
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***Additional Actions Could Improve
Compliance With Early Retirement
Distribution Tax Requirements***

May 22, 2020

Reference Number: 2020-10-018

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 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions.

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HIGHLIGHTS

ADDITIONAL ACTIONS COULD IMPROVE COMPLIANCE WITH EARLY RETIREMENT DISTRIBUTION TAX REQUIREMENTS

Highlights

Final Report issued on May 22, 2020

Highlights of Reference Number: 2020-10-018 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

Taxpayers who take an early distribution from their retirement accounts must pay a 10 percent additional tax unless they qualify for certain exceptions. The IRS's Automated Underreporter (AUR) Program systemically identifies taxpayers who took an early distribution but did not pay the tax. Failure to enforce taxpayer compliance with this tax creates an unfair burden on the majority of taxpayers who pay all of their taxes on time.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the AUR Program is identifying and working the most productive cases for which taxpayers potentially owe a 10 percent additional tax on early distributions from retirement plans.

WHAT TIGTA FOUND

Due to resource constraints, it is important the AUR Program work the highest priority cases with the most significant impact on tax administration. The AUR Program worked only 8 percent of Tax Year 2016 cases for which taxpayers reported an early distribution but did not pay the additional tax. Most cases selected for work were either later screened from further review or resulted in no assessment.

TIGTA compared the exceptions taxpayers claimed on Forms 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, with internally available information and identified 6,899 cases with potentially invalid exception claims. The IRS could have potentially assessed approximately

\$7.5 million for these returns. TIGTA identified: 1) 5,450 cases for which the retirement distribution was made from a type of retirement account that *****2***** ****2**** 2) 657 cases for which taxpayers did not *****2***** 3) 638 cases for which taxpayers did not have evidence of *****2***** and 4) 154 cases for which taxpayers received *****2***** *****2***** Periodic analysis of Form 5329 filings would allow the IRS to identify and notify taxpayers about potential noncompliance issues.

The AUR Program selected to work 368 of the 6,899 cases with potentially invalid Form 5329 exception claims. However, the AUR Program generally did not *****2***** *****2***** In these situations, AUR tax examiners closed the cases during screening without making changes to the taxpayers' accounts. AUR tax examiners did not make a determination about the *****2***** *****2***** *****2*****

In addition, AUR tax examiners *****2***** *****2***** *****2***** as part of the AUR Program. TIGTA estimates the IRS could have potentially assessed approximately \$2.8 million in taxes for potentially invalid responses.

WHAT TIGTA RECOMMENDED

TIGTA made four recommendations including that the IRS ensure AUR examiners ***2*** *****2***** *****2***** periodically analyze non-selected cases *****2***** *****2***** consider the feasibility of revising instructions for Form 5329; and ensure AUR examiners make *****2***** *****2***** *****2*****

In their response, IRS management agreed or partially agreed with three recommendations and plans to take corrective actions. However, the IRS *****2***** *****2***** *****2***** TIGTA believes these actions would improve tax compliance.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 22, 2020

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements
(Audit # 201810029)

This report presents the results of our review to determine whether the Automated Underreporter Program is identifying and working the most productive cases for which taxpayers potentially owe a 10 percent additional tax on early distributions from retirement plans. This review is included in our Fiscal Year 2020 Annual Audit Plan and addresses the major management challenge of Improving Tax Reporting and Payment Compliance.

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

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 Heather Hill, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations).



***Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements***

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***Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements***

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 |



Additional Actions Could Improve Compliance With Early Retirement Distribution Tax Requirements

Background

Many individuals use retirement plans to save for retirement. These types of plans allow employees to accumulate retirement savings in an individual account based on employee and employer contributions. To encourage saving for retirement, these types of plans provide individuals tax advantages for setting aside money for retirement. Figure 1 describes the most common qualified retirement plans.

Figure 1: Description of Common Qualified Retirement Plans

| Qualified Retirement Plans | Description |
|--|--|
| Pension Plan | Employer-sponsored plan for which the plan sponsor promises employees a specified monthly benefit at retirement based on a formula. |
| 401(k) plan | A plan in which employees have individual accounts to which the employee, employer, or both make contributions. Benefits are based on contributions and investment returns (gains and losses) on the accounts. |
| 403(b) plan | A plan designed for public education and tax-exempt entities. Both the plan sponsor and employees can make pretax contributions. |
| Federal Government's Thrift Savings Plan | A defined contribution plan, similar to a 401(k), for Federal employees. |
| Individual Retirement Arrangement (IRA) | An individual savings plan that provides tax advantages for setting aside money for retirement. |

Source: IRS definitions of qualified retirement plans on IRS.gov.

To discourage the use of retirement funds for purposes other than normal retirement, the law imposes a 10 percent additional tax on certain early distributions.¹ Generally, any distribution before the age of 59½ from a qualified retirement plan is assessed a 10 percent additional tax.

¹ Internal Revenue Code § 72(t).



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However, the law permits early distributions without paying the additional taxes under certain circumstances. For example, individuals are not subject to the 10 percent additional tax if they:

- Purchase their first home.
- Have expenses for higher education.
- Separated from service when reaching the age of 55 (age 50 for public safety employees).
- Are unemployed and need to pay health insurance premiums.
- Made payments to another individual under a qualified domestic relations order.²

Financial institutions report retirement distributions to the Internal Revenue Service (IRS) on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Included on the form are distribution codes that explain why the taxpayer received the distribution. For distributions not subject to the 10 percent additional tax, individuals should attach Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to their tax return to indicate that they qualify for an exception to the early distribution tax. The form should include the reason the taxpayer qualifies for an early distribution.

Taxpayers should report distributions from these retirement plans as income on their tax returns. If the early distribution does not qualify as an exception, taxpayers should also report and pay the 10 percent additional tax owed.

The IRS's Automated Underreporter (AUR) Program 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 discrepancies. Discrepancies are identified when there are mismatches between tax return data and third-party information. Due to resource constraints, the AUR Program cannot review every discrepancy. As a result, additional data analyses are performed on the population of individual tax returns with identified discrepancies to select the inventory that AUR tax examiners will review. The Information Return Case Selection program team should select cases that will: 1) yield the highest assessments, 2) address repeat offenders (taxpayers who have had potential discrepancies in more than one tax year), and 3) provide balanced coverage among all the different types of inventory that the AUR Program works.³

For cases subject to the 10 percent additional tax, the AUR Program matches the amounts reported by retirement plan trustees on Forms 1099-R to the amounts that taxpayers report on

² See Appendix V for a description of all 12-exception codes for the 10 percent additional tax for early distributions.

³ The Information Return Case Selection program team is the group within the Small Business/Self-Employed Division's Examination function that handles case selection for the AUR Program.



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their tax return to identify discrepancies.⁴ Additionally, if the Form 1099-R has an early distribution, the AUR Program compares it to the tax return to ensure that taxpayers paid the 10 percent additional tax.⁵ AUR tax examiners are supposed to manually review the associated return along with other information received by the IRS during the case analysis phase. During this process, the tax examiner matches the information returns that were filed with the IRS to the information reported on the taxpayer's return. There is additional information present in the case files during the case analysis phase that is not present when matching third-party documents to the tax return. For example, the Form 5329 is not present during matching but is available to the examiners during case analysis. A determination is made as to whether the case can be closed without any further action (referred to as screening out a case), whether the case needs additional research, or whether a notice needs to be generated to inform the taxpayer of a proposed tax change.⁶

This review was performed in the Small Business/Self-Employed (SB/SE) Division Examination function at the AUR Program campus in Fresno, California, and with information received from the SB/SE Division Examination Operations office in Hartford, Connecticut, during the period July 2018 through October 2019. 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.

⁴ The AUR Program works 61 different income categories. We reviewed the income category for taxpayers who reported the early distribution of retirement income on their return but did not pay the 10 additional percent tax due. Retirement income includes distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, *etc.* Taxpayers should report retirement income on lines 15 and 16 of Form 1040, *U.S. Individual Income Tax Return*.

⁵ Additional tax owed from early withdrawals is reported on line 59 (Additional tax on IRAs, other qualified retirement plans, *etc.*) on Form 1040.

⁶ Screening out a case would not require taxpayer contact. The notice most commonly used is the Computer Paragraph 2000 Notice, *Request for Verification of Unreported Income, Payments, or Credits*.



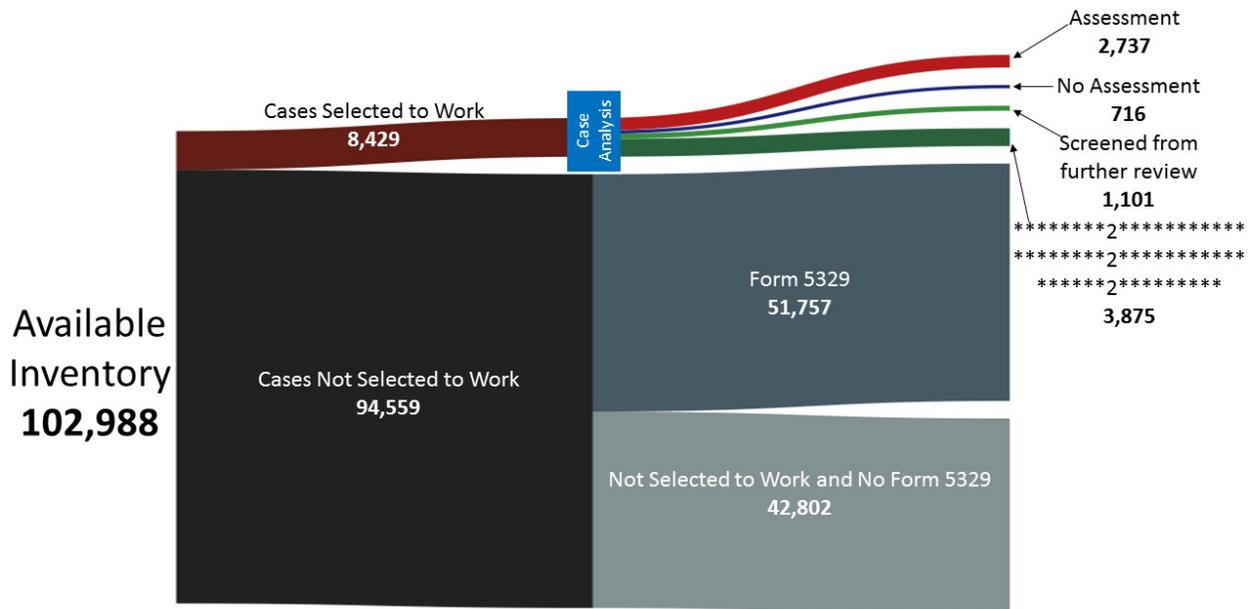
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Results of Review

Thousands of Potentially Productive Cases Are Not Worked

For Tax Year (TY) 2016, the AUR Program identified 102,988 cases for which the taxpayers reported an early distribution from their retirement account on their tax return but did not pay the 10 percent additional tax. Due to resource constraints, the AUR Program only reviews a fraction of the total number of tax returns it identifies as having discrepancies. During TY 2016, the AUR Program selected 8,429 (8 percent) of these cases to work.⁷ The remaining 94,559 cases (92 percent) were not selected. The majority of cases selected for work were either subsequently screened from further review or resulted in no assessment. Of the 8,429 cases selected for work, 2,737 (32 percent) resulted in additional assessments. Therefore, 3 percent of the 102,988 cases the AUR Program identified for which taxpayers reported an early distribution but did not pay the early distribution tax were ultimately assessed additional taxes by the AUR Program. Figure 2 shows how the AUR Program processed the 102,988 cases.

Figure 2: Processing of Early Distribution Case Inventory



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of AUR Program inventory data.

⁷ Our analysis is from AUR Program data provided as of May 20, 2019. Some cases were still being worked by AUR tax examiners.



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Given the relatively small number of cases that were worked, it is particularly important that the AUR Program work the highest priority cases with the most significant impact on tax administration. The AUR Program assessed additional taxes on 79 percent of cases worked (*i.e.* not subsequently screened out).

The IRS ***2***** listed on *****2*******

The AUR Program generally did *****2*****
*****2***** In total, 55,632 (54 percent) of the 102,988 taxpayers attached Forms 5329 to their tax returns. Figure 3 shows the exceptions claimed by these 55,632 taxpayers.⁸

Figure 3: Exceptions Claimed by Taxpayers on Forms 5329

| Early Distribution Exception Number | Quantity |
|--|---------------|
| 01 – Distributions (does not apply to IRAs) you receive after separation from service in or after the year you separate and reach age 55 (age 50 for qualified public safety employees) ⁹ | 3,624 |
| 02 – Distributions made as part of a series of substantially equal periodic payments | 2,020 |
| 03 – Distributions due to total and permanent disability | 3,840 |
| 04 – Distributions due to death | 1,573 |
| 05 – Distributions up to the amount you paid for unreimbursed medical expenses during the year (minus 7.5% of your adjusted gross income for the year) | 11,690 |
| 06 – Distributions made to an alternate payee under a qualified domestic relations order (does not apply to IRAs) | 1,328 |
| 07 – IRA distributions made to certain unemployed individuals for health insurance premiums ¹⁰ | 1,042 |
| 08 – IRA distributions made for qualified higher education expenses | 5,296 |
| 09 – IRA distributions made for the purchase of a first home, up to \$10,000 | 5,689 |
| 10 – Distributions made due to an IRS levy | 287 |
| 11 – Distributions to reservists while serving on active duty for at least 180 days | 120 |
| 12 – Other. ¹¹ Also, enter this code if more than one exception applies. | 19,123 |
| Total | 55,632 |

Source: TIGTA analysis of Form 5329 exception numbers obtained from the Modernized E-File data and cases not worked by the IRS.

⁸ *****2***** the AUR tax examiner sends out the notice stating that the taxpayer owes the 10 percent additional tax for taking an early distribution from his or her retirement account. See Appendix V for a more detailed explanation for each exception.

⁹ A non-IRA distribution is from an employer-sponsored retirement plan, such as a 401(k) plan.

¹⁰ Contributions taxpayers make to an IRA may be fully or partially deductible, depending on which type of IRA, and generally, amounts in the IRA (including earnings) are not taxed until distributed. In some cases, amounts are not taxed at all if distributed according to the rules.

¹¹ See Appendix V, Exception Number 12 – Other, which can be used if the taxpayer has a combination of the exceptions 01 through 11 or any one of the other criteria listed for the exception in Appendix V.



Additional Actions Could Improve Compliance With Early Retirement Distribution Tax Requirements

We analyzed the exceptions by using internal information available to AUR examiners for five of the 12 exception categories.¹² Our analysis identified 6,899 cases for which the exception to paying the 10 percent additional tax appeared invalid. For example:

- 5,450 taxpayers took a distribution from a type of retirement account that did not qualify for the exception claimed. For example, taxpayers may not take an early distribution from an employer-sponsored retirement plan, such as a 401(k) plan, *****2*****
*****2*****.¹³
- 657 taxpayers claimed the exception for *****2*****.
- 638 taxpayers did not have any evidence of *****2***** and claimed the exception on Form 5329 for *****2*****.
- 154 taxpayers took distributions *****2*****
*****2*****.

The AUR Program selected to work, but examiners later screened out, 3,875 (7 percent) of the 55,632 cases for which the *****2***** Similarly, we analyzed the 3,875 cases by using internal information available to AUR tax examiners for five of the 12 exception categories.¹⁴ Of these 3,875 cases, we identified 368 (9 percent) cases which appeared to have an invalid exception. However, AUR tax examiners did not *****2*****
*****2***** information available to them in the AUR case management system.¹⁵ For example:

- 274 taxpayers took a distribution from a type of retirement account that did not qualify for the exception claimed.
- 42 taxpayers claimed the exception for *****2*****.
- 37 taxpayers did not have any *****2***** and claimed the exception on Form 5329 for *****2*****.

¹² We used internal information available to review 16,979 cases that fall under exception numbers 01 (separated from service when reaching the age of 55 (age 50 for qualified public safety employees), 06 (alternate payee), 07 (certain unemployed individuals for health insurance premiums), 08 (qualified higher education expenses), and 09 (purchase of a first home). *****2*****
*****2*****.

¹³ The 5,450 originate from the following exception numbers: 590 for exception number 01; 193 for exception code 06; 575 for exception number 07; 2,082 for exception number 08; and 2,010 for exception number 09.

¹⁴ We were able to review 1,431 of the 3,875 cases that AUR examiners screened out. We were unable to review the remaining cases *****2*****
*****2*****.

¹⁵ These 368 cases were also included in the above analysis of all 55,632 cases *****2*****.



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- 15 taxpayers took distributions *****2*****
*****2*****.

Although AUR employees have the information readily available to identify this noncompliance, management stated that the AUR Program is not an audit. When evaluating a taxpayer’s explanation for unreported income it is not necessary to verify everything in the taxpayer’s response. In general, the taxpayer’s explanation will be taken at face value. However, the AUR tax examiner’s position description requires examiners to determine the acceptability of the taxpayers’ explanations and to make determinations using sound judgment concerning taxpayers’ data.

If the IRS *****2*****
*****2***** it could have potentially identified 6,899 taxpayers who improperly took an exception to the 10 percent additional tax and assessed approximately \$7.5 million in additional taxes.¹⁶ Failure to enforce compliance could lead to greater noncompliance in this area.

Taxpayers claimed exceptions *****2***** Analyses of Forms 5329 and 1099-R data identified 5,450 *****2*****
*****2***** . For example, *****2*****
*****2***** Taxpayers may not claim these exceptions if the distributions were made from another type of retirement plan, such as a pension plan or a 401(k). In addition, age-related exceptions and exceptions for distributions made to an alternate payee under a qualified domestic relations order do not apply if the distribution was made from an IRA.

AUR tax examiners are supposed to determine if the exception number claimed on the Form 5329 is clearly allowable based on the retirement plan.¹⁷ *****2*****
*****2***** Using data that were available to us, we were able to compare the exceptions reported on the Form 5329 with the retirement distribution types reported on the Forms 1099-R for 1,431 of the 3,875 cases that AUR examiners screened out. *****2*****
*****2*****
*****2***** .¹⁸ We estimate that the IRS could have potentially

¹⁶ 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.

¹⁷ Internal Revenue Manual 4.19.3.16.3(7) (Oct. 7, 2019).

¹⁸ Of the 5,450 taxpayers who did not take distributions from qualifying retirement plans, 274 were selected to be worked by the AUR Program, but examiners screened them out, and 5,176 cases were in the AUR Program’s inventory but were not selected to be worked.



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assessed \$5.8 million in additional taxes for the 5,450 taxpayers who claimed exceptions from
*****2*****.

Taxpayers *****2*****

Analyses identified 657 *****2*****

*****2*****

*****2*****. We estimate that the IRS could have potentially assessed approximately \$753,000 in additional tax if it *****2*****

Taxpayers did not *****2*****. Analyses identified

638 taxpayers who claimed the exception on Form 5329 *****2*****

*****2*****

*****2*****¹⁹ We

estimate that the IRS could have potentially assessed approximately \$735,000 in additional tax if *****2*****²⁰

Taxpayers took early distributions *****2*****. The

law allows *****2*****

*****2*****²¹ Analyses identified 154 taxpayers who took distributions ***2***

*****2*****

*****2***** We estimate that the IRS could have potentially assessed approximately \$230,000 in additional tax if *****2*****

*****2*****²²

Thousands of taxpayers claimed the ****2**** exception number 12 “Other” on Forms 5329.

The IRS instructs taxpayers who meet other criteria not included in the 11 exceptions or have more than one exception that applies to select the “Other” option when submitting Forms 5329.²³

*****2*****

*****2*****

Analyses identified 19,123 (34 percent) of the 55,632 taxpayers who filed Form 5329 claimed

¹⁹ *****2*****

*****2*****

*****2*****

*****2*****

²⁰ *****2*****

*****2*****

*****2*****

*****2*****

²¹ 26 U.S.C. § 72(t) (8) (B) (i).

²² The \$230,000 additional tax *****2*****

²³ Instructions for Form 5329 (2016).



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the exception “Other” in TY 2016. *****2*****
*****2*****

Recommendations

The Commissioner, SB/SE Division, should:

Recommendation 1: *****2*****
*****2*****
*****2*****
*****2*****
*****2*****
*****2*****
*****2*****.

Management’s Response: The IRS partially agreed with this recommendation. The implementation of necessary programming changes to accomplish this recommendation is subject to budgetary constraints, limited resources, and competing priorities. Consequently, due to these constraints, the IRS cannot provide an implementation date at this time. However, the IRS does not agree to change the AUR Program to ***2**
*****2*****.

Office of Audit Comment: TIGTA believes that programming changes would be minimal because third-party information is already available to AUR tax examiners in the AUR case management system and on the IRS’s Integrated Data Retrieval System,
*****2*****.

Recommendation 2: Use available data to periodically *****2*****
*****2*****. Notices should be sent to taxpayers who inappropriately took an early distribution and did not pay the additional tax.

Management’s Response: The IRS agreed with this recommendation. The IRS will use available data to periodically *****2*****
*****2***** and take the appropriate compliance action.

The IRS disagreed with the outcome measure stating that the five-year projection amplifies the potential revenue without considering the high probability of subsequent compliance after a taxpayer has been subjected to a compliance activity. In addition, the IRS stated that pursuing the cases suggested in this audit report comes with an opportunity cost and potentially a negative impact to voluntary compliance due to the redirection of resources from other compliance activities.

Office of Audit Comment: TIGTA’s methodology for projecting an outcome for five years assumes that, if TIGTA had not performed the audit and identified the condition which led to the outcome, the condition would have existed for up to five years without correction. These taxpayers would not have been subjected to a compliance activity that



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would have led to improved compliance. The estimates are intended to provide stakeholders a general measure of the cost of noncompliance in order to help inform decision-making.

Recommendation 3: Consider the feasibility of revising Form 5329 to instruct taxpayers to
*****2*****

Management’s Response: The IRS disagreed with this recommendation. IRS management stated that updating the instructions to *****2*****
*****2*****.

Implementing this change would require significant resources, including programming changes. The benefit to these extensive changes are currently unknown, and the IRS does not believe this additional data will enhance or enrich compliance efforts.

Office of Audit Comment: TIGTA believes that updating the instructions to ***2***
*****2***** would add value to the IRS’s compliance efforts. As stated in this report, 19,123 (34 percent) of the 55,632 taxpayers who filed Form 5329 in TY 2016 selected the “Other” exception code, ***2***
****2****. The *****2***** would provide the IRS with *****2***** which would improve tax compliance.

Tax Examiners ***2*******

When working a case, AUR examiners send out notices advising taxpayers that additional taxes are owed because they took an early distribution from their retirement account.²⁴ The notice states:

Premature distributions from a qualified retirement plan are subject to a 10% additional tax. Exceptions may apply as indicated in the instructions for Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. If the distributions shown on this notice qualify for an exception, submit a completed Form 5329.

In response to AUR Program notices, taxpayers may provide Forms 5329 or supporting documentation that fully resolves the discrepancy. AUR tax examiners are expected to determine the acceptability of the taxpayers’ explanations and to make determinations using sound judgment concerning taxpayers’ data.

*****2*****
*****2*****
*****2***** We reviewed a random sample of 31 of the 716 cases that the AUR

²⁴ The notice most commonly used is the Computer Paragraph 2000 Notice.



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Program worked in TY 2016 but did not assess the 10 percent additional tax and identified 14 (45 percent) cases for which the taxpayers' claims for exception were *****2*****:

- Eight cases involved taxpayers who provided a Form 5329 in response to the notice of discrepancy.
 - Six taxpayers' claims appeared invalid based on other readily available tax information, such as taxpayers who claimed an exception not permitted for the type of retirement plan.
 - *****1*****
*****1*****
- Six cases involved taxpayers who responded with other documentation or called the IRS with an explanation for not paying the 10 percent additional tax. However, it is unclear why the AUR Program did not assess the 10 percent additional tax *****2*****
*****2***** For example, taxpayers responded to the notice with a letter explaining why they did not pay the early distribution tax.
*****2*****
*****2*****
*****2*****.

For the remaining 17 (55 percent) cases, taxpayers provided explanations that were sufficiently supported by third-party documentation. For example, taxpayers responded with the exception to paying the early distribution tax because of higher education expenses. Third-party documents corroborated that the taxpayer took the early distribution for education expenses.

AUR tax examiners closed the cases with no changes to the taxpayer's account because, according to AUR Program management, the AUR Program is not an audit. When evaluating a taxpayer's explanation for unreported income it is not necessary to verify everything in the taxpayer's response. *****2*****
*****2***** However, we believe management should ensure that AUR employees take the appropriate steps to *****2*****
*****2***** We estimate the IRS could have potentially assessed approximately \$2.8 million in additional taxes for an additional 323 cases if it had *****2*****
*****2***** rather than generally accepting the taxpayer's explanation at face value, before closing the case with no additional tax assessments.²⁵

²⁵ We are 90 percent confident that the actual total number of cases is between 216 and 436 and the actual total amount of lost revenue is between \$1,469,233 and \$4,048,111.



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Recommendation

Recommendation 4: The Commissioner, SB/SE Division, should ensure that AUR Program tax examiners *****2*****.

Management's Response: The IRS partially agreed with this recommendation. The IRS will update Internal Revenue Manual procedures to assist tax examiners *****2*****the information available in the AUR system.

The IRS disagreed with the outcome measure stating that the small sample size undermined the reliability of the test. The resulting margins of error, even when computed at the low 90 percent confidence level, yield a large amount of imprecision and uncertainty about the outcome measure.

Office of Audit Comment: Management's planned corrective action meets the intent of the recommendation.

The outcome measure was projected on the results of statistically valid sample. TIGTA's contract statistician computed all the error rates and projections pertaining to our review of taxpayers' responses to notices sent by the AUR Program. We disclosed all of the projection ranges in the report.



Additional Actions Could Improve Compliance With Early Retirement Distribution Tax Requirements

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the AUR Program is identifying and working the most productive cases for which taxpayers potentially owe a 10 percent additional tax on early distributions from retirement plans. To accomplish this objective, we:

- I. Reviewed IRS processes and procedures to identify individuals who received an early distribution from their retirement plan and did not claim an exception to, or pay, the 10 percent additional tax.
 - A. Obtained and reviewed AUR Program policies and procedures to identify cases for which individuals received an early distribution from their retirement plan but did not pay the 10 percent additional tax.
 - B. Determined the documentation required and maintained by the IRS for taxpayers with exceptions for paying the 10 percent additional tax.
 - C. Interviewed AUR Program Selection and Policy personnel to determine their process for identifying these cases.
- II. Determined if the AUR Program is identifying and assigning the most productive cases for which taxpayers potentially owe a 10 percent additional tax on early distributions from retirement plans.
 - A. Obtained the IRS population of early distribution discrepancies for TY 2016 subject to the 10 percent additional tax identified by the AUR Program.
 - B. Compared this population to the Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, data to identify the taxpayers who filed an exception to paying the 10 percent additional tax.¹

¹ The Form 5329 was on the Modernized e-File tax return data, which is limited to electronically filed tax returns.



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1. Reviewed available tax information from the Data Center Warehouse, such as the National Account Profile data, to obtain the taxpayers' age and other third-party data, Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, Form 1098-T, *Tuition Statement*, and Forms 1098-E, *Student Loan Interest Statement*, to determine the validity of the exception numbers on the Form 5329.² We assessed the reliability of the data by validating the exception numbers on the Form 5329 to the Modernized e-File tax return data, and comparing the Form 5329 to the Forms 1099-R, 1098-E, and 1098-T on the IRS's Integrated Data Retrieval System.³ The data were determined to be reliable for meeting the audit objective.
- III. Assessed the AUR Program's review of cases for which a notice of discrepancy for the 10 percent additional tax was sent but no assessment was made to determine appropriateness.
- A. Using data from Step II.A., identified 716 cases and selected 31 to review in which the AUR Program sent a notice of discrepancy but did not assess the 10 percent additional tax.⁴
 - B. Reviewed these cases to determine if the taxpayers' claims for exception were permissible and adequately supported.

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: SB/SE Division Examination function's policies, procedures, and practices related to selecting early distribution cases subject to the 10 percent additional tax and determining the taxpayer's compliance with early distribution cases subject to the 10 percent additional tax. We evaluated these controls by interviewing IRS management and Examination function employees as well as conducting data analysis.

² The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits. The National Account Profile contains IRS and Social Security Administration information for date of birth, date of death, gender, and citizenship code for each Taxpayer Identification Number. The IRS obtains the National Account Profile file from the Social Security Administration and uses the file in the processing and verification of tax returns.

³ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

⁴ We selected our original sample size using a 90 percent confidence level, a ± 5 percent precision rate, and a 10 percent estimated error rate. We selected 120 cases to review but only reviewed 31 cases because some cases were still being worked by the AUR Program.



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Appendix II

Major Contributors to This Report

Deann L. Baiza, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Heather M. Hill, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Carl Aley, Director
David Bueter, Audit Manager
Jeffrey Stieritz, Lead Auditor
Kevin Nielsen, Information Technology Specialist (Data Analytics) – Applied Research and Technology Data Analyst



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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Headquarters Examination, Small Business/Self-Employed Division
Director, Enterprise Audit Management



**Additional Actions Could Improve Compliance
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Appendix IV

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; approximately \$7.5 million (\$37.5 million over five years) in additional taxes for 6,899 cases with invalid exceptions claimed on Forms 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts* (see page 4).¹

Methodology Used to Measure the Reported Benefit:

The AUR Program identified 102,988 cases for which the taxpayer reported the early distribution on the tax return but did not pay the 10 percent additional tax. We matched the 102,988 cases to the Forms 5329 and identified 55,632 cases for which taxpayers attached the form to their tax return for TY 2016. Using data available to IRS employees, we performed analysis to test the validity of five exception numbers claimed.² Our analysis identified 6,899 with invalid exceptions claimed on Forms 5329.³ We determined that *****2***** it could potentially assess \$7,493,106 in additional taxes (\$37,465,531 over five years.)

¹ 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.

² We tested five of the 12 exceptions for an aggregate of 16,979 cases. *****2*****
*****2***** All taxpayers and dollar values assessed are unique to the condition met.

³ We used internal information available to review a total of 16,979 cases that fall under exception numbers 01 (separated from service when reaching the age of 55 (age 50 for public safety employees), 06 (alternate payee), 07 (certain unemployed individuals for health insurance premiums), 08 (qualified higher education expenses), and 09 (purchase of a first home). *****2*****
*****2*****



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Type and Value of Outcome Measure:

- Increased Revenue – Potential; approximately \$2.8 million (more than \$13 million over five years) in additional taxes for 323 cases in which *****2*****
*****2*****
*****2*****.⁴

Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 31 cases of the 716 cases that the AUR Program worked but did not assess the 10 percent additional tax and identified 14 (45 percent) cases for which the *****2*****.⁵ We multiplied the number of errors by the average potential early distribution tax assessment for the 14 cases that did not follow established procedures. For these 14 cases, we took the early distribution amount subject to the 10 percent additional tax and multiplied by 10 percent to calculate the additional tax owed *****2*****. Based on the population of 716 such cases worked, we estimate the IRS could potentially assess taxes on an additional 323 cases,⁶ involving \$2,758,672 of additional taxes each year (\$13,793,360 over five years).⁷

⁴ 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.

⁵ We selected our original sample size using a 90 percent confidence level, a ±5 percent precision rate, and a 10 percent estimated error rate. We selected 120 cases to review but only reviewed 31 cases because some cases were still being worked by the AUR Program.

⁶ We are 90 percent confident that the actual total number of cases is between 216 and 436.

⁷ We are 90 percent confident that the actual total amount of lost revenue is between \$1,469,233 and \$4,048,111.



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Appendix V

***Exceptions to the Additional Tax
on Early Distributions Reported on Form 5329***

| Exception Number | Definition |
|------------------|---|
| 01 | Qualified retirement plan distributions (does not apply to IRAs) you receive after separation from service when the separation from service occurs in or after the year you reach age 55 (age 50 for qualified public safety employees). |
| 02 | Distributions made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from an employer plan, payments must begin after separation from service). |
| 03 | Distributions due to total and permanent disability. You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition. A medical determination that your condition can be expected to result in death or to be of long, continued, and indefinite duration must be made. |
| 04 | Distributions due to death (does not apply to modified endowment contracts). |
| 05 | Qualified retirement plan distributions up to the amount you paid for unreimbursed medical expenses during the year minus 10% or (7.5% if you or your spouse were born before January 2, 1952) of your adjusted gross income for the year. |
| 06 | Qualified retirement plan distributions made to an alternate payee under a qualified domestic relations order (does not apply to IRAs). |
| 07 | IRA distributions made to certain unemployed individuals for health insurance premiums. |
| 08 | IRA distributions made for qualified higher education expenses. |
| 09 | IRA distributions made for the purchase of a first home, up to \$10,000. |
| 10 | Qualified retirement plan distributions made due to an IRS levy. |
| 11 | Qualified distributions to reservists while serving on active duty for at least 180 days. |



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| Exception Number | Definition |
|------------------|--|
| 12 | <p>Other. Also, enter this code if more than one exception applies.</p> <p>The following exceptions also apply:</p> <ul style="list-style-type: none"> • Distributions incorrectly indicated as early distributions by code 1, J, or S in box 7 of Form 1099-R, <i>Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.</i> Include on line 2 the amount you received when you were age 59½ or older. • Distributions from a section 457 plan, which are not from a rollover from a qualified retirement plan. • Distributions from a plan maintained by an employer if: <ol style="list-style-type: none"> 1. You separated from service by March 1, 1986; 2. As of March 1, 1986, your entire interest was in pay status under a written election that provides a specific schedule for the distribution of your entire interest; and 3. The distribution is actually being made under the written election. • Distributions that are dividends paid with respect to stock described in section 404(k). • Distributions from annuity contracts to the extent that the distributions are allocable to the investment in the contract before August 14, 1982. For additional exceptions that apply to annuities, see <i>Tax on Early Distributions under Special Additional Taxes</i> in Publication 575, <i>Pension and Annuity Income</i>. • Distributions that are phased retirement annuity payments made to Federal employees. See Publication 721, <i>Tax Guide to U.S. Civil Servant Retirement Benefits</i>, for more information on the phased retirement program. |

Source: *Instructions for Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.*



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Appendix VI

Management's Response to the Draft Report

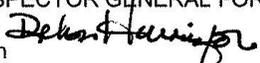


SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

February 24, 2020

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Additional Actions Could Improve
Compliance With Early Retirement Distribution Tax
Requirements (TIGTA #201810029)

Thank you for the opportunity to review the subject draft audit report. The IRS's Automated Underreporter (AUR) Program is a document-matching program that systemically matches information returns submitted by third parties against amounts reported by taxpayers on their individual income tax returns. The AUR program issues notices to taxpayers to resolve the identified discrepancies through a process that is less burdensome to the taxpayer and more efficient to the Service than conducting an examination. To maintain the program's productivity and efficiency, it is imperative the tax examiner's role remains within the scope of the program's intended purpose.

The AUR program may identify as many as 25 million discrepant cases per year and completes additional data analytics to identify the discrepancies that will: 1) yield the highest assessments, 2) address repeat offenders (taxpayers who have had potential discrepancies in more than one tax year), and 3) provide balanced coverage among all the different types of inventory the AUR program works. Effective case selection is critical to minimizing taxpayer burden, maximizing compliance, and ensuring the IRS is using its limited resources as effectively as possible. As TIGTA was able to show and as the IRS proved, we consistently select the most productive cases that address non-compliance with early retirement distribution tax requirements.

Your report includes several recommendations and outcome measures. We agree with some of your recommendations. However, we do not agree with any of your outcome measures. We believe the small sample size undermined the reliability of the test. The resulting margins of error, even when computed at the low 90% confidence level, yield a large amount of imprecision and uncertainty about the outcome measures. In addition, the five-year projection amplifies the potential revenue without considering the high probability of subsequent compliance after a taxpayer has been subjected to a



***Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements***

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compliance activity. Lastly, pursuing the cases suggested in this audit report comes with an opportunity cost and potentially a negative impact to voluntary compliance due to the redirection of resources from other compliance activities.

Attached is our detailed response to your recommendations. If you have any questions, please contact me or Scott Irick, Director, Examination Operations, Small Business/Self-Employed Division.

Attachment



**Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements**

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed (SB/SE) Division, *****2*****
*****2*****
*****2*****
*****2*****
*****2*****
*****2*****
*****2*****

CORRECTIVE ACTION:

We partially agree with this recommendation. The implementation of necessary programming changes to accomplish this objective is subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, we cannot provide an implementation date at this time. However, we do not agree to change the AUR program to *****2*****

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

Director, Exam Field and Campus Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

The Commissioner, SB/SE Division, should use available data to *****2*****
*****2***** Notices
should be sent to taxpayers who inappropriately took an early distribution and did not pay the additional tax.

CORRECTIVE ACTION:

We agree. We will use available data to periodically *****2*****
*****2***** and take the appropriate compliance action.

IMPLEMENTATION DATE:

May 15, 2021

RESPONSIBLE OFFICIAL:

Director, Exam Case Selection, SB/SE Division



**Additional Actions Could Improve Compliance
With Early Retirement Distribution Tax Requirements**

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RECOMMENDATION 3:

The Commissioner, SB/SE Division, should consider the feasibility of revising Form 5329 to instruct taxpayers to *****2*****
*****2*****

CORRECTIVE ACTION:

We disagree. Updating the instructions to *****2*****
*****2***** Implementing this change would require significant resources including programming changes. The benefit to these extensive changes is currently unknown and we do not believe this additional data will enhance or enrich our compliance efforts.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 4:

The Commissioner, SB/SE Division, should ensure AUR tax examiners****2****
*****2*****
*****2*****

CORRECTIVE ACTION:

We partially agree. We will update the IRM procedures to assist tax examiners in *****2*****
*****2***** the information available in the AUR system.

IMPLEMENTATION DATE:

December 15, 2020

RESPONSIBLE OFFICIAL:

Director, Exam Field and Campus Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls