TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Taxpayers Generally Comply With Annual Contribution Limits for 401(k) Plans; However, Additional Efforts Could Further Improve Compliance

October 25, 2018

Reference Number: 2019-10-002

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:
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TAXPAYERS GENERALLY COMPLY WITH ANNUAL CONTRIBUTION LIMITS FOR 401(K) PLANS; HOWEVER, ADDITIONAL EFFORTS COULD FURTHER IMPROVE COMPLIANCE

Highlights

Final Report issued on October 25, 2018

Highlights of Reference Number: 2019-10-002 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

IRS records show that, in Tax Year 2014, an estimated 53 million taxpayers contributed almost $255 billion to tax-qualified deferred compensation plans. A popular form of deferred compensation plans, known as 401(k) plans, permits employees to save for retirement on a tax-favored basis. However, there are rules that limit the amount individuals can contribute to a 401(k) plan each tax year. Individual noncompliance with these rules results in revenue loss to the Federal Government.

WHY TIGTA DID THE AUDIT

The overall objective of this audit was to determine whether IRS processes sufficiently identify and address excess contributions to 401(k) plans.

WHAT TIGTA FOUND

TIGTA analysis of IRS records showed that the vast majority of taxpayers are complying with tax laws designed to limit the annual amount of compensation that can be contributed to 401(k) retirement plans. Nonetheless, TIGTA identified two areas in which compliance could be improved: 1) some 401(k) plans did not prevent taxpayers from exceeding the annual limit and 2) some taxpayers exceed annual limits when contributing to multiple 401(k) plans.

TIGTA selected a statistical sample of taxpayers who may have exceeded annual limits when contributing to 401(k) plans in Tax Year 2014. Based on the sample, TIGTA estimates that approximately 1,400 taxpayers appeared to have exceeded the statutory limit when contributing to one 401(k) plan and, as a result, would owe additional taxes of about $8 million if found to be noncompliant. In these instances, 401(k) plan administrators did not appear to have controls in place to ensure that taxpayers contributing to their 401(k) plans did not exceed annual limits.

TIGTA also determined through review of the statistical sample that some taxpayers may have exceeded annual limits when contributing to multiple 401(k) plans. TIGTA estimates approximately 13,200 taxpayers who contributed to multiple 401(k) plans had potentially exceeded the annual limit and, as a result, would owe additional taxes of about $33 million if found to be noncompliant.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Acting Commissioner, Tax Exempt and Government Entities Division, should identify and provide guidance on 401(k) retirement plans that potentially allow taxpayers to exceed annual contribution limits. TIGTA also recommended that the Commissioner, Small Business/Self-Employed Division, should take actions to bring taxpayers who contribute more than the annual limit to multiple 401(k) plans into compliance with the law.

In their response, IRS management stated they plan to take the appropriate steps to educate employers with the largest number of participants with excess 401(k) deferrals. In addition, IRS management plans to conduct examinations for a sample of taxpayers who appear to have excess 401(k) deferrals.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

October 25, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Taxpayers Generally Comply With Annual Contribution Limits for 401(k) Plans; However, Additional Efforts Could Further Improve Compliance (Audit # 201710027)

This report presents the results of our review to determine whether Internal Revenue Service (IRS) processes sufficiently identify and address excess contributions to 401(k) plans. This review is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

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

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

Table of Contents

Abbreviations

e-file(d); e-filing	Electronically File(d); Electronic Filing
IRS	Internal Revenue Service
SIMPLE	Savings Incentive Match Plan for Employees
TY	Tax Year

Background

Employers are permitted to sponsor tax-deferred savings plans, which allow employees to elect to defer receiving a portion of their salary that is instead contributed on their behalf, before taxes, to an employer-sponsored plan. Internal Revenue Service (IRS) records indicate that an estimated 53 million taxpayers contributed almost $255 billion in Tax Year (TY)[1] 2014 to tax-qualified deferred compensation plans. A popular form of a deferred compensation plan is a 401(k) plan, which is designed for taxpayers to save for retirement. With the exception of Roth 401(k) plans (not addressed in this audit), salary deferrals (hereafter referred to as contributions) to a 401(k) plan are not subject to Federal income tax withholding at the time of the contribution and will not be taxed until withdrawn. Figure 1 summarizes three different types of 401(k) plans and their features for TY 2014.

Internal Revenue Service records show that an estimated 53 million taxpayers contributed almost $255 billion in Tax Year 2014 to a tax-qualified deferred compensation plan.

Figure 1: Types of 401(k) Plans and Features

	Traditional 401(k)	Safe Harbor 401(k)	SIMPLE[2] 401(k)
Annual Contribution Limit (age < 50)	$17,500	$17,500	$12,000
Annual Contribution Limit (Age ≥ 50)	$23,000	$23,000	$14,500
Taxation of Salary Contributions	Before Tax	Before Tax	Before Tax
Taxation of Qualified Distributions	Yes	Yes	Yes

Source: Summary of information on IRS.gov.

[1] The 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.
[2] SIMPLE (Savings Incentive Match Plan for Employees).

For TY 2014, contributions that were made to most 401(k) plans were limited to $17,500. However, taxpayers who are age 50 or older could contribute an extra $5,500 as a “catch-up” contribution, which increased the limit to $23,000 for taxpayers who are 50 years or older.

Any amount contributed to a 401(k) plan for the tax year that exceeds the annual contribution limit is considered an excess contribution. If the excess contribution for the tax year is withdrawn by April 15 of the following year, the taxpayer is required to report the excess contribution as income for the year it was contributed, but the earnings are taxable in the year distributed. If the excess contribution is not withdrawn by April 15 of the following year, the excess contribution should be considered taxable income in the year of the contribution and should then be taxed again in the year the taxpayer receives the distribution from the 401(k) plan(s).

Employers are required to notify employees and the IRS of the amount of contributions made by employees to qualified retirement plans in Box 12 on Form W-2, *Wage and Tax Statement*. A code “D” in box 12 represents contributions to a 401(k) retirement plan. When taxpayers file their tax return electronically, they are required to specifically state how much they contributed to a 401(k) retirement plan.

This review was performed by reviewing information obtained from Examination function offices within the Small Business/Self-Employed Division and Employee Plans function offices within the Tax Exempt and Government Entities Division headquartered in Washington, D.C., during the period August 2017 through March 2018. 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. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Taxpayers Are Mostly Compliant, but Some Taxpayers Contributed More Than the Annual Limit to One or More 401(k) Plans

***************************************2*********************************
***************************************2********************************
********2******** Nevertheless, our analysis of IRS records showed that the vast majority of taxpayers participating in 401(k) plans were compliant with laws designed to limit the amount that taxpayers are permitted to annually contribute. Even though most taxpayers were compliant, we determined that some 401(k) plans appeared to allow taxpayers to contribute more than the annual limit, and some taxpayers exceeded annual limits by contributing to more than one 401(k) plan. In addition, some taxpayers potentially exceeded contribution limits in multiple years.

We analyzed all electronically filed (e-filed) tax returns for TY 2014 and determined that only 36,898 (less than 1 percent) of 36.5 million taxpayers reported that they made a contribution to a 401(k) retirement plan(s) that exceeded annual contribution limits by $1,000 or more. We selected and reviewed a statistical sample[3] of 397 of the 36,898 taxpayers who potentially exceeded annual contribution limits and found that some taxpayers made errors when completing their tax returns and did not actually make excess contributions to their 401(k) plan(s). For example, taxpayers incorrectly entered the cost of their employer-sponsored health insurance (code DD in Box 12 of the Form W-2) as a contribution to a 401(k) plan (code D in Box 12 of the Form W-2) when e-filing their tax return. Therefore, it did not appear that every taxpayer who reported they had exceeded annual contribution limits to their 401(k) plan(s) actually had. However, 157 of the sampled taxpayers who reported excess contributions to 401(k) plans on their e-filed tax returns had the same amounts reported as a contribution to a qualified retirement plan on the employer-submitted Form W-2. Some of these taxpayers had one Form W-2 (indicating a single 401(k) plan), while others had more than one Form W-2 (indicating multiple 401(k) plans).

Individual 401(k) plans potentially allowed taxpayers to exceed annual limits

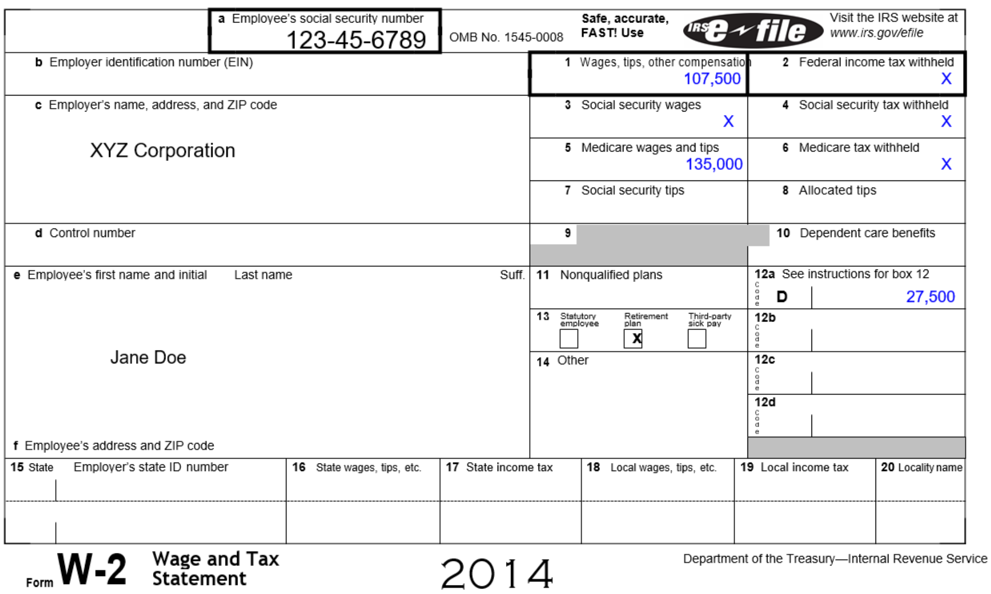
Based on our analysis, only 15 (10 percent) of the 157 sampled taxpayers, who reported making excess 401(k) plan contributions on their e-filed TY 2014 tax returns and whose employers reported the same amount as a contribution to a qualified retirement plan on Form W-2, had

[3] See Appendix I for details on our sampling methodology.

participated in only one 401(k) plan. None of the excess contributions were withdrawn by the taxpayers before April 15, 2015.

To illustrate, Figure 2 shows a hypothetical example of a taxpayer under the age of 50 who potentially made excess contributions to a 401(k) plan. In this example, the taxpayer may contribute up to $17,500 in TY 2014. However, when e-filing, the taxpayer provided Form W-2 information reporting that he or she contributed $27,500 to a 401(k) retirement plan (see box 12a, code "D"). This results in a potential excess contribution of $10,000 ($27,500 - $17,500).

Figure 2: Example of Potential Excess Contribution to a 401(k) Plan in TY 2014


a Employee's social security number 123-45-6789
OMB No. 1545-0008
Safe, accurate, FAST! Use IRS e-file
Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN)
1 Wages, tips, other compensation 107,500
2 Federal income tax withheld X
c Employer's name, address, and ZIP code
XYZ Corporation
3 Social security wages X
4 Social security tax withheld X
5 Medicare wages and tips 135,000
6 Medicare tax withheld X
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.
Jane Doe
11 Nonqualified plans
12a See instructions for box 12 D 27,500
13 Statutory employee / Retirement plan X / 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 2014
Department of the Treasury—Internal Revenue Service

Source: This is a hypothetical example and is not drawn from an actual case.

We estimate that approximately 1,400 taxpayers who contributed to only one 401(k) plan potentially exceeded the annual 401(k) contribution limit in TY 2014 and did not pay required taxes on the excess contributions. Based on our calculations, these taxpayers would owe additional taxes of about $8 million if found to be noncompliant.[4]

As noted previously, ***********************2*********************************** ***************2****************** According to the IRS, it relies on plan administrators to have controls in place to prevent taxpayers from contributing more than the maximum amount to their 401(k) plan. Based on the small number of cases we identified with potential excess contributions to a single 401(k) plan, administrators are generally successful in ensuring

[4] The point estimate projections are based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 751 and 2,051 taxpayers and that the point estimate for lost revenue is between $3,009,315 and $13,269,447. See Appendix IV.

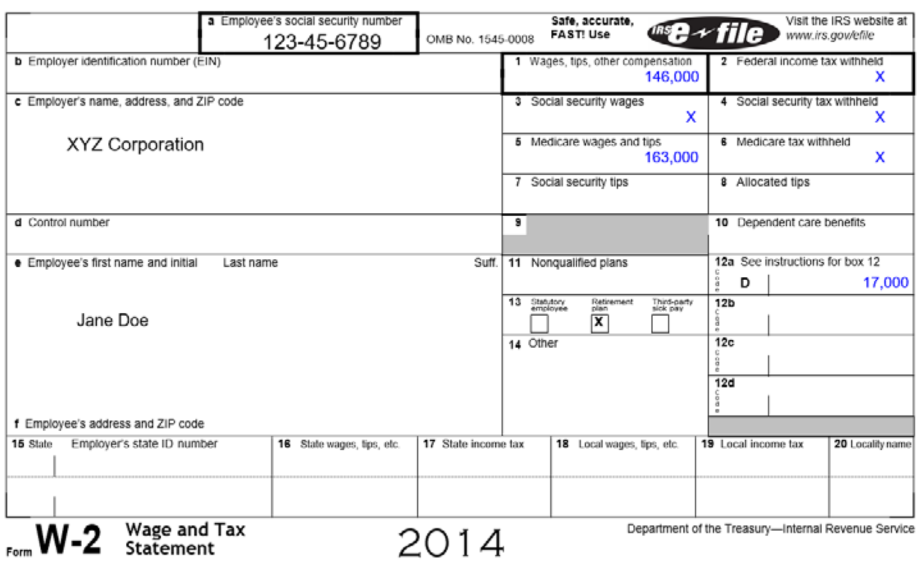
adherence to the limits. However, based on our sample results, we conclude that there are some 401(k) plans that do not appear to have controls in place to ensure that annual contribution limits are not exceeded or excess contributions are refunded to taxpayers.

Taxpayers potentially exceeded annual limits when contributing to multiple 401(k) plans

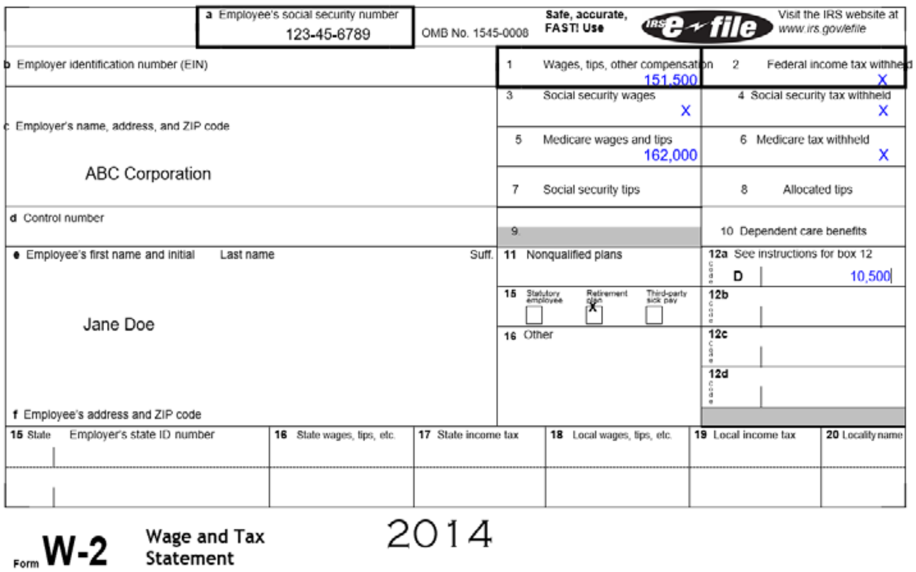
Based on our analysis, 142 (90 percent) of the 157 sampled taxpayers, who reported making excess 401(k) plan contributions on their e-filed TY 2014 tax returns and whose employers reported the same amount as contributions to qualified retirement plans on employer-submitted Forms W-2, participated in more than one 401(k) plan. None of the excess contributions were withdrawn by the taxpayers before April 15, 2015.

To illustrate, Figure 3 shows a hypothetical example of a taxpayer under the age of 50 who potentially made excess contributions while participating in more than one 401(k) retirement plan. In this example, the taxpayer may contribute up to $17,500 in TY 2014. However, when e-filing, the taxpayer provided Form W-2 information reporting that he or she contributed a total of $27,500 to 401(k) plans (see box 12a, code "D"). This results in a potential excess contribution of $10,000 ([$10,500 + $17,000] - $17,500).

Figure 3: Example of Potential Excess Contributions to More Than One 401(k) Plan in TY 2014



a Employee's social security number: 123-45-6789
OMB No. 1545-0008
Safe, accurate, FAST! Use IRS e-file
Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN)
1 Wages, tips, other compensation: 146,000
2 Federal income tax withheld: X
c Employer's name, address, and ZIP code: XYZ Corporation
3 Social security wages: X
4 Social security tax withheld: X
5 Medicare wages and tips: 163,000
6 Medicare tax withheld: X
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.: Jane Doe
11 Nonqualified plans
12a See instructions for box 12: Code D 17,000
13 Statutory employee / Retirement plan [X] / 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 2014
Department of the Treasury—Internal Revenue Service



a Employee's social security number 123-45-6789
OMB No. 1545-0008
Safe, accurate, FAST! Use IRS e-file
Visit the IRS website at www.irs.gov/efile

b Employer identification number (EIN)
1 Wages, tips, other compensation 151,500
2 Federal income tax withheld X
c Employer's name, address, and ZIP code
ABC Corporation
3 Social security wages X
4 Social security tax withheld X
5 Medicare wages and tips 162,000
6 Medicare tax withheld X
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.
Jane Doe
11 Nonqualified plans
12a See instructions for box 12 D 10,500
13 Statutory employee / Retirement plan X / 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 2014

Source: This is a hypothetical example and is not drawn from an actual case.

We estimate that approximately 13,200 taxpayers who contributed to multiple 401(k) plans potentially exceeded the annual 401(k) contribution limit in TY 2014 and did not pay required taxes on the excess contributions. Based on our calculations, these taxpayers would owe additional taxes of about $33 million if found to be noncompliant.[5]

If steps are not taken to address noncompliance, taxpayers may continue to exceed the annual contribution limits. Some taxpayers from our sample display a pattern of noncompliance. Review of Forms W-2 from the preceding (TY 2013) and subsequent (TY 2015) years for these taxpayers found that 32 (23 percent) of the 142 taxpayers made 401(k) contributions that potentially exceeded limits in one of these tax years as well, including seven taxpayers who may have exceeded contribution limits for all three of the tax years we reviewed. For example, we identified three taxpayers who reported making excess 401(k) contributions totaling almost $10,000 yearly over this three-year period.

As noted previously, the IRS relies on plan administrators to have controls in place to prevent taxpayers from contributing more than the maximum amount to their 401(k) plan. However, 401(k) plans are administered independently. Therefore, the IRS cannot rely on plan administrators to identify taxpayers participating in multiple 401(k) plans who cumulatively exceeded annual contribution limits.

[5] The point estimate projections are based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 11,848 and 14,546 taxpayers and that the point estimate for lost revenue is between $27,086,146 and $38,086,126. See Appendix IV.

Recommendations

Recommendation 1: The Acting Commissioner, Tax Exempt and Government Entities Division, should identify and provide guidance to 401(k) plans that potentially allow taxpayers to exceed annual contributions limits.

> ***Management's Response:*** The IRS partially agreed with the recommendation. IRS management agreed to identify appropriate educational or other steps for certain employers with the largest number of participants who have excess 401(k) contributions to remind them the plan needs internal controls to limit contributions.
>
> ***Office of Audit Comments:*** While the IRS only partially agreed with this recommendation, we agree with the IRS's plans and believe contacting certain employers with the largest number of participants who have excess 401(k) contributions should assist in improving potential noncompliance for taxpayers who appear to have exceeded the annual contribution limit to their 401(k) plan.

Recommendation 2: The Commissioner, Small Business/Self-Employed, should take actions to bring taxpayers who contribute more than the annual limit to multiple 401(k) plans into compliance with the law.

> ***Management's Response:*** IRS management agreed with the recommendation and plans to select and conduct examinations on a sample of taxpayers, through the authority of an approved Compliance Initiative Project, who appear to contribute more than the annual limit to 401(k) plans, with an emphasis on taxpayers with more than one plan in a single tax year. The IRS will use the results of these examinations to evaluate the level of noncompliance and determine whether additional compliance activities are warranted.
>
> ***Office of Audit Comments:*** While the IRS agreed to conduct examinations on a sample of taxpayers, IRS management disagreed with our estimate of potential lost revenue. The IRS stated the estimate assumes that staff are available to initiate compliance activities for all potentially noncompliant taxpayers. In addition, IRS management stated the estimate is for only one year of data and there is no evidence that it is representative of typical excess contributions, or that all the observations of potential excess contributions are noncompliant. We continue to believe that our outcome measure represents the potential noncompliance for taxpayers who appear to have exceeded the annual contribution limit to their 401(k) plan(s).

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether IRS processes sufficiently identify and address excess contributions to 401(k) plans. To accomplish our objective, we:

I. Determined whether controls associated with 401(k) plans were sufficient for the IRS to identify and address excess contributions to 401(k) plans.

  A. Determined what information reporting is required for contributions to and distributions from 401(k) plans.[1]

  B. Determined whether the IRS had processes or procedures to identify and address taxpayers who made excess contributions to 401(k) plans.

II. Determined whether information submitted by taxpayers and employers indicate that excess contributions were likely made to 401(k) plans in TY 2014.[2]

  A. Identified taxpayers who potentially made excess contributions to their 401(k) plans by analyzing information taxpayers reported on their e-filed tax returns as 401(k) plan contributions. We used National Account Profile[3] data to determine the age of the taxpayer who had a potential excess contribution. We assessed the reliability of the data by comparing information provided by taxpayers on their e-filed tax returns to Form W-2, *Wage and Tax Statement*, information on the IRS's Integrated Data Retrieval System.[4] In addition, we compared the age of the taxpayer from the National Account Profile data to tax return information on the IRS's Integrated Data Retrieval System. The data were determined to be reliable for meeting the audit objective.

  B. Determined whether taxpayers had likely made an excess contribution by reviewing information from employer-submitted Forms W-2 and Forms 1099-R, *Distributions*

[1] The Form W-2, *Wage and Tax Statement*, submitted by the employer may contain other non-401(k) retirement plans.
[2] Our analysis was limited to only those taxpayers who e-filed. Because Forms W-2 do not differentiate Safe Harbor 401(k) and Traditional 401(k) contributions from SIMPLE (Savings Incentive Match Plan for Employees) 401(k) contributions (which have a lower annual contribution limit), we considered an excess contribution to be combined contributions to Traditional, Safe Harbor, and SIMPLE 401(k) plans of greater than $17,500 for taxpayers under the age of 50 or greater than $23,000 for taxpayers age 50 or older.
[3] The National Account Profile is a compilation of selected entity data from various Master Files and the Social Security Administration.
[4] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. for TYs 2014 and 2015 and information from the IRS's Integrated Data Retrieval System.

C. Selected a statistically valid sample of 397 out of 36,898 taxpayers who potentially exceeded salary contribution limits to 401(k) plans by $1,000 or more.[5] The sample was selected using an estimated error rate of 50 percent, a confidence level of 95 percent, and a ±5 percent precision rate.[6]

D. Determined whether taxpayers who had a potential excess contribution in TY 2014 showed a pattern of exceeding contribution limits by reviewing tax information from TYs 2013 and 2015.

E. Estimated the amount of potential increased revenue for taxpayers identified as potentially exceeding annual contribution limits in Step II.C. by adding the excess contribution amount to taxpayers' taxable income and multiplying the excess contribution amount by the taxpayers' marginal income tax rates for TYs 2014 and 2015.

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 for identifying and addressing taxpayers who exceed annual contribution limits for 401(k) plans. We evaluated these controls by interviewing management and reviewing a random sample of taxpayers who potentially exceeded annual contribution limits to their 401(k) plan(s).

[5] We stratified the population into potential excess contributions of $1,000 to $9,999, $10,000 to $49,999, and greater than or equal to $50,000. We further divided each of the three strata into those taxpayers with one Form W-2 and taxpayers with multiple Forms W-2, resulting in six strata. We considered any excess contribution under $1,000 to be de minimis.

[6] A contract statistician assisted with developing the sampling plans and projections.

Appendix II

Major Contributors to This Report

Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Troy D. Paterson, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations)
LaToya R Penn, Acting Director
James V. Westcott, Audit Manager
Jeffrey R. Stieritz, Lead Auditor
John M. Jarvis, Senior Auditor
Nicole J. Blank, Auditor
Lance J. Welling, Information Technology Specialist (Data Analytics)

Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Small Business and Self-Employed Division
Acting Commissioner, Tax Exempt and Government Entities Division
Acting Director, Employee Plans, Tax Exempt and Government Entities Division
Director, Examination, Small Business/Self-Employed Division
Director, Office of Audit Coordination

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:

- Increased Revenue – Potential; $40,725,517 in increased revenue due to 14,598 taxpayers[1] potentially exceeding the annual contribution limit to their 401(k) plan(s), or $203,627,585 over five years[2] (see page 3).

Methodology Used to Measure the Reported Benefit:

We analyzed the amount of salary contributed to a 401(k) plan(s) as reported by taxpayers on their e-filed TY 2014 tax return to identify taxpayers who potentially made an excess contribution to a 401(k) plan(s). Once identified, we reviewed TY 2014 or TY 2015 Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* and removed taxpayers who timely withdrew their excess 401(k) contribution. As a result, we identified 36,898 taxpayers who e-filed and had potentially exceeded the annual limit to their 401(k) plan(s) by $1,000 or more.

We selected and reviewed a random sample of 397 of the 36,898 taxpayers.[3] For each of the 397 taxpayers in our sample, we manually researched the IRS's Integrated Data Retrieval System[4] for the Form W-2, *Wage and Tax Statement*, submitted by the employer and compared that to information submitted by the taxpayer on his or her tax return. When data submitted by the taxpayer did not match the data on the Form W-2 submitted by the employer, we assumed the employer-submitted Form W-2 to be correct and eliminated the taxpayer as potentially having made an excess contribution. This resulted in 157 taxpayers in our sample who potentially

[1] The point estimate projections are based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 13,101 and 16,095 taxpayers with lost revenue between $33,204,383 and 48,246,652.
[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.
[3] We stratified the population into potential excess contributions of $1,000 to $9,999, $10,000 to $49,999, and greater than or equal to $50,000. We further divided each of the three strata into those taxpayers with one Form W-2, *Wage and Tax Statement*, and taxpayers with multiple Forms W-2, resulting in six strata. We considered any excess contribution under $1,000 to be de minimis.
[4] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

exceeded their annual contribution limit to a 401(k) plan(s) in TY 2014.[5] To calculate the tax effect for the 157 taxpayers identified in our sample, we added the excess contribution to the taxpayer's taxable income[6] to determine his or her marginal tax rate. We then multiplied the excess contribution amount by the taxpayer's marginal tax rate for TYs 2014 and 2015 to calculate the tax effect or potential increased revenue to the Federal Government.

In Figure 1, we estimate that almost 14,600 taxpayers potentially made an excess contribution in TY 2014, which caused an estimated $40.7 million in lost revenue. In the future, if the IRS identifies and addresses individuals potentially making excess contributions to their 401(k) plans, it could potentially increase revenue by approximately $203.6 million over five years.

Figure 1: Sampled Taxpayers Who Potentially Made an Excess Contribution to Their 401(k) Plan in TY 2014

Analysis of Taxpayers With Potential Excess Contributions to 401(k) Plans							
Number of Forms W-2	Amount of Potential Excess Contributions	Taxpayers in Strata	Taxpayers Sampled	Potential Excess Contributions Identified	Percentage of Taxpayers With Potential Excess Contributions Identified	Estimated Number of Potential Excess Contributions	Estimate of Total Taxes Due on Potential Excess Contributions
1	$1,000 to < $10,000	5,593	60	8	13%	746	$975,690
1	$10,000 to < $50,000	3,090	33	7	21%	656	$7,163,691
1	≥ $50,000	5,452	59	0	0%	0	$0
2+	$1,000 to < $10,000	19,223	207	132	64%	12,258	$25,806,352
2+	$10,000 to < $50,000	3,192	34	10	29%	939	$6,779,785
2+	≥ $50,000	348	4	0	0%	0	$0
Total		36,898	397	157	40%	14,598[7]	$40,725,517[8]

[5] We could not separate SIMPLE 401(k) contributions from contributions to other 401(k) plans that have higher contribution limits. We used the higher annual contribution limit from traditional and Safe Harbor 401(k) plans to determine whether an excess contribution was made.

[6] For the purpose of calculating the additional tax owed in TYs 2014 and 2015, we did not include capital gains and qualified dividends from the taxable income because they are not taxed at the ordinary tax rate.

[7] The column for Estimated Number of Potential Excess Contributions differs from the sum total due to rounding.

[8] The column for Estimate of Total Taxes Due on Potential Excess Contributions differs from the sum total due to rounding.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

July 23, 2018

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy for Lisa J. Beard-Niemann
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Taxpayers Generally Comply with Annual Contribution Limits for 401(k) Plans; However, Additional Efforts Could Further Improve Compliance

Thank you for the opportunity to review the above subject draft audit report. A 401(k) plan allows participating employees to defer receiving a portion of their wages. Those wages are instead contributed before taxes to an employer-sponsored plan. There are limitations on the amounts that employees can contribute to a 401(k) each year and tax consequences if those limits are exceeded. Your audit report focused on contributions to 401(k) plans potentially in excess of those limits.

We appreciate your recognition that the overwhelming majority, 99.9%, of electronically filing taxpayers that participated in 401(k) plans were compliant with the laws limiting contributions. For the remaining 0.1%, we believe there may be reasons that a taxpayer appears to have exceeded the limit but in fact did not. An accurate determination as to whether non-compliance exists can only be made by conducting examinations. Using our limited compliance resources, we plan to select a sample of those taxpayers who appeared to exceed limitations and conduct audits to assess the level of actual non-compliance. We also plan to take appropriate steps to identify and educate certain employers with the largest number of participants with excess 401(k) deferrals.

We do not agree with the outcome measure of $40,725,517. The measure assumes that staffing is available to initiate compliance activities on all 14,598 taxpayers without stopping other compliance activities. Only about one third of the taxpayers identified in your sample would have met our threshold for selecting returns for examination. Additionally, there is only one year of data so there is no evidence that this is representative of typical excess contributions. There is also no evidence that all the observations of potential excess contributions are non-compliant.

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Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me or Brenda Dial, Director, Examination Operations, SB/SE Division.

Attachment

Attachment

RECOMMENDATION 1: The Acting Commissioner, Tax Exempt and Government Entities, should identify and provide guidance on 401(k) plans that potentially allow taxpayers to exceed annual contributions limits.

CORRECTIVE ACTION:
We partially agree with the recommendation. We will identify appropriate educational or other steps for certain employers with the largest number of participants that have excess 401(k) deferrals to remind them the plan needs internal controls to limit salary deferrals.

IMPLEMENTATION DATE:
January 15, 2020

RESPONSIBLE OFFICIAL:
Director, Employee Plans, Tax Exempt and Government Entities

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

RECOMMENDATION 2: The Commissioner, Small Business/Self-Employed, should take actions to bring taxpayers who contribute more than the annual limit to multiple 401(k) plans into compliance with the law.

CORRECTIVE ACTION:
We will select and conduct examinations on a sample of taxpayers, through the authority of an approved Compliance Initiative Project (CIP), that appear to contribute more than the annual limit to 401(k) plans, with an emphasis on taxpayers with more than one plan in a single tax year. We will use the results of these examinations to evaluate the level of noncompliance and determine whether additional compliance activities are warranted.

IMPLEMENTATION DATE:
October 15, 2020

RESPONSIBLE OFFICIAL:
Director, Examination Case Selection, Small Business/Self Employed Division

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