



*Processes Are Needed to More Effectively
Address Potentially Erroneous Excess
Social Security Tax Credit Claims*

September 3, 2014

Reference Number: 2014-40-058

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

PROCESSES ARE NEEDED TO MORE EFFECTIVELY ADDRESS POTENTIALLY ERRONEOUS EXCESS SOCIAL SECURITY TAX CREDIT CLAIMS

Highlights

**Final Report issued on
September 3, 2014**

Highlights of Reference Number: 2014-40-058 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The Federal Insurance Contributions Act (FICA) tax is a U.S. Federal payroll tax imposed to fund Social Security and Medicare. The Social Security tax portion of the FICA tax is computed as a percentage of wages earned. The employee's portion of the Social Security tax is withheld from the employee's wages by most employers and paid to the IRS on the employee's behalf. Individuals with more than one employer whose Social Security tax withholding exceeds the limit for a given tax year may be entitled to a credit (hereinafter referred to as the Excess Social Security Tax Credit or the credit) on their tax returns.

WHY TIGTA DID THE AUDIT

Individuals can claim the Excess Social Security Tax Credit as a refundable credit on Form 1040, *U.S. Individual Income Tax Return*. In Tax Year 2011, more than 1.3 million tax returns included Excess Social Security Tax Credit claims for more than \$1.6 billion. TIGTA initiated this audit to determine the effectiveness of the IRS's processes to ensure that taxpayers are accurately claiming excess Social Security tax withholding credits.

WHAT TIGTA FOUND

TIGTA reviewed a statistically valid sample of 322 of 87,319 tax returns for which the total amount of Social Security tax withholding employers reported to the IRS on Forms W-2, *Wage and Tax Statement*, did not support the credit amount claimed by the taxpayers on their tax returns. The review found that 231

(72 percent) returns had potentially erroneous claims totaling \$177,854.

Neither the information reported on or included with these 231 tax returns nor our research of wage and withholding information reported by employers supported the amount of Excess Social Security Tax Credit claimed by these individuals.

Of the 231 tax returns with questionable Excess Social Security Tax Credit claims, 40 could have been identified as questionable at the time the tax returns were processed. The remaining 191 (83 percent) of the 231 tax returns involved discrepancies between the credit claimed by the taxpayer and the amount the employers reported on Forms W-2.

The IRS has established processes to identify these discrepancies. However, the IRS only reviews a small portion of the questionable claims it identifies. The IRS generally has no other processes or procedures to address these questionable Excess Social Security Tax Credit claims. TIGTA estimates that the IRS allowed more than \$12.9 million in erroneous credits in Tax Year 2011 (\$64 million forecasted over five years).

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division, ensure that employees follow established procedures when verifying claims and develop a strategy that adequately addresses tax returns identified with a discrepancy between the Social Security tax withholding reported by taxpayers and reported by employers.

The IRS agreed with three of the four recommendations and has updated processing procedures and plans to ensure that employees are properly trained. While the IRS plans to redesign filters used to identify erroneous credits, it does not plan to revise its strategy to address Social Security tax withholding discrepancies to include the use of soft notices.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 3, 2014

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Processes Are Needed to More Effectively
Address Potentially Erroneous Excess Social Security Tax Credit
Claims (Audit # 201240017)

This report presents the results of our review to determine the effectiveness of the Internal Revenue Service's processes to ensure that taxpayers are accurately claiming excess Social Security tax withholding credits. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

e-file(d), e-filing	Electronically file(d), electronic filing
FICA	Federal Insurance Contributions Act
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



Processes Are Needed to More Effectively Address Potentially Erroneous Excess Social Security Tax Credit Claims

Background

The Federal Insurance Contributions Act (FICA)¹ tax is a U.S. Federal payroll tax imposed on both employees and employers to fund Social Security and Medicare. The Social Security tax portion of the FICA tax is computed as a percentage of wages earned. The Social Security tax is withheld from employees' wages by most employers and paid to the Internal Revenue Service (IRS) on employees' behalf. The Calendar Year 2013 tax rate for the Social Security tax was 6.2 percent paid by the employer and 6.2 percent withheld from the employee, for a total of 12.4 percent. Employers report total Social Security tax withheld to the employee and the IRS in box 4 on Form W-2, *Wage and Tax Statement*. Figure 1 shows the Form W-2 for Calendar Year 2013.

Figure 1: Calendar Year 2013 Form W-2

22222		a Employee's social security number		OMB No. 1545-0008	
b Employer identification number (EIN)		1 Wages, tips, other compensation		2 Federal income tax withheld	
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld	
		5 Medicare wages and tips		6 Medicare tax withheld	
		7 Social security tips		8 Allocated tips	
d Control number		9		10 Dependent care benefits	
e Employee's first name and initial Last name Suff.		11 Nonqualified plans		12a	
		13 Statutory employee Retirement plan Third-party sick pay		12b	
		14 Other		12c	
				12d	
f Employee's address and ZIP code					
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax
					20 Locality name
Form W-2 Wage and Tax Statement		2013		Department of the Treasury — Internal Revenue Service	
Copy 1—For State, City, or Local Tax Department					

Source: IRS.gov.

Employers can only withhold Social Security tax from an employee until a specific wage amount is reached. The maximum taxable wage amount is set by the U.S. Social Security Administration and can vary from year to year. For example, the maximum wage amount

¹ 26 U.S.C §§ 3101-3128.



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subject to the Social Security tax for Calendar Year 2013 was \$113,700, and the maximum Social Security tax that could be withheld was \$7,049.40 (\$113,700 multiplied by 6.2 percent).

Individuals are entitled to repayment of Social Security tax withholding that exceeds the maximum withholding amount for a specific year. The Code of Federal Regulations states that any individuals who have had more than the correct amount of Social Security tax withheld by one employer must be repaid by that employer.² However, if an individual has more than one employer and the individual's combined Social Security tax withholding from all employers exceeds the maximum annual withholding amount, the individual can claim the excess amount of Social Security tax withheld as a refundable credit (hereinafter referred to as the Excess Social Security Tax Credit or the credit)³ on Form 1040, *U.S. Individual Income Tax Return*. For example:

Taxpayer A has one employer who withheld \$8,000 in Social Security tax from his or her wages for Calendar Year 2013. To obtain the excess withholding, Taxpayer A is required to contact his or her employer to recover the \$950.60 (\$8,000 less the \$7,049.40 limit for Calendar Year 2013) in excess Social Security tax that was withheld from his or her wages. Whereas, Taxpayer B has one full-time employer and one part-time employer. Combined, these employers withheld \$8,000 in Social Security tax from his or her wages for Calendar Year 2013. To obtain the excess withholding, Taxpayer B can claim a refundable credit on his or her Tax Year^[4] 2013 Form 1040 for the \$950.60 in excess Social Security tax that was withheld from his or her wages.

The Excess Social Security Tax Credit is claimed on Form 1040, line 69 – *Excess social security and tier 1 RRTA⁵ tax withheld*. For Tax Year 2011, the IRS received more than 1.3 million tax returns that included claims for more than \$1.6 billion in excess Social Security tax withholding. Figure 2 shows where individuals claim the Social Security tax credit on Form 1040.

² 26 C.F.R. 601.401(c)(2)(i).

³ A refundable credit is not limited to the amount of an individual's tax liability and can result in a Federal tax refund that is larger than the amount of a person's Federal income tax withholding for that year.

⁴ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁵ Railroad Retirement Tax Act (RRTA) taxes fund railroad worker retirement benefits. Railroad employers are subject to a separate and distinct system of employment taxes from the Federal Insurance Contributions Act and the Federal Unemployment Tax Act (26 U.S.C. §§ 3301–3311) systems covering most other employers. The IRS is responsible for collecting these taxes. These taxes are imposed by chapter 22 of the Internal Revenue Code.



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Figure 2: Payments Section of Form 1040

Payments If you have a qualifying child, attach Schedule EIC.	62	Federal income tax withheld from Forms W-2 and 1099	62			
	63	2012 estimated tax payments and amount applied from 2011 return	63			
	64a	Earned income credit (EIC)	64a			
	b	Nontaxable combat pay election 64b				
	65	Additional child tax credit. Attach Schedule 8812	65			
	66	American opportunity credit from Form 8863, line 8	66			
	67	Reserved	67			
	68	Amount paid with request for extension to file	68			
	69	Excess social security and tier 1 RRTA tax withheld	69			
	70	Credit for federal tax on fuels. Attach Form 4136	70			
	71	Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> Reserved c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885	71			
	72	Add lines 62, 63, 64a, and 65 through 71. These are your total payments ▶	72			

Source: Form 1040 for Tax Year 2012.

This review was performed within the Wage and Investment Division's Reporting Compliance function in Atlanta, Georgia, and the Submission Processing function in Cincinnati, Ohio, during the period of August 2012 through January 2014. 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.



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Results of Review

**Processes Are Needed to More Effectively Address Potentially
Erroneous Excess Social Security Tax Credit Claims**

Analysis of the 1.3 million Tax Year 2011 tax returns with an Excess Social Security Tax Credit claim identified 87,319 tax returns with questionable claims totaling more than \$101 million.⁶ For each of these tax returns, the total amount of Social Security tax withholding reported to the IRS by employers on Forms W-2 did not support the amount claimed as a credit by the taxpayers on their tax returns. Our review of a statistically valid sample of 322⁷ of the 87,319 tax returns found that 231 returns (72 percent) had potentially erroneous claims for Excess Social Security Tax Credits totaling \$177,854.

***The IRS may have paid more than
\$12.9 million in potentially
erroneous Excess Social Security
Tax Credits in Tax Year 2011.***

Neither the information reported on or included with these 231 tax returns nor our research of wage and withholding information reported by employers supported the amount of Excess Social Security Tax Credit claimed by these individuals. Based on the results of our sample, we estimate that the IRS may have paid more than \$12.9 million⁸ in potentially erroneous Excess Social Security Tax Credits on 25,728 Tax Year 2011 returns⁹ as a result of weaknesses in its verification processes. Over five years, we forecast that the IRS could pay more than \$64 million in potentially erroneous Excess Social Security Tax Credits as a result of these weaknesses.¹⁰

⁶ The maximum wage amount subject to Social Security tax withholding in Tax Year 2011 was \$106,800, and the withholding rate was 4.2 percent.

⁷ We reviewed a statistically valid sample because not all information needed for our analysis was captured on the IRS's Form W-2 file. Specifically, box 14 (which details the withholding associated with the Railroad Retirement Tax Act tax) and box 12 (which details the amount of withholding related to tip income) are not included in the file. This information is available on an individual's tax account.

⁸ See Appendix IV for details of our projection.

⁹ See Appendix IV for details of our projection.

¹⁰ See Appendix IV. 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.



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Improvements are needed to ensure the accuracy of claims for the Excess Social Security Tax Credit at the time tax returns are processed

The IRS has developed processes in an effort to identify questionable Excess Social Security Tax Credit claims at the time tax returns are processed. For example, for electronically filed (e-filed) tax returns with an Excess Social Security Tax Credit claim, the IRS verifies that information from more than one employer is included with the tax return. For paper-filed tax returns with an Excess Social Security Tax Credit claim, the IRS compares the amount claimed on the tax return to the amount of Social Security tax withheld and reported on Forms W-2 attached to the tax return. If additional information is needed to verify the amount of Excess Social Security Tax Credit claimed, the IRS will correspond with the taxpayer.

However, our review identified that improvements are needed to these processes to better identify questionable claims at the time tax returns are processed. For example, of the 231 tax returns we identified with questionable Excess Social Security Tax Credit claims, 40 (17 percent) could have been identified as questionable at the time the tax returns were processed. The credits claimed on these 40 tax returns totaled \$23,235 and were not supported by information included with or on the tax returns. Our analysis of why these 40 tax returns were not identified as potentially questionable shows:

- 24 paper-filed tax returns with Excess Social Security Tax Credit claims totaling \$17,176 were not identified because IRS employees did not follow verification procedures. For example, IRS employees did not verify that the total wages reported on the tax returns were below the maximum amount at which an employee would exceed the Social Security tax withholding limit. The maximum wage amount subject to Social Security tax withholding in Tax Year 2011 was \$106,800. As long as a taxpayer's total wages are at or below \$106,800, their Social Security tax withholding will not exceed the annual withholding limit. The IRS's procedures for verifying Excess Social Security Tax Credit claims on paper-filed tax returns require tax examiners to ensure that the taxpayer has more than one employer, the wages and withholding reported are reasonable (by comparing the withholding reported to the total wages reported), and the Social Security tax withholding exceeds the annual maximum withholding amount.
- 9 e-filed tax returns with Excess Social Security Tax Credit claims totaling \$2,921 were not identified *****2*****
*****2*****
*****2*****. For example, the amount of Social Security tax withholding reported on the tax return exceeds the amount reported as Social Security wages.
- 6 e-filed tax returns with Excess Social Security Tax Credit claims totaling \$2,806 were not identified *****2*****
*****2***** , with this



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employer being the taxpayer's sole employer. The Code of Federal Regulations states that any individual with more than the correct amount of Social Security tax withheld by one employer must be repaid by that employer.¹¹

- *****1*****
*****1*****
*****1*****
*****1*****.

Apart from reviewing a small number of tax returns, the IRS generally has no processes or procedures to address questionable Excess Social Security Tax Credit claims

The remaining 191 (83 percent) of the 231 tax returns we identified with questionable Excess Social Security Tax Credit claims involved discrepancies between the Excess Social Security Tax Credit claimed by the taxpayer and the Social Security income and/or withholding reported on Forms W-2 by employers. For example, on:¹²

- 80 tax returns with Excess Social Security Tax Credit claims totaling \$74,217, the Forms W-2 provided by the taxpayer showed that the taxpayer had more than one employer and the total Social Security tax withholding was in excess of the maximum annual limit. However, Forms W-2 submitted to the IRS by the employers showed that part of the reported income and withholding was earned by the taxpayer's spouse. As a result, neither the taxpayer nor the spouse had excess Social Security tax withholding.
- 67 tax returns with Excess Social Security Tax Credit claims totaling \$51,582, we were unable to confirm the amount of credit being claimed because no corresponding Form(s) W-2 has been reported to the IRS for these taxpayers by the employer(s) listed on these tax returns.
- 47 tax returns with Excess Social Security Tax Credit claims totaling \$29,400, the IRS has corresponding Forms W-2 for the taxpayer; however, the amount of Social Security tax withholding reported to the IRS by the employer does not match the Social Security tax withholding amounts reported by the taxpayer on these tax returns.

Subsequent to the processing of tax returns, three times each year, the IRS performs a match to compare Excess Social Security Tax Credit amounts claimed to Social Security income and withholding information reported by employers. This match is performed to identify those tax returns with a discrepancy between the Social Security tax withholding reported by taxpayers and the withholding reported by employers. For example, the IRS reported that it adjusted the

¹¹ 26 C.F.R. § 601.401(c)(2)(i).

¹² Three of the 191 tax returns contained more than one error. As a result, the number of tax returns shown in the bullets totals more than 191 returns.



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Excess Social Security Tax Credit on 10,595 (84 percent) of the 12,565 Tax Year 2010 tax returns¹³ it analyzed as part of its post-processing matching program, resulting in the assessment of approximately \$31 million in additional tax and the issuance of \$431,308 in additional tax refunds.

However, despite this reconciliation identifying taxpayers erroneously claiming the Excess Social Security Credit, the IRS only reviews a small portion of the questionable claims it identifies. *****2*****

*****2*****
*****2*****. The IRS

stated that because of resource limitations, it is unable to review all of the tax returns it identifies with a discrepancy between the Social Security tax withholding reported by taxpayers and the withholding reported by employers.

Apart from reviewing a small number of tax returns, the IRS generally has no other processes or procedures to address these questionable Excess Social Security Tax Credit claims. The use of soft notices could significantly expand the IRS's ability to address the discrepancies between the Social Security tax withholding reported by taxpayers and the withholding reported by employers. For example, soft notices could alert individuals to potential errors related to their Excess Social Security Tax Credit claim. The notices commonly provide individuals with information specific to the eligibility or reporting requirements related to the potential error and suggest the filing of a Form 1040X, *Amended U.S. Individual Income Tax Return*, if an error has occurred.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure that IRS employees follow established procedures when verifying taxpayers' claims for the Excess Social Security Tax Credit at the time tax returns are processed.

Management's Response: The IRS agreed with this recommendation. IRS management stated that in preparation for the 2015 Filing Season, the IRS is taking steps to ensure that employees are trained and aware of procedures to be followed when processing returns claiming the Excess Social Security Tax Credit. In the interim, the IRS plans to inform and remind employees of procedures through unit meetings, Alert Messages issued through the Servicewide Electronic Research Program, and Interim Procedural Updates.

¹³ Tax Year 2010 was the most current information available from the IRS.



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Recommendation 2: *****2*****
*****2*****
*****2*****
*****2*****.

Management's Response: The IRS agreed with this recommendation. The IRS stated that business rules are being developed that will *****2*****
*****2*****
*****2*****
*****2*****.

Recommendation 3: *****2*****
*****2*****
*****2*****.

Management's Response: The IRS agreed with this recommendation. The IRS stated that business rules being developed to *****2*****
*****2*****
*****2*****.

Recommendation 4: Develop a strategy that adequately addresses tax returns identified with a discrepancy between the Social Security tax withholding reported by taxpayers and the withholding reported by employers. This strategy should include determining the net benefit of using soft notices as an alternative approach to address these discrepancies.

Management's Response: The IRS did not agree with this recommendation. The IRS stated that it has a process in place to identify discrepancies between the amounts of Social Security tax withholding reported by taxpayers and employers. However, the IRS's ability to address all discrepancies identified is constrained by limited resources, requiring a compliance strategy that selects the most egregious erroneous claims for review. The IRS agreed that the use of soft notices would increase its ability to address identified discrepancies. However, it stated that soft notices would also strain limited resources *****2*****
*****2*****,
*****2*****
*****2***** and, therefore, the IRS does not intend to take action on this recommendation.

In addition, the IRS agreed that the 67 tax returns we identified could not be reconciled to corresponding Form W-2 data reported to the IRS by employers. However, based upon additional research the IRS performed on these accounts, it believes most of these claims are likely to be valid. Therefore, the IRS did not agree with the full amount of the outcome measure related to correcting weaknesses in its verification processes.



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Office of Audit Comment: We agree that the IRS must ensure that its limited resources are used effectively and efficiently to address taxpayer noncompliance. However, the IRS has not provided us with data to support its claim that using soft notices would result in an ineffective use of its limited resources.

Regarding the 67 credits claimed that could not be reconciled to corresponding Form W-2 data, we agree with the IRS's assumptions and conclusions based on its additional research and have adjusted our outcome measure accordingly.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the effectiveness of the IRS's processes to ensure that taxpayers are accurately claiming excess Social Security tax withholding credits. To accomplish our objective, we:

- I. Evaluated the effectiveness of IRS controls to verify the accuracy of Excess Social Security Tax Credit claims.
 - A. Identified IRS processes and procedures to verify taxpayers' claims at the time tax returns are processed and subsequent to the completion of tax return processing.
 - B. We used data from the Treasury Inspector General for Tax Administration (TIGTA) Data Center Warehouse¹ to identify and match more than 1.3 million Tax Year² 2011 returns for which the IRS allowed an Excess Social Security Tax Credit claim to the Forms W-2, *Wage and Tax Statement*, filed by employers for Tax Year 2011. We identified 87,319 tax returns with Excess Social Security Tax Credit claims totaling more than \$101 million for which it does not appear the credit is supported by the Social Security tax withholding reported by employers.³ We assessed the reliability of this data by comparing 100 records to the Integrated Data Retrieval System⁴ and determined that the data were sufficiently reliable for the purposes of this report.
 1. Reviewed a statistically valid sample of 322 of the 87,319 tax returns to determine if Forms W-2 available to the IRS at the time the tax return was processed support the taxpayer's claims for the Excess Social Security Tax Credit. We compared the Excess Social Security Tax Credit claimed to information contained in the IRS's Information Return Master File⁵ and to information contained on Forms W-2 submitted by the taxpayers with their tax return.

¹ Centralized storage and administration of files (which provides access to IRS data).

² A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

³ The maximum wage amount subject to Social Security tax withholding in Tax Year 2011 was \$106,800, and the withholding rate was 4.2 percent.

⁴ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

⁵ An IRS database that contains third-party information documents for taxpayers, such as Forms W-2 and Forms SSA-1099, *Social Security Benefit Statement*.



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2. Evaluated the 231 tax returns we identified for which the Excess Social Security Tax Credit claim was not supported to determine why the IRS allowed the credit. We quantified the effect of the control weaknesses we identified.

Sampling Criteria

We selected and reviewed a statistically valid sample of 322 of the 87,319 tax returns we identified for which it appears the Excess Social Security Tax Credit claim was not supported by the Social Security tax withholding reported by employers. We reviewed a statistically valid sample because not all information needed to evaluate the accuracy of the Excess Social Security Tax Credit claim is captured on the IRS's Form W-2 file. Specifically for Form W-2, box 14 (which details the withholding associated with Railroad Retirement Tax) and box 12 (which details the amount of withholding related to tip income) are not included in the file. This information is available on an individual's tax account. Our sample was selected using two stratum based on the method taxpayers used to file their tax return – paper tax returns and e-filed tax returns. We selected our sample using a 95 percent confidence level, a ± 5 percent precision, and a 30 percent estimated error rate. Our sampling methodology was developed by TIGTA's contract statistician.

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 IRS's policies, procedures, and practices related to the processing of claims for excess Social Security tax withheld. We evaluated these controls through interviews with IRS management, analysis of IRS policies and procedures, and reviews of Excess Social Security Tax Credits claimed by taxpayers.



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Appendix II

Major Contributors to This Report

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Accounts Services)
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Lance Welling, Senior Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Chief Counsel CC
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Accounts Services SE:W:CAS
Director, Submission Processing 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
National Taxpayer Advocate TA
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division
SE:W:S:PEI



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Cost Savings, Funds Put to Better Use – Potential; \$12,907,712 in Excess Social Security Tax Credits; \$64,538,560¹ forecast over five years (see page 4).

Methodology Used to Measure the Reported Benefit:

Using the IRS's Individual Return Transaction File,² we identified 1.3 million Tax Year³ 2011 individual tax returns for which the IRS allowed an Excess Social Security Tax Credit claim. We matched the primary and secondary taxpayers shown on the 1.3 million tax returns to the IRS's file of employer-provided Forms W-2, *Wage and Tax Statement*, maintained on the TIGTA Data Center Warehouse.⁴ Our analysis identified 87,319 tax returns with Excess Social Security Tax Credit claims totaling more than \$101 million for which it appears the employers' Forms W-2 did not support the credit. However, not all of the information required to fully assess the accuracy of an Excess Social Security Tax Credit claim is captured on the IRS's Form W-2 file. Specifically, Form W-2 box 14 (which details the withholding associated with Railroad Retirement Tax) and box 12 (which details the amount of withholding related to tip income) are not included in the file. As a result, we used statistical sampling to estimate the impact of the missing data on our assessment of the accuracy of Excess Social Security Tax Credit Claims.

We selected a statistically valid sample of 322 tax returns from the 87,319 returns we identified in our data analysis. Our sample was selected using a 95 percent confidence level, a 30 percent estimated error rate, and a ± 5 percent precision. In addition, we stratified the selection of our sample based on the method used to file the tax return – 276 e-filed returns and 46 paper returns. Our sampling methodology was developed by TIGTA's contract statistician.

¹ The five-year forecast of potential cost savings (funds put to better use) is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

² Contains data transcribed from initial input of the original individual tax returns during returns processing.

³ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁴ A TIGTA Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators.



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We then compared the Excess Social Security Tax Credit amount allowed on each tax return in our statistical sample to the associated employer Forms W-2 shown on the IRS's Information Return Master File.⁵ We found that 231 (72 percent) of the 322 tax returns had Excess Social Security Tax Credit claims totaling \$177,854 that were not supported by information reported on employers' Forms W-2. The IRS subsequently reviewed and disallowed the Excess Social Security Tax Credit claim on 31 of the 231 tax returns as a result of its income matching program. The IRS also reviewed an additional 30 tax returns as a result of its income matching program but did not adjust the Excess Social Security Tax Credit. For purposes of this outcome measure, we did not consider the 61 returns as exceptions and excluded them from the totals.

We reduced our outcomes based on the IRS's additional research related to the 67 credits claimed that could not be reconciled to corresponding Form W 2 data. Because 10 of the 67 cases had already been eliminated from our outcome, we eliminated the additional 57 cases. As such, we projected the outcome on 113 exception cases.

To project the number of tax returns for which taxpayers received questionable Excess Social Security Tax Credits in Tax Year 2011, we:

- Calculated the ratio of each of the sample strata (e-filed and paper) to the population of 87,319 tax returns.
 $74,902 \text{ e-filed returns} / 87,319 \text{ tax returns} = 85.78 \text{ percent}$
 $12,417 \text{ paper returns} / 87,319 \text{ tax returns} = 14.22 \text{ percent}$
- Calculated the error rate for each of the sample strata.
 $87 \text{ e-filed exceptions} / 276 \text{ e-filed returns} = 31.52 \text{ percent}$
 $26 \text{ paper exceptions} / 46 \text{ paper returns} = 56.52 \text{ percent}$
- Calculated the error rate for the statistical sample of 322 tax returns.
 $(\text{e-filed ratio} \times \text{e-filed error rate}) + (\text{paper ratio} \times \text{paper error rate}) = \text{sample error rate}$
 $(85.78 \text{ percent} \times 31.52 \text{ percent}) + (14.22 \text{ percent} \times 56.52 \text{ percent}) = 35.08 \text{ percent}$
- Calculated the projected number of tax returns with questionable Excess Social Security Tax Credit claims.
 $87,319 \times 35.08 \text{ percent} = 30,629 \text{ tax returns}^6$

⁵ An IRS database that contains third-party information documents for taxpayers, such as Forms W-2 and Forms SSA-1099, *Social Security Benefit Statement*.

⁶ The total number of tax returns was calculated using actual numbers rather than the rounded numbers presented here.



*Processes Are Needed to More Effectively Address
Potentially Erroneous Excess Social Security Tax Credit Claims*

To project the amount of questionable Excess Social Security Tax Credit claims taxpayers received in Tax Year 2011, we:

- Calculated the ratio of each of the sample strata (e-filed and paper) to the population of 87,319 tax returns.
 $74,902 \text{ e-filed returns} / 87,319 \text{ tax returns} = 85.78 \text{ percent}$
 $12,417 \text{ paper returns} / 87,319 \text{ tax returns} = 14.22 \text{ percent}$
- Calculated the average error dollars rate for each of the sample strata.
 $\$38,432 / 276 \text{ e-filed returns} = \139
 $\$18,288 / 46 \text{ paper returns} = \398
- Calculated the average error dollars for the statistical sample of 322 tax returns.
 $(\text{e-filed ratio} \times \text{average e-filed error dollars}) + (\text{paper ratio} \times \text{average paper error dollars})$
 $= \text{sample average error dollars}$
 $(85.78 \text{ percent} \times \$139) + (14.22 \text{ percent} \times \$398) = \$176$
- Calculated the estimated amount of potentially erroneous Excess Social Security Tax Credit claims taxpayers received.
 $87,319 \times \$176 = \$15,366,324^7$

Based on our results, we estimate that the IRS may have paid \$15,366,324 in questionable Excess Social Security Tax Credit claims on 30,629 Tax Year 2011 returns as a result of weaknesses in its verification processes. We are 95 percent confident that our estimate of the number of tax returns for which potentially erroneous credits were allowed falls between 26,148 and 35,109. We are 95 percent confident that our estimate of the amount of potentially erroneous credits allowed falls between \$10,320,886 and \$20,411,761. Our projections were calculated by TIGTA's contract statistician.⁸

We further revised our projection to account for the portions of the projected potentially erroneous credits that are likely to be valid and likely to be adjusted (disallowed as erroneous) based on the results of the IRS's information matching program. According to the IRS, it adjusted the credit on 10,595 (84 percent) of the 12,565 Tax Year 2010 tax returns it analyzed as part of its post-processing matching program. This indicates that 84 percent of the credits claimed were in fact erroneous (and the other 16 percent were found to be valid).

⁷ The total dollar amount was calculated using actual numbers rather than the rounded numbers presented here.

⁸ These point estimate projections are based on two-sided 95 percent confidence intervals.



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To compensate for the 16 percent of claims that are likely to be found valid, we estimate that 84 percent of our projected potentially erroneous credits are likely to be found to be erroneous. As a result, we reduced our projected potentially erroneous credits by 16 percent and claimed only the 84 percent likely to be erroneous. Therefore, we estimate that the IRS may have paid \$12,907,712 in questionable Excess Social Security Tax Credit claims on the 25,728 erroneous claims, as calculated below.

- $30,629 \times 84 \text{ percent} = 25,728$
- $\$15,366,324 \times 84 \text{ percent} = \$12,907,712$

The actual amount of revenue the IRS will protect is dependent on the actions the IRS takes to address our audit findings and will not be known until actions are implemented.

We forecast that the IRS could pay \$64,538,560⁹ in potentially erroneous Excess Social Security Tax Credit claims over the next five years as a result of weaknesses in its verification processes.

⁹ The five-year forecast of potential cost savings (funds put to better use) is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



*Processes Are Needed to More Effectively Address
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Appendix V

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

JUL 22 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland *Debra Holland*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processes Are Needed to More Effectively
Address Potentially Erroneous Excess Social Security Tax Credit
Claims (Audit # 201240017)

We appreciate the opportunity to review the subject draft report and provide comments. As noted, the Excess Social Security Tax Credit is available to individuals who have had multiple employers during the tax year, and whose collective wages from those employers exceeded the maximum amount of wages taxable under the Federal Insurance Contributions Act (FICA). The excess FICA tax, above the maximum annual amount, paid through employer withholding, is allowable as a refundable credit against the individual's income tax liability.

With the increased volume of electronic return filings experienced in recent years, the IRS has noted the same issues observed by the Treasury Inspector General for Tax Administration (TIGTA), regarding errors made by taxpayers in claiming the credit for excess FICA tax. Many of the errors identified in the TIGTA's analysis appear to be attributable to errors taxpayers made when transcribing Form W-2, *Wage and Tax Statement*, information provided by their employers to their tax return preparation software. This includes the erroneous creation of a second Form W-2, when the earnings were taxed in multiple state or local jurisdictions, but only one wage statement was issued by the employer. This error led to overstatements of FICA taxes withheld. We have updated procedures used by our employees in processing returns claiming credit for excess FICA tax, and are revising business rules used in processing electronic returns to ensure those appearing to claim an erroneous excess credit are diverted for additional review and correction. We will also ensure employees are trained on procedures for processing claims for excess FICA tax credits.

We agree that the exception cases identified by the TIGTA's analysis are questionable. However, after additional review, we disagree with the conclusion that 67 tax returns, claiming wages that could not be reconciled to corresponding Form W-2 data reported



*Processes Are Needed to More Effectively Address
Potentially Erroneous Excess Social Security Tax Credit Claims*

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to the IRS by employers, led to potentially erroneous credit claims totaling \$51,582. Consequently, we also disagree with the potential outcome measure of \$114 million for Funds Put to Better Use, to the extent of the effect these cases have on the computation. Our additional review of these cases found that the amount of unreconciled wages, in almost all instances, resulted in a corresponding amount of income tax that exceeded the amount of excess FICA tax credit claimed. We selected a sample of the accounts and were able to reasonably ascertain the missing employer through comparison of prior and subsequent-year tax returns. In our judgment, these cases do not represent erroneous credit claims.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Ivy McChesney, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



*Processes Are Needed to More Effectively Address
Potentially Erroneous Excess Social Security Tax Credit Claims*

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Ensure that IRS employees follow established procedures when verifying taxpayers' claims for the Excess Social Security Tax Credit at the time tax returns are processed.

CORRECTIVE ACTION

In preparation for the 2015 Filing Season, we are taking steps to ensure employees are trained and aware of procedures to be followed when processing returns claiming the Excess Social Security Tax Credit. In the interim, employees are informed and reminded of procedures through unit meetings, Alert Messages issued through the Servicewide Electronic Research Program, and Interim Procedural Updates.

IMPLEMENTATION DATE

February 15, 2015

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 2

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

CORRECTIVE ACTION

Business rules are being developed that will *****2*****
** *****2*****
*****2*****

IMPLEMENTATION DATE

February 15, 2016

RESPONSIBLE OFFICIAL

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



*Processes Are Needed to More Effectively Address
Potentially Erroneous Excess Social Security Tax Credit Claims*

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 3

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

CORRECTIVE ACTION

Business rules being developed to *****2*****
*****2*****

IMPLEMENTATION DATE

February 15, 2016

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 4

Develop a strategy that adequately addresses tax returns identified with a discrepancy between the Social Security tax withholding reported by taxpayers and the withholding reported by employers. This strategy should include determining the net benefit of using soft notices as an alternative approach to address these discrepancies.

CORRECTIVE ACTION

As noted in the report, the IRS has a process in place to identify discrepancies between the amounts of Social Security tax withholding reported by taxpayers and employers. Our ability to address all discrepancies identified is constrained by limited resources, requiring a compliance strategy that selects the most egregious erroneous claims for review. The use of soft notices would increase our ability to address identified discrepancies; however, they also strain limited resources *****2*****
*****2*****
*****2***** . Consequently, we do not intend to take action on this recommendation.



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IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A