplemental Income and Loss*, or Schedule F, *Profit or Loss From Farming*. For contributions to their own retirement plan account, self-employed taxpayers take a deduction on line 28 of Form 1040. For

¹ Compensation is defined as the pay a participant received for personal services for a year, including wages, salaries, commissions, and bonuses. For self-employed individuals, compensation is a person's earned income, defined as the net earnings from self-employment (gross income from a trade or business minus allowable business deductions). For a self-employed individual, net earnings also include a partner's distributive share of partnership income or loss from Form 1065, *U.S. Return of Partnership Income*.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

SEPs, the deduction on line 28 is limited to the smaller of a maximum contribution amount² or 25 percent of the self-employed taxpayer's net earnings.

This review focused on the IRS's controls for providing reasonable assurance that SEP deductions intended for self-employed taxpayers are accurate and that the amounts deducted are consistent with amounts reported on third-party payer documents submitted by trustees and financial institutions. We also reviewed how controls over SEP deductions affected other self-employed retirement plan deductions on line 28 of Form 1040. Deductions that were made on behalf of employees on a corresponding Schedule C, E, or F were not included in the scope of this audit.

Within the IRS, the Wage and Investment (W&I) Division is responsible for individual taxpayers who claim deductions on Form 1040, line 28, for contributions to their own retirement plan account. As part of its mission, the W&I Division checks for errors or improper refunds when it processes individual tax returns. In addition, the W&I Division administers the Automated Underreporter (AUR) program that uses third-party data to identify taxpayers who have understated or overstated entries on previously processed tax returns.

This review was performed at the W&I Division Headquarters in Atlanta, Georgia. We also interviewed and received information from the Tax Exempt and Government Entities Division Employee Plans function in Dallas, Texas, during the period October 2012 through June 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

² For Tax Year 2011, the maximum contribution amount was \$49,000. For Tax Year 2012, the maximum contribution amount was \$50,000.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Results of Review

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*****2*****. By following up on improper deductions we identified, the IRS could potentially protect more than \$14 million in revenue for Tax Year 2011.3 In addition, if the IRS improves controls in this area for future tax return processing, it could protect more than \$71 million in additional revenue over five years.4

Some taxpayers who contribute to SEPs are claiming potentially improper deductions

For Tax Year 2011, approximately 200 taxpayers who did not file a Schedule C, E, or F to report net earnings from self-employment claimed more than \$2 million in SEP deductions on line 28 of Form 1040. Since taxpayers are not required to state on Form 1040, line 28, whether the deduction they are claiming is for a SEP or another type of self-employed retirement plan, we used Form 54985 information returns that are filed with the IRS subsequent to individual tax returns to determine that these taxpayers were contributing specifically to a SEP. We reviewed a random sample of 50 of these accounts and verified that these taxpayers contributed to a SEP and claimed a deduction on line 28, but they did not file a Schedule C, E, or F to indicate that they were self-employed. Reporting net earnings from self-employment is a requirement for taking a SEP deduction on line 28.

3 The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$6,562,922 and \$22,000,546.

4 See Appendix IV. The five-year forecast for potential revenue protection is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

5 Forms 5498 indicate whether contributions were made to a SEP, SIMPLE, or other qualified retirement plan.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

We reviewed the tax accounts for five taxpayers who would have had a significant tax increase if their Form 1040, line 28, deduction had been denied in Tax Year 2011 and determined that four taxpayers had each claimed potentially improper deductions of up to \$17,500 on one or both of their previous two tax returns. Of the five taxpayers, three had taxable income that exceeded or would have exceeded \$100,000 had the deduction not been allowed, *****1*****

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Since there is no information available when an individual tax return is filed for the IRS to know whether a deduction is for a SEP or another self-employed retirement plan claimed on line 28 of Form 1040 (e.g., SIMPLE, Keogh Plans), we expanded our review to look at all deductions claimed on line 28 of Form 1040. All taxpayers claiming a deduction on line 28 are required to be self-employed, regardless of whether they are making contributions to a SEP or any other self-employed retirement plan associated with line 28.

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*****2*****. In addition, if the IRS improves controls in the future *****2*****
*****2*****, it could protect an additional \$71 million in revenue over five years.⁶

IRS officials reviewed a sample of taxpayers we identified as having potentially improper deductions *****2*****
*****2*****. However, IRS officials also noted that some taxpayers *****2***** may be self-employed because they paid self-employment taxes. According to IRS officials, these taxpayers may be improperly reporting self-employed business income from Form 1099-MISC, *Miscellaneous Income*, on Form 1040, line 21, *****2*****. As a result, taxpayers may be paying self-employment taxes based on income reported on Form 1099-MISC *****2*****
*****2*****.

We reviewed the IRS’s documentation of its analysis and determined that some taxpayers were receiving income through Forms 1099-MISC and paying self-employment taxes. However, it is unclear whether these taxpayers were self-employed because other types of income reported on

⁶ See Appendix IV. The five year forecast for the potential revenue protection is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Form 1099-MISC are not considered self-employed business income. As such, these tax returns and related reporting may be improper and should be considered by the IRS for a review to determine if line 28 deductions should be allowed.

Recommendations

Recommendation 1: The Director, Submission Processing, W&I Division, should enhance existing validation programs.

Management's Response: The IRS agreed that some cases were allowed to process when there was no discernable income from self-employment income reported on the returns. The IRS stated that it will take immediate actions, in preparation for the 2014 Filing Season, to remind employees of the procedures for marking these returns for further review and the appropriate action to be taken when the review finds that income from self-employment has not been included on the return.

Office of Audit Comment: While IRS management agreed to evaluate whether manual and automated processes could be improved, they stated that procedures are in place to determine whether taxpayers claiming deductions reported self-employment income, but these procedures were not followed in some cases.

IRS management also stated that it did not agree with the full amount of our projected outcome measure because they believe the issue may be due to placement errors rather than noncompliance. IRS management noted that some taxpayers report miscellaneous income from self-employment on line 21 of Form 1040 and calculate self-employment tax on Form 1040, Schedule SE. The IRS views these placement errors as inconsequential.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

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*****2*****. It is important to note that the IRS’s own instructions for line 21 of Form 1040 show what is to be reported and includes items such as gambling winnings, prizes, awards, jury duty pay, taxable distributions from education accounts, etc. Furthermore, IRS instructions for line 21 of Form 1040 state “Do not report on this line any income from self-employment or fees received as a notary public. Instead, you must use Schedule C, C-EZ, or F, even if you do not have any business expenses.” Therefore, we disagree with the IRS’s position that tax returns with amounts on line 21 only involve placement errors. We continue to believe that our outcome measure represents the potential for identifying improper self-employed retirement plan deductions over five years if controls are improved.

Recommendation 2: The Director, Compliance, W&I Division, should initiate actions to determine whether the taxpayers we identified who claimed potentially improper SEP and other retirement plan deductions in Tax Year 2011 should be assessed additional tax.

Management’s Response: IRS management agreed with our recommendation and stated that they will review the accounts identified and determine whether actions should be taken to address erroneous contribution deductions. IRS management added that consideration will be given to whether self-employment net earnings actually were reported, albeit on an incorrect line of the return, the materiality of the potential adjustment and assessment, and the assessment statute of limitations.

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When tax returns are received, the IRS can identify taxpayers who claimed deductions for SEP, SIMPLE, or other qualified retirement plans on line 28 but did not report that they were self-employed on a Schedule C, E, or F. However, it cannot test whether specific requirements for taking a SEP deduction are met until after tax returns are filed and Forms 5498 are received.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

This is because third parties segregate SEP contributions on Forms 5498 from other types of retirement plan contributions. Once the IRS has this third-party data, it has the opportunity to determine if requirements for taking SEP deductions were met on previously filed tax returns.

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To be able to claim a SEP deduction on line 28 of Form 1040, self-employed taxpayers must show net earnings from a self-employed business. In addition, SEP deductions are limited to the smaller of a maximum contribution amount⁷ or 25 percent of the self-employed taxpayer's net earnings. *****2*****

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*****2***** . By following up on improper deductions we identified, the IRS could potentially realize approximately *****2*****⁸
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*****2***** . Self-employed taxpayers are required to report net earnings from at least one business to be eligible for a SEP deduction. We reviewed the tax account data for a random sample¹¹ of 50 of the 164 taxpayers to determine the tax impact if potentially improper SEP deductions are disallowed. *****2*****

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⁷ For Tax Year 2011, the maximum contribution amount was \$49,000. For Tax Year 2012, the maximum contribution amount was \$50,000.
⁸ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$3,480,091 and \$8,281,457.
⁹ See Appendix IV. The five-year forecast for potential increased revenue is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.
¹⁰ Forms 5498 indicate whether contributions were made to IRAs including SEP, SIMPLE, Roth IRAs, or traditional IRAs.
¹¹ See Appendix I for details on our sampling methodology.
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Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Recommendation

Recommendation 3: To determine whether taxpayers are meeting requirements for taking a SEP deduction that can only be tested after tax returns are filed, the Director, Compliance, W&I Division, should use third-party data to detect potentially improper SEP deductions.

Management's Response: IRS management did not agree that additional actions are necessary. According to the IRS, it has a robust compliance program that allocates limited resources across a broad range of tax provisions to provide a balanced enforcement presence and promote voluntary taxpayer compliance. The IRS further explained that examiners are required under the auditing standards to address large, unusual, or questionable items present on tax returns. In addition, the IRS stated that the examiners have access to third-party data when reviewing returns to determine if they should be audited, when planning an audit after selection, and while conducting an audit.

Office of Audit Comment: The IRS did not address our specific finding of potential noncompliance.

Our review of tax return data for two random samples... This greatly exceeds the average additional assessment of approximately \$1,600 for the overall IRS AUR compliance program. If the IRS determines that the AUR program is not equipped for these types of analyses, then other compliance alternatives, such as compliance projects that use the Compliance Data Environment,16 may provide a method for bringing taxpayers with these types of issues into compliance. As such, we continue to believe that the IRS should enhance its use of third-party data in this area and that our outcome measure represents the potential for identifying improper SEP deductions over five years if controls are improved.

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Since taxpayers can claim deductions for contributions to other types of self-employed retirement plans on the same tax return line as SEPs, we expanded our review to determine how

16 The Compliance Data Environment provides a centralized information system with tax return data and other related information that IRS employees use to analyze and deliver tax returns for examinations and other compliance projects.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

the IRS could use third-party data to validate other deductions on line 28 of Form 1040. **2**

IRS officials informed us that the AUR program does identify mismatch conditions between line 28 deductions and amounts reported on Forms 5498. However, we determined that mismatch conditions identified by the AUR program may be due to the fact that certain retirement plans for which taxpayers can claim deductions on line 28, such as Keogh Plans, are not subject to third-party reporting. *****2*****17 *****2*****18*****

*****2***** . When the IRS uses complete information from independent third parties, compliance rates are extremely high. For example, compliance rates associated with amounts on tax returns that are subject to substantial information reporting and withholding, such as wages and salaries, is 99 percent. Further, reported amounts on tax returns that have substantial information reporting but no withholding still have a very high 92 percent compliance rate. In contrast, reported amounts that have little or no information reporting, such as business income, have compliance rates of only 44 percent.¹⁹

Legislative Recommendation

Recommendation 4: The Director, Compliance, W&I Division, should work with the Department of the Treasury to assess whether it would be cost effective to recommend legislative changes *****2*****

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19 IRS, Tax Gap for Tax Year 2006 Overview (January 6, 2012).



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

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Management's Response: IRS management responded that, although contributions for qualified retirement plans are not reported on Form 5498, such plans are subject to reporting on Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*, when plan assets exceed \$250,000 or the plan is reporting for its final year. As part of the auditing standards, in addition to addressing large, unusual, or questionable items, IRS examiners are required to inspect all related returns of the taxpayer and to ensure that the taxpayer is in compliance with all filing requirements. IRS management stated that since the AUR program is not an audit program, the level of complexity affecting qualified plans is comparatively high, and the volume of affected taxpayers is relatively low, they do not believe there are gains to be made by imposing additional reporting requirements on these plans. The IRS will determine if procedures can be revised to improve the examination referral process when returns identified by the AUR program are found to have questionable qualified plan issues.

Office of Audit Comment: The corrective actions planned by the IRS do not address the condition that the recommendation is intended to address. The IRS responded that, while other qualified plans may not be subject to Form 5498 reporting requirements, the plans are subject to reporting on Form 5500-EZ when the plans have assets that exceed \$250,000 or the plan is reporting for its final year. However, Forms 5498 and 5500-EZ serve different purposes and are required for different reasons. Form 5498 is used by independent third-parties or trustees to report contributions that are made to IRAs (including SEPs), while Form 5500 series returns are used to determine if employee benefit plans are operated and managed in accordance with prescribed standards.

More than 36,000 taxpayers claimed deductions totaling more than \$560 million for Tax Year 2011 *****2*****

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*****2*****. We continue to believe that the IRS should follow through on this recommendation.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS’s controls and third-party data are adequate to identify improper SEP deductions for contributions made by self-employed taxpayers to their own SEP retirement plan account. To accomplish this objective, we:

- I. Identified and evaluated existing procedures and controls for processing Form 5498, IRA Contribution Information, data reflecting contributions to taxpayer SEP accounts.
A. Researched existing guidelines and met with IRS staff to determine if IRS compliance programs validated the SEP contribution amount (shown in box 8 of Form 5498).
B. Met with IRS W&I Division staff to determine how discrepancies are resolved when IRS compliance programs identify a mismatch between the SEP amount shown by third-party trustees on Form 5498 and the SEP deduction on a self-employed taxpayer’s individual tax return.
II. Identified deductions for SEP contributions that were inconsistent with other items reported on Form 1040, U.S. Individual Income Tax Return.
A. Requested an extract from the Data Center Warehouse1 of Tax Year 2011 Form 5498 data2 and sorted the information by each of the indicators (IRA, SEP, SIMPLE, and Roth IRA) shown in box 8 to identify taxpayers having a deposit to their SEP account.
B. Identified all taxpayers with deductions on line 28 of Form 1040 who had information on other parts of the Form 1040 that was inconsistent with being eligible for taking the deduction.

1 The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration for the purpose of analyzing data for ongoing audits.

2 To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration Office of Strategic Data Services validated the data that were extracted and we verified the accuracy of information from Forms 5498 and Forms 1040 by researching the IRS’s Integrated Data Retrieval System, which is the IRS computer system capable of retrieving and updating stored taxpayer account information. We did so for all accounts sampled to ensure that the amounts presented were supported by external sources. Based on our tests, we concluded that the data were sufficiently reliable for our audit.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

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- III. Determined whether IRS processes were sufficient to identify taxpayers claiming a potentially improper deduction on Form 1040, line 28. We also determined whether third-party payer documents submitted by trustees/financial institutions sufficiently enabled the IRS to confirm deductions made by taxpayers on Form 1040, line 28.
 - A. Identified all taxpayers from Tax Year 2011 who claimed a deduction on Form 1040, line 28.
 - B. Determined the number of taxpayers from Step III.A who did not have a matching Form 5498 filed for Tax Year 2011.

Internal controls methodology

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS’s policies, procedures, and practices for receiving and validating SEP information reported on taxpayers’ returns. We evaluated these controls by interviewing management, reviewing tax returns where the taxpayer claimed a SEP deduction that was inconsistent with other information reported on the tax return, and comparing Form 5498 data to Form 1040, line 28.

³ A contract statistician assisted with developing our sampling plans and projections. We used a random sample to ensure that each account had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

Appendix II

Major Contributors to This Report

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Allison P. Meyer, Auditor

Brian W. Hattery, Information Technology Specialist



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Assistant Secretary of the Treasury for Tax Policy
Deputy Commissioner for Services and Enforcement SE
Acting Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Chief Counsel CC
National Taxpayer Advocate TA
Audit Liaisons:
 Director, Communications and Liaison, Tax Exempt and Government Entities
 Division SE:T:CL
 Commissioner, Wage and Investment Division SE:W



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

Appendix IV

Outcome Measures

This appendix provides detailed information on the measurable impact our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential, \$14,281,734¹*****2*****, or \$71,409,000² over five years (see page 3).

Methodology Used to Measure the Reported Benefit:

To determine the amount of additional tax due for taxpayers who claimed potentially improper SEP deductions, we analyzed all 139,809,971 Tax Year 2011 Forms 1040 input through September 12, 2012, and identified 702,167 having an entry on line 28, “Self-employed SEP, SIMPLE, and qualified plans.” *****2*****
*****2***** Taxpayers must report net earnings from self-employment to take a deduction on line 28 of Form 1040.

We selected a random sample of 50 returns and computed the amount of additional tax due *****2*****.³ We did so by:

1. Determining the taxpayers’ filing status, taxable income (line 43 of Form 1040), and tax (line 44 of Form 1040).
2. Adding the amount by which their returns overstated the deduction shown on Form 1040, line 28, to their taxable income.
3. Computing the tax amount for the updated taxable income.

¹ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$6,562,922 and \$22,000,546.

² The five-year forecast for potential revenue protection is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change. The five-year forecast was rounded to the nearest \$1,000.

³ We discussed the methodology used to validate the data for this population with a contract statistician, who agreed with our approach. We also determined the estimated tax revenue lost information that is included in Figure 1.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

4. Calculating the difference between the original and updated tax amounts.
5. Projecting the total amount of additional tax due.

Figure 1 provides the details of our estimate of lost tax revenue for SEPs and other retirement plans.

**Figure 1: Tax Year 2011 Estimate of Tax Revenue Lost
From Improper Self-Employed Retirement Plan Deductions Claimed**

Tax Return Characteristic	Estimated Potential Lost Tax Revenue		
	Lower Limit	Point Estimate	Upper Limit
*****2***** *****2***** *****2*****	\$6,562,922	\$14,281,734	\$22,000,546

Source: Treasury Inspector General for Tax Administration contract statistician.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$5,880,774⁴ *****2*****
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Methodology Used to Measure the Reported Benefit:

To determine the amount of additional tax due for taxpayers who claimed potentially improper SEP deductions, we analyzed all 139,809,971 Tax Year 2011 Forms 1040 input through September 12, 2012, and identified 702,167 having an entry on line 28, “Self-employed SEP, SIMPLE, and qualified plans.” We then compared Forms 5498, *IRA Contribution Information*,⁵ showing a contribution to a SEP account with returns that had deductions on line 28. ***2***
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⁴ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$3,480,091 and \$8,281,457.

⁵ Forms 5498 indicate whether contributions were made to IRAs including SEP, SIMPLE, Roth IRAs, or traditional IRAs.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

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Forms 1040 meeting the above criteria either do not meet the requirements to take a SEP deduction on line 28 of Form 1040 or overstate the SEP deduction amount allowed. We selected a random sample of 100 returns⁶ and computed the amount of additional tax due

*****2*****.⁷ We did so by:

1. Determining the taxpayers' filing status, taxable income (line 43 of Form 1040), and tax (line 44 of Form 1040).
2. Adding the amount by which their returns overstated the deduction shown on Form 1040, line 28, to their taxable income.
3. Computing the tax amount for the updated taxable income.
4. Calculating the difference between the original and updated tax amounts.
5. Projecting the total amount of additional tax due.

Figure 2 provides the details of our estimate of lost tax revenue for SEPs.

⁶ We chose a random sample of 50 of the 164 returns involving taxpayers who claimed a SEP deduction but had no self-employment net earnings on Schedules C, E, or F and a random sample of 50 of the 1,148 returns involving taxpayers who claimed a SEP deduction that exceeded 25 percent of their self-employment net earnings.

⁷*****2*****.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

**Figure 2: Tax Year 2011 Estimate of Tax Revenue Lost From
Improper Simplified Employee Pension Plan Deductions Claimed**

Tax Return Characteristic	Estimated Potential Lost Tax Revenue		
	Lower Limit	Point Estimate	Upper Limit
*****2***** *****2*****	\$1,040,496	\$2,346,547	\$3,652,597
*****2***** *****2***** *****2***** *****2*****	\$1,447,851	\$3,534,227	\$5,620,604
Total:		\$5,880,774⁸	

Source: Treasury Inspector General for Tax Administration contract statistician.

⁸ The point estimate was computed by adding the projections from each of the tax return characteristics sampled. The point estimate projections are based on a two-sided 95 percent confidence interval for each tax return characteristic. We are 95 percent confident that the point estimate is between \$3,480,091 and \$8,281,457.



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Appendix V

Management's Response to the Draft Report



COMMISSIONER WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE ATLANTA, GA 30308

JAN 06 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT FROM: Peggy Bogadi Commissioner, Wage and Investment Division SUBJECT: Draft Audit Report – Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed (Audit # 201210031)

Thank you for the opportunity to review the subject draft report. While we believe actions can be taken to improve the execution of existing processes, we generally disagree with the facts and conclusions presented in the report.

We disagree with the Treasury Inspector General for Tax Administration's (TIGTA) conclusion that controls are not in place to detect potentially improper Self-Employed Retirement Plan (SEP) deductions. Current procedures are in place to determine whether taxpayers claiming SEP deductions on the Form 1040 reported self-employment income on the tax return.

Employees are instructed to deny the deduction if there were no evidence that the taxpayer reported self-employment income on Schedule C, Profit or Loss From Business (Sole Proprietorship), Schedule E, Supplemental Income and Loss, or Schedule F, Profit or Loss From Farming. Some taxpayers receive non-employee compensation, commonly reported on Form 1099-MISC, Miscellaneous Income, or other amounts of income derived from self-employment activities, and do not report those earnings on Schedules C, E, or F but instead report the self-employment income on the "Other Income" on Line 21 and calculate the resulting self-employment tax liability on Schedule SE, Self-Employment Tax.

When a Schedule C, E, or F is not filed with the return, and the employees cannot reconcile the amounts reported on Lines 21 and Schedule SE, they are instructed to deny the SEP deduction. *****2*****



*Millions of Dollars in Potentially Improper
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We do not agree with the projected Outcome Measures of \$71.4 million over five years *****2*****
*****2*****
*****2*****. Although taxpayers may report items on their returns in incorrect locations, when their intent is clearly evident and the error does not result in an understatement of total income, taxable income, and total tax liability, the placement error is inconsequential. We believe the TIGTA has overstated the Outcome Measures by equating the placement errors to non-compliance with the Code.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Steve Klingel, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-9085.

Attachment



Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed

Attachment

RECOMMENDATIONS

RECOMMENDATION 1

The Director, Submission Processing, W&I Division, should enhance existing validation programs

*****2*****
*****2*****
*****2*****
*****2*****

CORRECTIVE ACTION

We agree that some cases were allowed to process when there was no discernible income from self-employment income reported on the returns. We will take immediate actions, in preparation for the 2014 Filing Season, to remind employees of the procedures for marking these returns for further review, and the appropriate action to be taken when the review finds that income from self-employment has not been included on the return. We will also review manual and automated processes to determine if systemic improvements can be made to enhance the validation of Self-Employed Retirement Plan (SEP) deductions.

IMPLEMENTATION DATE

Reinforce employee awareness of existing processing requirements - April 15, 2014
Assess opportunities for systemic enhancements - October 15, 2014

RESPONSIBLE OFFICIAL

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

Recommendation

RECOMMENDATION 2

The Director, Compliance, W&I Division, should initiate actions to determine whether the taxpayers we identified who claimed potentially improper SEP and other retirement plan deductions in Tax Year 2011 should be assessed additional tax.

CORRECTIVE ACTION

We will review the accounts identified and determine whether actions should be taken to address erroneous contribution deductions. Consideration will be given to whether self-employment actually was reported, albeit on an incorrect line of the return, the materiality of the potential adjustment and assessment, and the assessment statute of limitations.



*Millions of Dollars in Potentially Improper
Self-Employed Retirement Plan Deductions Are Allowed*

IMPLEMENTATION DATE

April 15, 2015

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

Recommendation

RECOMMENDATION 3

To determine whether taxpayers are meeting requirements for taking an SEP deduction that can only be tested after tax returns are filed, the Director, Compliance, W&I Division, should use third party data to detect potentially improper SEP deductions.

CORRECTIVE ACTION

Third-party data is already available for use in determining if income or expenses have been improperly reported. The IRS has a robust compliance program that allocates limited resources across a broad range of tax provisions to provide a balanced enforcement presence and promote voluntary taxpayer compliance. Examiners are required under the auditing standards to address large, unusual, or questionable items present on tax returns. The examiners have access to third-party data when reviewing returns to determine if they should be audited, when planning an audit after selection, and while conducting an audit. We disagree that additional actions are necessary.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

Recommendation

RECOMMENDATION 4

The Director, Compliance, W&I Division, should assess whether it would be cost effective for the IRS to work with the Department of the Treasury to recommend legislative changes *****2*****
*****2*****



*Millions of Dollars in Potentially Improper
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*****2*****
*****2*****
*****2*****
*****2*****

CORRECTIVE ACTION

Although contributions for qualified retirement plans are not reported on Form 5498, *IRA Contribution Information*, such plans are subject to reporting on Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*, when plan assets exceed \$250,000 or the plan is reporting for its final year. As part of the auditing standards, in addition to addressing large, unusual, or questionable items, examiners are required to inspect all related returns of the taxpayer and to ensure the taxpayer is in compliance with all filing requirements. Since the Automated Underreporter Program (AUR) is not an audit program, the level of complexity affecting qualified plans is comparatively high, and the volume of affected taxpayers is relatively low, we do not believe there are gains to be made by imposing additional reporting requirements on these plans. We will determine if procedures can be revised to improve the examination referral process when returns identified by the AUR program are found to have questionable qualified plan issues.

IMPLEMENTATION DATE

April 15, 2015

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.