Millions of Taxpayers Took Early Retirement Distributions but Some Did Not Pay the Additional Tax, Claim an Exception, or Report the Income

September 30, 2024

Report Number: 2024-100-065

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HIGHLIGHTS: Millions of Taxpayers Took Early Retirement Distributions but Some Did Not Pay the Additional Tax, Claim an Exception, or Report the Income

Final Audit Report issued on September 30, 2024 | **Report Number 2024-100-065**

Why TIGTA Did This Audit

This audit was initiated to determine whether the IRS is effectively ensuring that taxpayers comply with Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts,* filing and payment requirements when they receive an early distribution from a retirement account. The Internal Revenue Code imposes a penalty for the failure to file Form 5329, unless the taxpayer can show that the delinquency is due to reasonable cause and not due to willful neglect.

Impact on Tax Administration

Many individuals use retirement plans to save for their retirement. However, the law imposes a 10 percent additional tax on certain early retirement distributions. Early distributions are also reportable and subject to income taxes.

The failure to file penalty for Form 5329 applies to the amount owed from the return due date (not the extended due date) until the form is filed, with a maximum delinquency of five months (5 percent per month, 25 percent maximum penalty). Without the Form 5329 failure to file penalty, there are potentially no consequences for taxpayers who take an early retirement distribution, do not pay the additional 10 percent tax, and do not provide the IRS with the exception they are claiming for not paying the additional tax.

What TIGTA Found

TIGTA's analysis of Tax Year 2021 tax return information identified approximately 2.8 million taxpayers who received early distributions of approximately $12.9 billion but did not pay the additional 10 percent tax and did not file Forms 5329. These taxpayers could be subject to approximately $1.29 billion in additional taxes and/or approximately $322 million in Form 5329 failure to file penalties.

In general, taxpayers for whom third parties reported early distributions should have reported and paid the additional 10 percent tax, filed a Form 5329 claiming an exception, or both if only a portion of the early distribution was excepted. Our analysis applied the Form 5329 failure to file penalty on the 10 percent additional tax owed because the law applies the penalty to the amount owed on the return due date. However, IRS management was uncertain if it was appropriate to apply the penalty to this amount because taxpayers who belatedly file Forms 5329 are claiming exceptions to the tax and the subsequent amount owed is potentially zero, rendering the penalty amount to zero.

Additionally, approximately 2.3 million of the 2.8 million taxpayers did not properly report $11.4 billion in early distributions as taxable income, including 880 taxpayers with distribution amounts over $200,000. The Automated Underreporter (AUR) function may notify taxpayers who had potential noncompliance. However, according to AUR management, taxpayers who are potentially noncompliant with early distributions may not always receive notifications. Amending the AUR notice program to alert taxpayers who are potentially noncompliant with income and taxes associated with early distributions could help bring more taxpayers into compliance.

Summary of Results

2.3 million
Number of Taxpayers.

880
Taxpayers with early distribution amounts over $200,000 and not properly reported as income.

What TIGTA Recommended

TIGTA made five recommendations to the IRS to improve compliance with early retirement distributions, including developing guidance for the applicability and computation of the failure to file penalty for delinquent Forms 5329, and amending the AUR notice program to include alerting potentially noncompliant taxpayers.

The IRS agreed or partially agreed with three recommendations and plans to remind stakeholders of filing requirements, collaborate with the IRS Office of Chief Counsel, and determine the feasibility of transcribing additional data. However, the IRS disagreed with reviewing tax returns in which the taxpayers had early distributions over $200,000 and failed to file Form 5329, and amending the AUR notice program.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

September 30, 2024

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Danny R. Verneuille
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Millions of Taxpayers Took Early Retirement Distributions but Some Did Not Pay the Additional Tax, Claim an Exception, or Report the Income (Audit No.: 202310009)

This report presents the results of our review to determine whether the Internal Revenue Service is effectively ensuring that taxpayers comply with Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, filing and payment requirements when they receive an early distribution from a retirement account. This review is part of our Fiscal Year 2024 Annual Audit Plan and addresses the major management and performance challenge of *Tax Compliance and Enforcement*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Bryce Kisler, Assistant Inspector General for Audit (Management Services and Exempt Organizations).

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Background

Many individuals use retirement plans to save for their retirement. To discourage the use of retirement funds for purposes other than retirement, the law imposes a 10 percent additional tax on certain early retirement distributions.[1] Generally, any distribution made before the age of 59½ from a qualified retirement plan is assessed a 10 percent additional tax. However, the law permits early distributions without paying the additional tax under certain circumstances. For example, individuals may not be subject to the 10 percent additional tax if they use the money from an:

- Individual Retirement Arrangement (IRA) to purchase their first home.
- IRA for higher education expenses.
- Employer-sponsored qualified plan after separation from service when reaching the age of 55 (or the earlier age 50 or 25 years of service under the plan for public safety employees).
- IRA if unemployed and need to pay health insurance premiums.
- Employer-sponsored qualified plan to make payments to another individual under a qualified domestic relations order.

Generally, individuals must file Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, with their tax return when they receive early distributions from their retirement accounts. However, taxpayers do not have to file Form 5329 if they received a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* with a distribution code 1 – *Early distribution, no known exception (in most cases, under age 59½)*, and the taxpayer owes the additional tax on the full distribution amount shown on the form. Additionally, taxpayers do not need to file Form 5329 or pay the 10 percent additional tax when rolling over the amount into another retirement plan or an IRA within 60 days of the distribution.[2]

Internal Revenue Code § 6651(a)(1) imposes a penalty for the failure to file Form 5329 unless the taxpayer can show that the delinquency is due to reasonable cause and not due to willful neglect. The failure to file penalty for Form 5329 applies to the amount owed from the return due date (not the extended due date) until the form is filed, with a maximum delinquency of five months (5 percent per month, 25 percent maximum penalty). Although often filed with Form 1040, *U.S. Individual Income Tax Return*, Form 5329 is a distinct tax return document. If it is required and delinquent, the failure to file penalty applies even if the taxpayer filed Form 1040.

[1] Internal Revenue Code § 72(t).

[2] An IRA is a tax-favored personal savings arrangement that allows individuals to set aside money for retirement. Contributions made to a Traditional IRA may be fully or partially deductible and are generally not taxed until you take a distribution from your IRA. A Roth IRA is an IRA that is subject to the same rules that apply to a Traditional IRA, with the following exceptions: 1) contributions cannot be deducted with a Roth IRA; 2) qualified distributions are tax-free, assuming that the requirements are satisfied; 3) amounts in a Roth IRA are not subject to the required minimum distribution rules during the life of the original IRA owner; and 4) in order to make a regular contribution to a Roth IRA, the individual must not have income that exceeds the income limit for the year.

Retirement plan providers report retirement distributions to the Internal Revenue Service (IRS) and taxpayers on Form 1099-R. Form 1099-R includes codes that explain why the taxpayer received the distribution. Retirement plan providers report Traditional and Roth IRA contributions to the IRS and IRA owners on Form 5498, *IRA Contribution Information*. A separate Form 5498 should be filed for each IRA held by an individual.

After the tax return is filed, the IRS has programs to identify potential reporting discrepancies. The Small Business/Self-Employed (SB/SE) Division's Automated Underreporter (AUR) function systemically matches taxpayer income and deductions submitted on information returns by third parties, *e.g.,* employers, banks, and brokerage firms, against amounts reported by taxpayers on their individual income tax returns to identify any discrepancies. Discrepancies are identified when there are mismatches between the information reported on the tax return and third-party information. The AUR function has over 60 work streams for which they identify and select cases, including cases for which taxpayers were potentially noncompliant with retirement distribution rules. Additionally, the SB/SE Division's Correspondence Examination function may work early distribution cases that the AUR function refers or is unable to work because of the number of information documents.

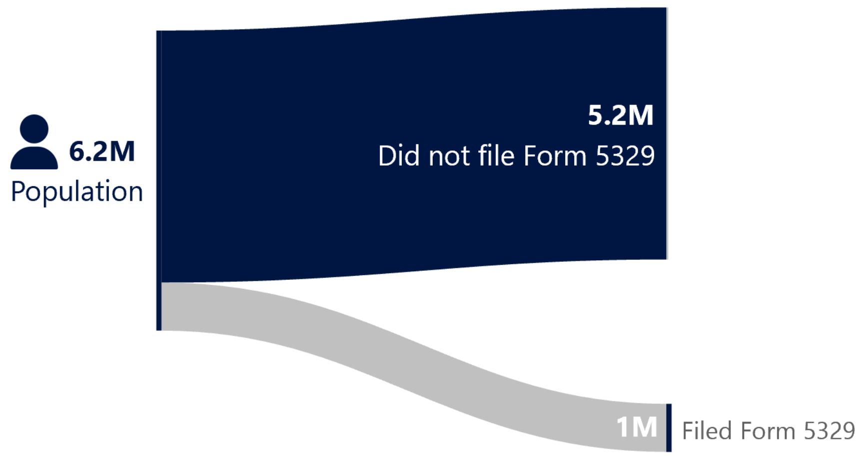
Results of Review

Taxpayers Received $12.9 Billion in Early Retirement Distributions, but Most Did Not Claim an Exception or Pay the Additional Tax

Our analysis of Tax Year (TY) 2021 Forms 1099-R and other tax return information identified approximately 6.2 million taxpayers who had one or more associated Forms 1099-R indicating that the taxpayers took an early distribution that could be subject to the 10 percent additional tax.[3] Generally, taxpayers must pay a 10 percent additional tax on the early distribution amount unless they claim an exception by filing Form 5329. Approximately 1 million of these taxpayers had attached Forms 5329, indicating that the taxpayers had a potential exception to paying the additional tax. However, approximately 5.2 million taxpayers did not have an attached Form 5329. The law also imposes a failure to file penalty of 5 percent of the taxes owed per month (25 percent maximum) for failing to file Form 5329. Figure 1 shows the number of taxpayers who had early distributions that could be subject to the 10 percent additional tax on early distributions.

[3] To obtain this population, we took into consideration Forms 1099-R with only the following distribution codes: "1" - Early distribution, no known exception (in most cases, under age 59½); "J" - Early distribution from a Roth IRA, no known exception (in most cases, under age 59½); "L" - Loans treated as distributions; "M" - Qualified plan loan offset; or "5" - Prohibited transaction. We identified these specific distribution codes because they can be considered a taxable event. Additionally, we removed Forms 1099-R for which the taxpayer had any of the following: 1) Forms 1099-R for which the Information Returns Master File showed the following distribution codes: "3" – Disability or "4" – Death; 2) Forms SSA-1099, *Social Security Benefit Statement*, with a Trust Fund Code of "D" for disability; 3) Forms 5498 for which the Information Returns Master File showed a Rollover Contribution in Box 2; and 4) taxpayers who turned age 59 in TY 2021. Other tax return information includes Forms SSA-1099, Forms 5498, and any other information obtained from the Information Returns Master File, Individual Master File, and Individual Returns Transaction File.

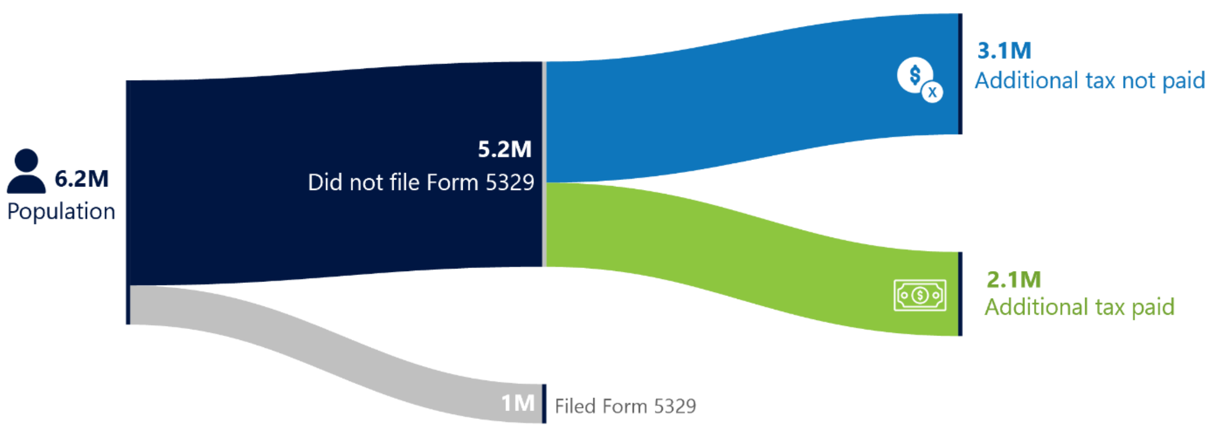
Figure 1: Analysis of TY 2021 Forms 1099-R and Other Tax Return Information With and Without Forms 5329



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of TY 2021 individual tax return information and Forms 5329. M = Million.

Approximately 3.1 million of the 5.2 million taxpayers did not self-report the 10 percent additional tax on their tax returns. Figure 2 shows the number of taxpayers with no reported additional tax and no attached Form 5329 claiming an exception.

Figure 2: Taxpayers Who Did Not Pay the 10 Percent Additional Tax or File Form 5329



Source: TIGTA analysis of TY 2021 individual tax return information and Forms 5329. M = Million.

Taxpayers taking an early distribution have the option of moving their funds to other retirement accounts, which is also known as a rollover. Individuals can directly or indirectly roll over funds. A direct rollover occurs when a retirement plan provider directly transfers the distributed funds to another retirement account. An indirect rollover occurs when a plan provider issues a payment to the individual and the individual then contributes the funds to a new retirement account. For both direct and indirect rollovers, the individual should be issued Form 1099-R for the distribution. For both direct and indirect rollovers, a Form 5498 should also be issued for the contribution from a non-IRA account to the new IRA account.[4] However, for a direct rollover from one IRA account to another, a Form 5498 should not be issued for a transfer of funds.[5]

For indirect rollovers, taxpayers should report the rollover amount on Form 1040, line 4a*, IRA distributions* or line 5a, *Pensions and annuities*, and write "rollover" on the line. Approximately 300,000 of the 3.1 million taxpayers potentially rolled their funds to another retirement account. Third-party reporting on Forms 1099-R for the remaining 2.8 million taxpayers showed a total taxable amount of approximately $12.9 billion.[6] These taxpayers could be subject to the 10 percent additional tax of approximately $1.29 billion and/or the potential failure to file penalty for Form 5329 of approximately $322 million.[7]

Of the approximate 2.8 million taxpayers, 990 had distributions over $200,000, including eight tax returns with distributions over $1 million. The IRS should consider compliance treatment for a sample of these tax returns, or more recent returns meeting these criteria, and include similar cases in future examination inventory if the results show a high risk of noncompliance. In general, taxpayers for whom third parties reported early distributions should have reported and paid the 10 percent additional tax, filed a Form 5329 claiming an exception, or both if only a portion of the early distribution was excepted.

The IRS has limited ability to identify noncompliance with early distributions. For example, in TY 2021, the AUR function identified approximately 371,000 cases for which taxpayers took an early retirement distribution and worked a limited number of cases meeting a certain dollar threshold because of resource limitations. The IRS must rely on post-processing procedures because some information returns are not due to the IRS until after most tax returns have already been processed. For example, retirement plan providers are required to file Form 1099-R with the IRS by March 31 of the following tax year. Therefore, these forms are generally not available when most tax returns are filed.

Additionally, only certain line items [redacted].[8] [redacted] In response to a previous TIGTA report from May 2020, the IRS said it would [redacted].[9] [redacted]

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[4] Rollovers from an IRA to a non-IRA qualified plan would not be reported on a Form 5498.

[5] Rollovers converted from traditional IRAs to Roth IRAs would generally need to be reported on a Form 5498.

[6] Our analysis was limited to data that is available to the IRS. Our analysis also eliminated any tax returns that showed an individual took an early distribution in TY 2021 and received a Form 5498 in TYs 2021 and/or 2022, indicating that they potentially indirectly rolled over the early distribution into another retirement account. Further, our analysis eliminated any tax returns for which taxpayers reported any amount on Forms 1040, lines 4a, 4b, 5a, or 5b. Lastly, some of these taxpayers could have received distributions for disaster relief. Our analysis removed taxpayers who had a disaster relief indicator for TY 2021. Taxpayers should file Form 8915F, *Qualified Disaster Retirement Plan Distributions and Repayments,* to avoid paying the 10 percent additional tax. We did not identify any Forms 8915F for Processing Year 2022. We identified 3,461 taxpayers with total distributions of $33,205,508 who filed a Form 8915F for Processing Year 2023. However, absent of a full audit of the taxpayers, it is difficult to quantify the actual effect.

[7] See Appendix II for the calculation of estimates.

[8] The Taxpayer Services Division's Submission Processing function [redacted]

[9] TIGTA, Report No. 2020-10-018, *Additional Actions Could Improve Compliance With Early Retirement Distribution Tax Requirements* (May 2020).

[redacted]

Our analysis applied the Form 5329 failure to file penalty to the 10 percent additional tax owed for the early distribution because the law applies the penalty on the amount owed on the return due date. When taxpayers filed their return, they did not claim an exception to the additional tax. We believe the penalty provides an incentive for taxpayers to file Forms 5329 claiming an exception instead of simply not reporting or paying the additional tax. However, IRS management was uncertain if it was appropriate to apply the penalty to the 10 percent additional tax because taxpayers who belatedly file Forms 5329 are claiming exceptions to the tax and the subsequent amount owed is potentially zero, rendering the penalty amount to zero. SB/SE Division management should work with the IRS Office of Chief Counsel to establish guidance for the applicability and computation of the failure to file penalty for delinquent Forms 5329. Without the Form 5329 failure to file penalty, there are potentially no consequences for taxpayers who take an early retirement distribution, do not pay the 10 percent additional tax, and do not provide the IRS with the exception they are claiming for not paying the additional tax.

The Commissioner, SB/SE Division, should:

Recommendation 1: Collaborate with the IRS Office of Chief Counsel to develop guidance for the applicability and computation of the failure to file penalty for delinquent Forms 5329.

> **Management's Response:** The IRS partially agreed with this recommendation. The IRS agreed that improving Form 5329 filing compliance would increase the efficiency of its compliance activities and reduce taxpayer burden. The IRS will identify opportunities to remind affected stakeholders of Form 5329 filing requirements. Additionally, the IRS agreed that it should collaborate with the IRS Office of Chief Counsel on the applicability and computation of penalties including the failure to file penalty for Forms 5329. However, the IRS disagreed with TIGTA's statutory interpretation of Internal Revenue Code § 6651 penalty applicability and computation to Forms 5329. The IRS's interpretation of penalty applicability and computation is consistent with the plain language of Internal Revenue Code § 6651.
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> > **Office of Audit Comment:** TIGTA did not make a statutory interpretation of Internal Revenue Code § 6651 penalty applicability and computation for Forms 5329, which is why we recommended that the SB/SE Division collaborate with the IRS Office of Chief Counsel. While it is encouraging that SB/SE Division management agreed that they should collaborate with the IRS Office of Chief Counsel, TIGTA is concerned that during the audit, SB/SE Division management stated that they were not [redacted]
> >
> > TIGTA believes that educating taxpayers concerning their responsibilities regarding Form 5329 is an important step in encouraging voluntary tax compliance. However, when necessary and appropriate, penalties should be used as enforcement tools to encourage willful noncompliant taxpayers to comply with the law.

Recommendation 2: Review a sample of tax returns in which the taxpayers had early distributions over $200,000, did not pay the additional tax, and failed to file Form 5329 to determine the appropriate compliance treatment.

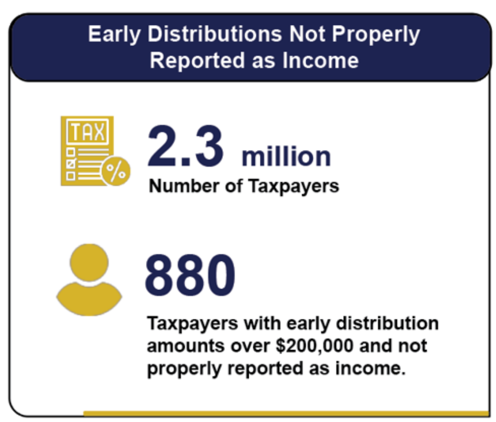
Management's Response: The IRS disagreed with this recommendation. The IRS's AUR and Campus Selection functions already have several workstreams where these types of cases are being reviewed and selected. There is no indication that these specific cases were not properly reviewed and selected as part of their normal processes. Many early distributions are rollovers or are otherwise excepted from the additional tax and are screened out during the IRS's preliminary review. During the audit, the IRS reviewed a sample of these cases and determined that these cases were properly non-selected in favor of more productive work.

Office of Audit Comment: Based on IRS feedback provided during the review, our analysis removed taxpayers for which there were indications of rollovers. Further, while the IRS stated that the sampled cases it reviewed were properly non-selected, it is unclear to TIGTA how these cases are potentially less productive than other AUR cases. In addition, according to the IRS, noncompliance with early distributions [redacted] We did not evaluate the AUR and Campus Selection functions' case selection criteria during this audit.

Recommendation 3: Coordinate with the Commissioner, Taxpayer Services, to [redacted]

Management's Response: The IRS agreed with this recommendation. The IRS will coordinate with Taxpayer Services to determine the feasibility of [redacted]

Many Taxpayers Did Not Properly Report Early Retirement Distributions As Income



Of the 2.8 million taxpayers who took an early distribution, did not file the Form 5329, and did not pay the additional 10 percent tax, approximately 2.3 million also did not properly report a total of $11.4 billion as taxable income.[10] Generally, early distributions from retirement accounts should be reported as taxable income.[11] Of the approximately 2.3 million taxpayers,

[10] Our analysis was done using information obtained from the Modernized Tax Return Database and datasets from the Individual Master File, Individual Returns Transaction File, and Information Returns Master File for TYs 2021 and 2022.

[11] Certain tax-favored accounts, such as a Roth IRA, are generally not taxable unless an individual takes a distribution before reaching age 59½ and before the account is five years old.

880 potentially did not properly report as income early distributions over $200,000, including six with early distributions over $1 million.

Taxpayers could have mistakenly reported the distribution as income on other lines of their Form 1040. Taxpayers should report IRA distributions that are considered income on Form 1040, lines 4a and/or 4b, *Taxable amount*. Pension and annuity distributions considered as income should be reported on Form 1040, lines 5a and/or 5b, *Taxable amount*.[12] Taxpayers may have mistakenly reported the early distribution on lines 5a and/or 5b. Taxpayers may have also mistakenly combined the early distribution with other income and reported it on one of the other lines on Form 1040.

Our analysis eliminated tax returns for which taxpayers reported any amount on Form 1040, lines 4a, 4b, 5a, or 5b. To determine if taxpayers may have reported the distribution somewhere else on their tax return, we also removed any instances in which Forms 1040, line 8, *Other income from Schedule 1, line 10,* were greater than the total taxable distribution reported on Forms 1099-R. After removing those taxpayers, our analysis identified 2.3 million taxpayers for which the full amount of the distribution may not have been reported as additional income because the total additional income line on the tax return was less than the distribution amount.[13]

Although these 2.3 million taxpayers potentially did not properly report the early distributions as income on their tax returns, the law requires a 20 percent withholding from Internal Revenue Code § 401(k)s and other qualified retirement plans. Retirement plan providers also generally withhold 10 percent for IRA distributions, but taxpayers can elect to have no taxes withheld.[14] Approximately 1.7 million of the 2.3 million taxpayers had taxes withheld by their retirement plan providers.[15] However, taxes were not withheld for approximately 600,000 taxpayers who received $1.6 billion in early distributions, including 178 taxpayers who received early distributions over $200,000 and potentially did not report the income or pay the 10 percent additional tax. The IRS has post-processing programs in place to identify potential income reporting noncompliance. For example, the AUR function performs income document matching to determine if taxpayers report all their income. However, like all IRS compliance functions, the AUR function has limited resources and cannot work every discrepancy.

Most taxpayers who had taxes withheld from their early distributions potentially did not report either the income or the withheld amount as payments, which could be an indication that many taxpayers were not aware of their obligations. In addition to working underreporter cases, the

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[12] Distributions from Internal Revenue Code § 401(k)s and other qualified retirement plans are also generally reported on Form 1040, lines 5a and/or 5b.

[13] Taxpayers may have reported the early distribution as additional income, but had other adjustments that decreased it such as net operating losses, *etc*. Some taxpayers also may have not reported the early distribution as income but reported other income on Form 1040, line 8, that exceeded the early distribution. Additionally, this portion of the analysis focused exclusively on taxpayers who had filed their tax returns electronically due to paper tax returns not being fully transcribed. Therefore, taxpayers with paper tax returns would have been excluded from our analysis of the 2.3 million taxpayers who potentially did not properly report their early distributions as income on their tax returns.

[14] Taxpayers who indirectly move all distributed funds to another retirement account may file a tax return to recover the taxes withheld.

[15] To determine whether taxes were or were not withheld, we combined both the primary and secondary (if applicable) taxpayers' total Forms 1099-R taxes withheld. To calculate the average withholding rate, we divided the total taxes withheld by total taxable distributions reported on Forms 1099-R.

AUR function has a notice program with an approximate 28 percent response rate that encourages taxpayers who had potential noncompliance issues to file an amended return to resolve their discrepancies. However, according to AUR management, noncompliance with early distributions is behavior that is [redacted]

Amending the AUR notice program to alert taxpayers who are potentially noncompliant with income and taxes associated with early distributions [redacted] could improve their response rate and help bring more taxpayers into compliance. Taxpayers who took an early distribution and did not file a Form 5329 claiming an exception are potentially subject to both the 10 percent additional tax as well as income taxes, for which the minimum tax rate in TY 2021 was 10 percent. Even at the current response rate of 28 percent, and assuming all taxpayers were in the lowest income tax bracket of 10 percent, we estimate that notifying these 2.3 million taxpayers could potentially increase revenue by approximately $160 million each year.[16]

In addition, our analysis identified 12,126 taxpayers who potentially did not report the income from their early distributions but potentially reported the withheld taxes as payments on their tax return.[17] These taxpayers may have been aware of their obligations and knowingly claimed improper refunds. We provided the IRS a list of 135 taxpayers who potentially reported withholdings of more than $10,000 but did not report the income. According to the IRS, it researched these taxpayers' accounts and stated that:

- 46 taxpayers reported the income on the wrong line of their return.[18]
- 35 taxpayers had adjustments on their tax return that offset the reported income.[19]
- 33 taxpayers did not report either the income or the taxes withheld.[20]
- 21 taxpayers did not report the income but claimed the withholding amounts, including four taxpayers who claimed more than $25,000 in payments.

The IRS should determine the appropriate compliance treatment for the 54 taxpayers who did not report the income and potentially owe additional taxes and consider the future examination potential for additional taxpayers who are similarly situated.

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[16] See Appendix II for the calculation of estimates.

[17] Our analysis compared the Form 1099-R withholdings with the amount reported on Form 1040, line 25b, *Federal income tax withheld from: Form(s) 1099,* and estimated tax payments. Additionally, this portion of the analysis took into consideration only those taxpayers who electronically filed.

[18] We could not systemically identify all tax returns with misreported income on the full population because of the complexity of the tax returns and the different areas taxpayers could misreport income.

[19] We did not systemically identify tax returns with adjustments on the full population because these taxpayers should have potentially filed a Form 5329 with an exception to paying the additional tax. We also could not determine if the adjustments were because of the early distribution.

[20] Our analysis compared the total taxes reported on Forms 1099-R to the total amounts reported on Forms 1040, line 25b, and line 26*, 2021 estimated tax payments and amount applied from 2020 return,* to identify if taxpayers reported the withheld amounts from Forms 1099-R on the tax returns. Taxpayers who misreported the withheld amounts on another tax line or made a large, estimated tax payments would not be systemically identified.

The Commissioner, SB/SE Division, should:

Recommendation 4: Amend the AUR notice program to include alerting taxpayers who are potentially noncompliant with early retirement distributions [redacted]

Management's Response: The IRS disagreed with this recommendation. The IRS already includes these taxpayers in its AUR notice program. In addition, taxpayers who are potentially noncompliant with early distributions are already included in the AUR function's inventory and are subject to traditional AUR compliance action.

Office of Audit Comment: As stated in the report, management acknowledged that [redacted]

Recommendation 5: Determine the appropriate compliance treatment for the 54 taxpayers who did not report the early retirement distributions as income on their tax returns and consider future compliance treatments for similarly situated taxpayers.

Management's Response: The IRS partially agreed with this recommendation. The IRS will determine if compliance treatment is warranted for the 54 taxpayers. However, the IRS stated that it does not need to consider any new future compliance treatments for these types of taxpayers because the AUR processes already select similarly situated taxpayers under two separate workstreams for underreported distributions and overreported withholdings.

Office of Audit Comment: TIGTA believes that the IRS should assess the results of its review of the 54 taxpayers before dismissing consideration of future compliance treatments for taxpayers in similar situations.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS is effectively ensuring that taxpayers comply with Form 5329 filing and payment requirements when they receive an early distribution from a retirement account. To accomplish our objective, we:

- Assessed the effectiveness of IRS processes and procedures to ensure taxpayers complied with Form 5329 filing and payment requirements when they received an early distribution from a retirement account.
  - Obtained and reviewed IRS processes and procedures for when individuals fail to file Form 5329 when they receive an early distribution from a retirement account.
  - Interviewed SB/SE AUR and Campus Examination function personnel to identify how they identify and work delinquent Form 5329 cases.
- Identified and performed an analysis of individuals who received an early distribution from a retirement account in TY 2021 and failed to file Form 5329 and pay the additional 10 percent tax.
  - Obtained Information Returns Master File Forms 1099-R data for TY 2021 to identify individuals who received an early distribution from a retirement account.
  - Performed queries to identify taxpayers who potentially took an early distribution, did not pay the additional 10 percent tax, and failed to file Form 5329.
  - Calculated the 10 percent additional tax for receiving an early distribution.
  - Calculated the 25 percent Form 5329 failure to file penalty.
  - Performed queries to identify taxpayers who potentially did not report the early distribution as income and/or claimed the tax withheld as payment on their tax returns.

Performance of This Review

This review was performed with information obtained from the SB/SE Division's AUR and Correspondence Examination functions headquartered in Lanham, Maryland, and the Taxpayer Services Division's Submission Processing function headquartered in Atlanta, Georgia, during the period April 2023 through July 2024. 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.

Major contributors to the report were Bryce Kisler, Assistant Inspector General for Audit (Management Services and Exempt Organizations); Carl Aley, Director; David Bueter, Audit Manager; Jeremy Berry, Lead Auditor; Nicole Pangallo, Senior Auditor; and Terrence Walton, Information Technology Data Specialist.

Data Validation Methodology

We obtained Form 5329 extracts from the Modernized Tax Return Database and Individual Returns Transaction File, along with other datasets from the Individual Master File, Individual Returns Transaction File, and Modernized Tax Return Database for TY 2021. In addition, we obtained extracts from the Information Returns Master File for TYs 2020 through 2022. These datasets were available on TIGTA's Data Center Warehouse.[1] We reviewed the data and ensured that each file contained the specific data elements we requested. Additionally, we compared random samples of each extract and verified that the data in the extracts were the same as the data captured in the Integrated Data Retrieval System.[2] We also performed analyses to ensure the validity and reasonableness of our data, such as minimum/maximum analysis of dollar values, transaction dates, and tax periods. We determined that the information extracted from TIGTA's Data Center Warehouse and the Modernized Tax Return Database was sufficiently reliable for the purposes of this report.

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 that the following internal controls were relevant to our audit objective: the policies, procedures, and practices related to taxes on early retirement distributions in the SB/SE and Taxpayer Services Divisions. We evaluated these controls by reviewing source documents, interviewing IRS management and employees, and conducting data analyses.

[1] A collection of IRS databases containing various types of taxpayer accounts as well as IRS and TIGTA employee information that TIGTA maintains for the purpose of analyzing data for ongoing audits. Datasets that were on the Modernized Tax Return Database were not on the Data Center Warehouse, so we obtained these extracts directly from the IRS.

[2] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Appendix II

Outcome Measures

This appendix presents detailed information on the measurable impact that 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:

Increased Revenue – Potential; $1,610,336,480 over five years in estimated additional taxes and/or failure to file penalties potentially owed by 2,832,911 taxpayers who took an early retirement distribution (see Recommendations 1 through 3).

Methodology Used to Measure the Reported Benefit:

We analyzed TY 2021 Forms 1099-R and other tax return information and identified 2,832,911 taxpayers who potentially took early retirement distributions but did not self-report the additional 10 percent early distribution tax on their tax returns or file Forms 5329 claiming an exception to the additional tax.[1] The failure to file penalty for Form 5329 applies to the amount owed from the return due date (not the extended due date) until the form is filed, with a maximum delinquency of five months (5 percent per month, 25 percent maximum penalty). The 2,832,911 taxpayers had related Forms 1099-R with total taxable amounts of $12,882,691,820. These tax returns could be subject to the additional 10 percent early distribution tax of $1,288,269,182 and/or the failure to file penalty of $322,067,296.

To arrive at the early distribution additional tax, we multiplied $12,882,691,820 by 10 percent, which is $1,288,269,182. To calculate the failure to file penalty, we multiplied $1,288,269,182 by 25 percent, which is $322,067,296. To be conservative, we calculated the outcome based on the lower amount ($322,067,296) even though many of these taxpayers could be subject to the 10 percent additional tax on the full amount of the early distribution. Over a five-year period, we forecast this could potentially result in increased revenue of $1,610,336,480 ($322,067,296 x 5).[2]

Management's Response: The IRS disagreed with this outcome measure stating that Internal Revenue Code § 6651 penalties are computed based on unpaid tax shown on the Form 5329, which in many cases is $0 or is limited as the early distributions to which the additional tax is applied are reduced by any associated basis. As discussed, IRS data show a very high percentage of the taxpayers who fail to file a Form 5329 meet the exception to the additional tax, meaning the potential additional taxes would be much smaller than estimated in the outcome measure. Consequently, the failure to file penalties would also be much smaller than estimated.

[1] Other tax return information includes Form SSA-1099, Form 5498, and any other information obtained from the Information Returns Master File, Individual Master File, and Individual Returns Transaction File.

[2] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

Office of Audit Comment: These 2.8 million taxpayers did not report the 10 percent additional tax on their tax return and did not file Form 5329 claiming an exception. Without Form 5329 being filed, it is not possible to know if the 10 percent additional tax was fully or partially excepted. IRS management did not provide support showing a high percentage of these taxpayers met an exception to the additional tax; however, even if they did, the taxpayers would potentially still be subject to the Form 5329 failure to file penalty. The potential outcome measure is based only on the failure to file penalty, which is up to 25 percent of the additional taxes. However, including the potential additional taxes could have significantly increased the estimated amount of revenue. During the audit, IRS management stated that [redacted]. These estimates are intended to provide stakeholders a general measure of the cost of noncompliance to help inform their decision-making. To reduce the risk of including taxpayers to which the 10 percent additional taxes and/or failure to file Form 5329 penalties would not apply, we met with the IRS multiple times to discuss our methodology. Every issue raised by the IRS, short of auditing each individual tax return, was factored into our methodology. However, the amount of increased revenue could be lower or higher than estimated based on the actual audit results if the IRS audited these forms.

Type and Value of Outcome Measure:

Increased Revenue – Potential; $799,487,055 over five years in estimated additional taxes for early retirement distributions and the Federal income taxes for 2,297,544 taxpayers who potentially took an early distribution but did not report the income (see Recommendations 4 and 5).

Methodology Used to Measure the Reported Benefit:

We analyzed TY 2021 tax return information and identified 2,832,911 taxpayers who did not report early distributions as income on their Form 1040, line 4a, 4b, 5a, and 5b, or claim an exception to the additional tax. These taxpayers are potentially subject to both the 10 percent additional tax for early distributions and Federal income taxes, for which the minimum tax rate was 10 percent in TY 2021. We matched these 2,832,911 taxpayers against the Modernized Tax Return Database to remove any instance in which Forms 1040, line 8, was greater than the total taxable distribution reported on Forms 1099-R to eliminate taxpayers who may have mistakenly reported the income as additional income. This reduced the total exception population to 2,297,544 taxpayers who took an early distribution but did not fully report the income.

From the 2,297,544 taxpayers, we identified 582,861 (25 percent) taxpayers, with taxable distributions of $1,599,317,637, who did not have any taxes withheld on their Forms 1099-R. These 582,861 taxpayers could be subject to additional taxes of $89,561,788. To arrive at this estimate, we multiplied the total taxable distributions of $1,599,317,637 by 28 percent, which is $447,808,938. We used 28 percent because that is the current response rate for the AUR notice program. We then multiplied the $447,808,938 by 20 percent (early distribution additional tax of 10 percent plus the income taxes, for which the minimum tax rate was 10 percent in TY 2021), which is $89,561,788.

For the remaining 1,714,683 (75 percent) taxpayers, we determined the average withholding on their Form 1099-R was 17.45 percent and the taxable distributions were $9,850,927,641. We determined that these 1,714,683 taxpayers could be subject to additional taxes owed of $70,170,929. To arrive at this estimate, we multiplied the $9,850,927,641 by the AUR notice program response rate of 28 percent, which is $2,758,259,739. We subtracted the average tax withholding rate of 17.45 percent from 20 percent (additional tax and the income taxes) to arrive at 2.55 percent and multiplied it by $2,758,259,739, which is $70,335,623.

In total, notifying these 2,297,544 taxpayers could increase revenue by $159,897,411 ($89,561,788 + $70,335,623) each year. Over a five-year period, we forecast this could potentially result in increased revenue of $799,487,055 ($159,897,411 x 5).[3]

Management's Response: The IRS disagreed with this outcome measure stating that based on its review of selected cases, the estimate reflected in the outcome measure does not account for taxpayers who reported the income on lines of Form 1040 not considered by TIGTA, taxpayers not subject to the additional taxes as the early distributions qualify for an exception to the additional tax, or situations in which the additional tax is applied only to the early distributions as reduced by any associated basis.

Office of Audit Comment: IRS management did not provide any support for their review of the 135 cases. TIGTA's analysis eliminated tax returns for which taxpayers reported any amount on Form 1040, lines 4a, 4b, 5a, or 5b. We agree taxpayers could have mistakenly reported the income on other lines. To determine if taxpayers may have reported the distribution somewhere else on their tax return, we also removed any instances in which Forms 1040, line 8, *Other income from Schedule 1, line 10,* were greater than the total taxable distribution reported on Forms 1099-R. Without examining each taxpayer's tax return, it is difficult to determine if the taxpayer misreported the income on another line. The amount of increased revenue in the outcome measure could be lower or higher than estimated based on the actual audit results if the IRS audited these forms. The estimates are intended to provide stakeholders a general measure of the cost of noncompliance to help inform their decision-making.

[3] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

Appendix III

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

September 13, 2024

MEMORANDUM FOR DANNY R. VERNEUILLE
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Lia Colbert Maha H. Williams Digitally signed by Maha H. Williams Date: 2024.09.13 14:38:43 -04'00'
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – *Millions of Taxpayers Took Early Retirement Distributions but Some Did Not Pay the Additional Taxes, Claim an Exception, or Report the Income (Audit No.: 202310009)*

Thank you for the opportunity to review and comment on the above subject draft report. The law that applies to qualified retirement plans is complex and the timing of the filing of relevant information returns relating to these plans makes analysis of these issues challenging. We appreciate TIGTA's efforts to address these challenges.

Qualified retirement plans (which include individual retirement arrangements (IRAs)) are important vehicles to support individuals to save for their retirement. To discourage the use of retirement funds for purposes other than retirement, the law imposes a 10 percent addition to tax on early retirement distributions. However, there are exceptions to the 10 percent additional tax for a range of situations. For instance, to the extent that a distribution from a qualified retirement plan is not includible in gross income by reason of a rollover (as described in Internal Revenue Code section 402(c) or 408(d)(3) in the case of an IRA), the 10 percent additional tax under section 72(t) would not apply.

Form 5329 is used to report a variety of issues related to retirement accounts (including excess contributions and failure to take required minimum distributions). Part I of the Form 5329 is required to be filed if a taxpayer receives an early distribution (other than from a Roth IRA) that meets an exception to the tax on early distributions, but the corresponding Form 1099-R does not indicate an exception, or the exception doesn't apply to the whole distribution. Form 5329 is not required to be filed by taxpayers who do not meet an exception to the addition to tax when early distributions are correctly reported on a Form 1099-R.

The failure to file penalty under section 6651 can apply to the failure to file a Form 5329 (unless the failure is due to reasonable cause and not willful neglect). However, we disagree with TIGTA about the application and resulting computation of the section

6651 failure to file penalty in the context of a Form 1040 where a taxpayer fails to file a Form 5329 to indicate that an early distribution meets an exception to the addition to tax. Under section 6651(a), the penalty is computed on "the amount required to be shown as a tax on *such return*," i.e., the Form 5329. Where a taxpayer should have filed a Form 5329 to claim an exception to the addition to tax on early distributions, there is $0 tax required to be shown on that return, consequently the computed penalty would be $0. If a portion of the early distribution is taxable and should have been reported on Form 5329, the addition to tax applies only to the portion of the distribution that does not meet the exception, as reduced by any associated basis. Under section 6651(b), no additional tax is due if there is no underpayment on the Form 1040 as a whole.

The IRS Automated Underreported (AUR) program has several dedicated work streams to identify early distributions for tax compliance actions. When evaluating identified potential cases for compliance actions, our AUR function screens out cases where IRS information indicates the taxpayer meets one of the applicable exceptions. The screen-out process routinely eliminates more than half of the identified potential early distributions cases and among the remaining taxpayers selected for audit, the no-change rate reflects many taxpayers ultimately demonstrate that they meet the exception to the additional tax. Similarly, our review of selected cases indicates taxpayers often report early distributions as income on the Form 1040, albeit on improper lines, including lines not reviewed by TIGTA as part of this audit. In addition, the timing of the filing of information returns may result in some rollovers incorrectly appearing to be early distributions that were not reported as income—for example, a distribution may be received and subject to information reporting in one year while the timely rollover occurs and is reported on an information return in the following year.

We appreciate TIGTA acknowledging our efforts to promote taxpayer education and compliance through our soft notice program. Soft notices are more effective for recurring non-compliance, so we believe it is not prudent to divert these resources away from more productive work to more early distribution cases—especially where early distribution cases are already potentially subject to our traditional compliance actions.

[redacted]. We also agree taxpayers should file the Form 5329 when taking early distributions, including when they meet an exception to the addition to tax, as this will improve the efficiency of our compliance activities and reduce taxpayer burden. We will identify options to remind impacted stakeholders of the Form 5329 filing requirements.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or Daniel Lauer, Director of Exam Headquarters, Small Business/Self-Employed Division.

Attachment

Attachment

Recommendations

The Commissioner, SB/SE Division, should:

RECOMMENDATION 1:
Collaborate with IRS Chief Counsel to develop guidance for the applicability and computation of the failure to file penalty for delinquent Forms 5329.

CORRECTIVE ACTION:
We partially agree. We agree that improving Form 5329 filing compliance would increase the efficiency of our compliance activities and reduce taxpayer burden. We will identify opportunities to remind impacted stakeholders of the Form 5329 filing requirements. We also agree that we should collaborate with the IRS Office of Chief Counsel on the applicability and computation of penalties, and we have collaborated on the failure to file penalty for Forms 5329. We routinely collaborate to ensure our statutory interpretation of penalty applicability and computation is accurate. However, we disagree with TIGTA's statutory interpretation of the section 6651 penalty applicability and computation to Forms 5329. Our interpretation of penalty applicability and computation is consistent with the plain language of IRC section 6651.

IMPLEMENTATION DATE:
August 15, 2025

RESPONSIBLE OFFICIAL:
Director, Headquarters Examination, SB/SE

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
Review a sample of tax returns in which the taxpayers had early distributions over $200,000, did not pay the additional tax, and failed to file Form 5329 to determine the appropriate compliance treatment.

CORRECTIVE ACTION:
We disagree. Our AUR and Campus Case Selection functions already have several workstreams where these types of cases are being reviewed and selected. There is no indication these specific cases were not properly reviewed and selected as part of their normal processes. Many early distributions are rollovers or are otherwise excepted from the additional tax and are screened out during our preliminary review. During the audit,

we reviewed a sample of these cases and determined that these cases were properly non-selected in favor of more productive work.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 3:
Coordinate with the Commissioner, Taxpayer Services, [redacted].

CORRECTIVE ACTION:
We agree. We will coordinate with Taxpayer Services to determine the feasibility of [redacted]

IMPLEMENTATION DATE:
February 15, 2025

RESPONSIBLE OFFICIAL:
Director, Headquarters Examination, SB/SE

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:
Amend the AUR notice program to include alerting taxpayers who are potentially noncompliant with early retirement distributions [redacted]

CORRECTIVE ACTION:
We disagree. We already include these taxpayers in our AUR soft notice program. In addition, taxpayers who are potentially noncompliant with early distributions are already included in our AUR discrepant inventory and are subject to traditional AUR compliance action.

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IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 5:
Determine the appropriate compliance treatment for the 54 taxpayers who did not report the early retirement distributions as income on their tax returns and consider future compliance treatments for similarly situated taxpayers.

CORRECTIVE ACTION:
We partially agree. We will determine if compliance treatment is warranted for the 54 taxpayers we reviewed. However, we do not need to consider any new future compliance treatments for these types of taxpayers because our AUR processes already select similarly situated taxpayers under two separate workstreams for underreported distributions and overreported withholdings.

IMPLEMENTATION DATE:
February 15, 2025

RESPONSIBLE OFFICIAL:
Director, Exam Case Selection, SB/SE

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this corrective action as part of our internal management system of controls.

OUTCOME MEASURE #1:
Increased Revenue – Potential; $1,610,336,480 over five years in estimated additional taxes and/or failure to file penalties potentially owed by 2,832,911 taxpayers who took an early retirement distribution (see Recommendations 1 through 3).

IRS RESPONSE:
We disagree. Section 6651 penalties are computed based on unpaid tax shown on the Form 5329, which in many cases is $0 or is limited as the early distributions to which the additional tax is applied are reduced by any associated basis. As discussed, our data show a very high percentage of the taxpayers who fail to file a Form 5329 meet

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the exception to the additional tax, meaning the potential additional taxes would be much smaller than estimated in the outcome measure. Consequently, the failure to file penalties would also be much smaller than estimated.

OUTCOME MEASURE #2:
Increased Revenue – Potential; $799,487,055 over five years in estimated additional taxes for early retirement distributions and the Federal income taxes for 2,297,544 taxpayers who potentially took an early distribution but did not report the income (see Recommendations 4 and 5).

IRS RESPONSE:
We disagree. Based on our review of selected cases, the estimate reflected in the outcome measure does not account for taxpayers that reported the income on lines of the Form 1040, not considered by TIGTA, taxpayers not subject to the additional taxes as the early distributions qualify for an exception to the additional tax, or situations in which the additional tax is applied only to the early distributions as reduced by any associated basis.

Appendix IV

Abbreviations

AUR	Automated Underreporter
IRA	Individual Retirement Arrangement
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year

**To report fraud, waste, or abuse,
contact our hotline on the web at www.tigta.gov or via e-mail at
oi.govreports@tigta.treas.gov.**

To make suggestions to improve IRS policies, processes, or systems affecting taxpayers, contact us at www.tigta.gov/form/suggestions.

Information you provide is confidential, and you may remain anonymous.