

# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



## **Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential**

February 13, 2023

Report Number: 2023-30-009

**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.**

# HIGHLIGHTS: Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential

Final Audit Report issued on February 13, 2023

Report Number 2023-30-009

## Why TIGTA Did This Audit

This audit was initiated to assess the IRS's controls over the selection and examination of employment tax cases, including relief from employment tax obligations that may be provided under Section 530 of the Revenue Act of 1978. In October 2022, the IRS reported that the estimated gross employment Tax Gap was \$93 billion (19 percent of the total \$496 billion gross Tax Gap) for Tax Years 2014 through 2016.

## Impact on Tax Administration

Employers are generally required to withhold Federal income, Federal Insurance Contribution Act, and additional Medicare taxes (commonly known as "employment" taxes) from their employees' earnings and forward to the U.S. Treasury on the employees' behalf. Additionally, employers are liable for taxes imposed by the Federal Unemployment Tax Act. The IRS examines some employment tax returns to determine if wages, tips, compensation, credits, and taxes are reported accurately.

Employment tax examinations are mainly conducted by the Small Business/Self-Employed (SB/SE) Division. The SB/SE Division's employment tax examinations assessed over \$2.1 billion in additional taxes for Fiscal Years 2018 to 2020. The Specialty Employment Tax Examination function is responsible for approximately 83 percent of the total proposed assessments from employment tax issues worked by the SB/SE Division.

## What TIGTA Found

Specialty Employment Tax examinations have higher average dollars assessed per return when compared to overall SB/SE Division employment tax examinations; however, these examinations also have a higher no-change rate, indicating that the IRS may not be selecting the most productive cases.

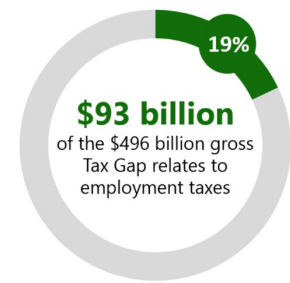
TIGTA observed issues related to the classification process (during which classifiers determine which tax returns will be sent to the field for potential examination, based on certain risk factors) including: lack of effective managerial reviews of the classification process, failure to consistently document classification decisions, and failure to follow IRS procedures for classification. In addition, IRS examiners are not adequately documenting their work in the electronic case management system, called the Issue Management System, which will hamper the IRS's efforts to move to paperless examination files.

In a previous employment tax-related audit, TIGTA recommended that the IRS work with the Treasury Assistant Secretary for Tax Policy to amend Section 530 of the law (which provides a safe harbor for businesses that may have incorrectly treated workers as independent contractors), so that the IRS can take prospective action to enforce the law on employers that misclassify workers as independent contractors. In this audit, TIGTA determined that the IRS does not have a method to track business taxpayers that were granted relief from Section 530 provisions.

## What TIGTA Recommended

TIGTA recommended that the Commissioner, SB/SE Division:

- 1) require that quality standards be documented in the classification process and create a segregation of duties for managerial reviews;
  - 2) ensure that all required managerial reviews are properly conducted and documented;
  - 3) create a tracking mechanism for cases that are granted Section 530 relief;
  - 4) issue a policy alert to remind examiners of procedures and guidance when documenting cases that were granted Section 530 relief; and
  - 5) ensure that managers are verifying that all required and applicable documentation is included in Issue Management System case files, such as by completing a Manager's Quality Checklist.
- IRS management agreed with four recommendations and partially agreed with the recommendation to track cases that are granted Section 530 relief. While IRS management agreed to explore the feasibility of a Section 530 tracking mechanism, implementing such a system would provide information to IRS management and outside stakeholders, such as Congress, to assess the scope of cases that are receiving Section 530 relief.





TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

## U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

February 13, 2023

**MEMORANDUM FOR:** ACTING COMMISSIONER OF INTERNAL REVENUE

*Heather Hill*

**FROM:**

Heather M. Hill  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential (Audit # 202030005)

This report presents the results of our review to assess the Internal Revenue Service's controls over the selection and examination of employment tax cases, including relief from employment tax obligations that may be provided under Section 530 of the Revenue Act of 1978.<sup>1</sup> This review is part of our Fiscal Year 2023 Annual Audit Plan and addresses the major management and performance challenge of *Increasing Domestic and International Tax Compliance and Enforcement*.

Management's complete response to the draft report is included as Appendix II. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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<sup>1</sup> Pub. L. 95-600, 92 Stat. 2763.

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## Background

Employers are generally required to withhold Federal income tax, the employee portion of Federal Insurance Contribution Act taxes, and additional Medicare taxes (when applicable) from their employees' earnings and forward to the U.S. Treasury on the employees' behalf. Additionally, employers are liable for an equal portion of Federal Insurance Contribution Act taxes, and separately liable for all the taxes imposed under the Federal Unemployment Tax Act. Collectively, the withheld employee taxes and imposed employer taxes are commonly known as "employment" taxes. The Internal Revenue Service (IRS) accepts most employment tax returns as filed. However, the IRS examines some employment tax returns to determine if wages, tips, compensation, credits, and taxes are reported accurately. In October 2022, the IRS reported that the estimated gross employment Tax Gap was \$93 billion (19 percent of the total \$496 billion gross Tax Gap) for Tax Years 2014 through 2016.<sup>1</sup>

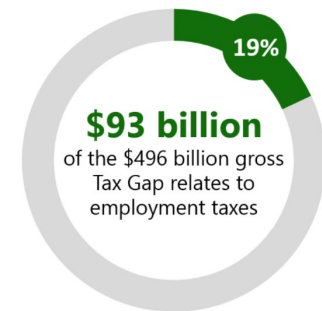


Figure 1 shows the number and the gross collections amount of employment tax returns filed and gross amounts collected during Tax Years 2015 through 2020.

**Figure 1: Summary of Employment Tax Returns Filed and Amounts Collected During Tax Years 2015 Through 2020**

Tax Year	Returns Filed	Gross Collections Amount <sup>2</sup>
2015	30,196,000	\$1.02 trillion
2016	30,460,000	\$1.07 trillion
2017	30,680,601	\$1.12 trillion
2018	30,942,654	\$1.13 trillion
2019	31,566,173	\$1.21 trillion
2020	28,028,002	\$1.27 trillion

Source: IRS Statistics of Income Tables.

When employers treat their workers as employees, they are required to withhold Federal income taxes from their workers' salaries and are generally required to issue a Form W-2, *Wage and Tax Statement*, annually. Additionally, employers are generally required to file the following two types of employment tax returns when certain minimum thresholds are met:

<sup>1</sup> See Appendix III for a glossary of terms. The gross employment Tax Gap is composed of three components: nonfiling, underreporting, and underpayment. The estimated gross employment Tax Gaps for these components are \$7 billion, \$82 billion, and \$5 billion, respectively. The detail does not add up due to rounding.

<sup>2</sup> Gross collections includes penalties and interest in addition to taxes.

## Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential

- Form 941, *Employer's Quarterly Federal Tax Return*, is required to be filed each quarter for the reporting of withheld income, Social Security, and Medicare taxes and the employer's share of Social Security and Medicare taxes.
- Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, is required to be filed each year for the reporting of the employer's unemployment taxes.

When workers are treated as independent contractors, businesses are required to file an information return such as Form 1099-NEC, *Nonemployee Compensation*, or Form 1099-MISC, *Miscellaneous Information*. Additionally, if a business files any information returns, they must submit Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, each year.

### The Small Business and Self-Employed (SB/SE) Division's Employment Tax Program

The SB/SE Division serves approximately 57 million taxpayers, with approximately 26.8 million employment tax return filers. The SB/SE Division Employment Tax Program's mission is to help small business and self-employed taxpayers understand and meet their tax obligations. The IRS's SB/SE Division's Employment Tax Program provides program leadership for all IRS employment tax matters, including the development, execution, and evaluation of quality multifunctional compliance and assistance programs on a nationwide basis.

The SB/SE Division works approximately 99 percent of all employment tax examinations. Figure 2 shows all closed SB/SE Division examination results for Fiscal Years (FY) 2018 through 2020.

**Figure 2: SB/SE Division Closed Employment Tax Examination Results - All Field and Correspondence**

	FY 2018	FY 2019	FY 2020
Returns Examined	42,670	43,989	26,988
Total Dollars Assessed	\$617,995,560	\$1,053,359,935	\$443,228,026
Average Hours per Return	7.6	6.5	7.3
Average Dollars per Hour	\$1,919	\$3,659	\$2,262
Average Dollars Assessed per Return	\$14,483	\$23,946	\$16,423
No-Change Rate	10.4%	10.5%	9%

Source: Treasury Inspector General for Tax Administration's (TIGTA) analysis of the Audit Information Management System database for FYs 2018 through 2020.

The SB/SE Division's Employment Tax Program is divided into three separate and distinct functions:

- The Specialty Employment Tax (ET) Examination function examines businesses to ensure compliance with employment tax laws through the application of integrity and fairness, which allows taxpayers the ability to understand and comply with all applicable tax laws. The Specialty ET Examination staff includes revenue agents, tax compliance officers, revenue officer examiners, and tax examiners who perform examinations either in the field or at a campus via correspondence audit.

- The Employment Workload Selection and Delivery (ET-WSD) group is part of Exam Case Selection. The ET-WSD manages the selection, classification, and delivery for Specialty ET Examination.<sup>3</sup>
- Specialty Exam Policy establishes policies and procedures to support compliance with employment tax laws.

### **Determining Section 530 relief during examinations**

The proper determination of whether a worker is an employee or an independent contractor is important because it impacts several other issues that relate to proper examination adjustments. This determination results in significant tax implications for the worker, the employer, and the IRS because employers and workers have different tax obligations depending on their status as an employee or independent contractor. The misclassification of employees as independent contractors is a nationwide problem affecting millions of workers that continues to grow and contribute to the employment tax portion of the Tax Gap.

If an employer misclassifies workers as independent contractors, the employer could be subject to retroactively paying Federal employment taxes, penalties, and interest related to those workers. Section 530 of the Revenue Act of 1978<sup>4</sup> is a safe harbor provision that prevents the IRS from retroactively and prospectively reclassifying workers who were treated as non-employees (*i.e.*, "independent contractors") as employees and subjecting the business to Federal employment taxes, penalties, and interest for such misclassification, provided that the employer meets all the requirements of Section 530.<sup>5</sup> In order for an employer to qualify for Section 530 relief, the following three requirements must be met for each tax year for each class of workers:<sup>6</sup>

- Reporting Consistency: The business must have filed all required Federal tax returns (including information returns) consistent with its treatment of each worker as not being employees.
- Substantive Consistency: The business (and any predecessor business) must have treated the workers, and any similar workers, as independent contractors. If the business treated similar workers as employees for the tax year under examination or in a prior tax year, this relief provision is not available.

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<sup>3</sup> Internal Revenue Manual (IRM) 1.1.16.5.3.5.1 (Mar. 15, 2022).

<sup>4</sup> Pub. L. 95-600, 92 Stat. 2763.

<sup>5</sup> Section 530 of Pub. L. 95-600, 92 Stat. 2763 (1978) as amended by Pub. L. 96-167, 93 Stat. 1278 (1979); Pub. L. 96-541, 95 Stat. 3204 (1980); Pub. L. 97-248, 96 Stat. 552 (1982); and Pub. L. 104-188, 110 Stat. 1766 (1996). If granted relief, Section 530 terminates the employer's, not the worker's, employment tax liability under Internal Revenue Code (I.R.C.) Subtitle C.

<sup>6</sup> IRM 4.23.5.3.3 (Nov. 22, 2017).



- Reasonable Basis: The business must have had a reasonable basis for not treating the workers as employees, such as a court case or a ruling issued to the business from the IRS or an audit by the IRS in which the workers were not reclassified.<sup>7</sup>

This relief applies to eligible taxpayers in cases involving determinations of employment status, *i.e.*, worker classification cases, for all periods under examination and all future periods.<sup>8</sup> In other words, the IRS cannot assess taxes against these businesses for past underpayment of employment taxes and cannot reclassify independent contractors as employees going forward.

Through the safe-harbor provisions, Congress sought to provide relief for business taxpayers that had consistently treated workers as independent contractors and exercised good faith in making the decision to do so, even though under common law the workers might be considered employees. Congress's motivation for enacting the safe-harbor provisions is described in a 1979 Joint Committee on Taxation report stating that relief for taxpayers was needed because:

*[I]n the late 1960s, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees.*<sup>9</sup>

During the 1976 Tax Reform Act conference, a request was included that the IRS not apply any changed or new positions related to worker reclassifications. Congress believed that it was appropriate to provide interim relief for taxpayers who were involved in employment tax status controversies with the IRS, as a result of the IRS's proposed reclassifications of workers. The relief was meant to be temporary until Congress could "resolve the many complex issues involved in this area." In a prior report on the IRS's SS-8 Worker Classification function, we identified 15 worker classification requests from workers who were working for "gig economy" related businesses that were granted Section 530 relief, meaning the IRS could not audit the gig economy businesses for past or future worker misclassification errors.<sup>10</sup> We recommended (and the IRS agreed) that the IRS should work with the Treasury Assistant Secretary for Tax Policy to recommend to Congress that Section 530 be amended so that the IRS could at least prospectively audit businesses that were granted Section 530 relief even though they misclassify workers as independent contractors. However, Congress has not made any changes to Section 530.

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<sup>7</sup> For examinations that began before January 1, 1997, the prior IRS audit does not have to have been an audit for employment tax purposes as long as the audit entailed no assessment attributable to the business's treatment, for employment tax purposes, of workers holding positions substantially similar to the positions held by the workers whose treatment is at issue. For examinations that began after December 31, 1996, the prior IRS audit must have included an examination for employment tax purposes of the status of the individual involved or any individual holding a position substantially similar to the position held by the individual involved. IRM 4.23.5.3.3.5 (Nov. 22, 2017).

<sup>8</sup> Section 530 relief can apply with respect to any employees defined in I.R.C. § 3121(d), I.R.C. § 3306(i), and I.R.C. § 3401(c). Under Section 530(d), relief does not apply to certain technically skilled workers who provide services under a three-party arrangement.

<sup>9</sup> Joint Committee on Taxation, JCS-7-79, *General Explanation of the Revenue Act of 1978* p. 300 (March 12, 1979); see also S. Rep't No. 1263, 95th Cong., 2d Sess. (1978); H.R. Rep't No. 1748, 95th Cong., 2d Sess. (1978).

<sup>10</sup> TIGTA, Report No. 2018-30-077, *Improvements to the SS-8 Program Are Needed to Help Workers and Improve Employment Tax Compliance* p. 7 (Sept. 2018).



Employment tax examination issues are categorized into “wage issues” or “worker classification issues.” Based on an average annual income of \$51,626 per person, a business that misclassifies a worker as an independent contractor reduces the amount of employment taxes it pays by approximately \$4,370 per worker.<sup>11</sup> For all worker classification issues, the examiners must determine whether the taxpayer qualifies for Section 530 relief. According to the IRM, the first step in any worker classification examination into whether a taxpayer has employment tax obligations with respect to workers must be to determine whether the taxpayer meets the requirements of Section 530.<sup>12</sup> Generally, a worker status determination for a class of workers is not made by an examiner if the taxpayer is entitled to Section 530 relief with respect to those workers. However, workers may be determined to be employees through another means, such as an employee plans examination. In addition, workers may request a determination of their individual worker status by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

According to the Internal Revenue Manual (IRM), examiners are required to fully develop the facts of each worker classification issue and document the details of the audit steps taken and information gathered in the examination case file.<sup>13</sup> If the examiner determines that the taxpayer is entitled to Section 530 relief for a particular class of workers, the examination of the worker classification issue for that class of workers is terminated and no determination is made for whether the workers are employees or independent contractors. To obtain Section 530 relief, it is not necessary that the classification of workers be legally correct. If the examiner determines that the taxpayer is not entitled to Section 530 relief, the examiner will continue the audit and determine the proper status of the workers.

The IRS has made some improvements and changes to its future employment tax enforcement strategy based on data from historical employment tax cases and in response to TIGTA’s previous recommendations, including:

- Improving identification guidance and training on some emerging market issues, such as the gig economy: In prior reports, TIGTA identified instances in which the IRS did not have the processes in place to track or identify certain workers in the gig economy where referrals to Specialty ET Examination were warranted.<sup>14</sup> Additionally, TIGTA identified some of these cases were mishandled due to a lack of guidance and training.
  - The IRS has since created additional guidance and training regarding gig economy cases to ensure accurate processing of Form SS-8.
  - The IRS also noted recent additions to its Specialty ET Examination workstreams to identify potential gig economy workers, including:

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<sup>11</sup> Based upon Bureau of Labor information, we calculated an average annual salary by taking the average hourly wage of \$24.82 per hour and multiplied by 40 hours worked per week to get to the weekly income. The weekly income was multiplied by 52 weeks per year to arrive at \$51,626 as the average annual salary. Social Security tax of 6.2 percent, Medicare tax of 1.45 percent, and Federal Unemployment Tax Act tax of 6 percent on the first \$7,000 in wages were calculated on the \$51,626 salary to reach \$4,370 in employment taxes.

<sup>12</sup> IRM 4.23.5.3.1 (Nov. 22, 2017).

<sup>13</sup> IRM 4.23.3 (Feb. 25, 2021).

<sup>14</sup> TIGTA, Report No. 2018-30-077, *Improvements to the SS-8 Program Are Needed to Help Workers and Improve Employment Tax Compliance* (Sept. 2018); TIGTA Report No. 2019-30-016, *Expansion of the Gig Economy Warrants Focus on Improving Self-Employment Tax Compliance* (Feb. 2019).

- [REDACTED]
- [REDACTED]
- [REDACTED]
- In July 2020, the IRS revamped its Emerging Issues Process which allows employees to submit any identified emerging issues for the IRS to consider for development of a mitigation or compliance strategy. The IRS noted that outcomes could result in compliance projects, taxpayer/preparer education and outreach, changes to forms/publications, or any other compliance strategies. As of January 2022, the IRS has received four employment tax-related submissions leading to the development of risk assessments on two of the issues.
  - Improving case selection: The IRS notes that data and analytics are transforming the way government operates and it continues to be a cross-agency priority to leverage data as a strategic asset.

In FY 2020, the IRS piloted an Innovation Lab to test new approaches for detecting emerging compliance risks, as well as creating and refining treatments to drive compliance before a pattern of noncompliance develops. The Innovation Lab includes a diverse array of participants, including data scientists, technology specialists, and subject matter experts to work across IRS enforcement programs to provide analytical solutions to address specific compliance programs.

The first series of Innovation Lab projects focused on issues related to employment tax. Initial results from those projects led to the identification of over 78,000 noncompliant employers, recommended changes to filing requirements, and the development of new educational materials. The ET-WSD is currently working with the Innovation Lab to determine the best mix and volume of work among all of the Specialty ET Examination sources of work to make the most efficient use of ET-WSD and Examination resources. Additionally, the analysis developed with the Innovation Lab attempts to create a case selection model that better aligns IRS employee resources (including skills and geographic location) with known sources of productive employment tax work. In the past, the IRS noted potential imbalances between the geographic distribution of case assignment (*i.e.*, case-to-employee ratios examined by place of duty) and the examiners available to work those cases. A high ratio of cases-to-employees suggested potential understaffing, while a low ratio suggested potential underutilization of existing Examination resources. The IRS plans to expand its testing and implementation through a multiyear process to determine if improvements to case selection productivity can be seen.

## **Results of Review**

The SB/SE Division's employment tax examinations assessed over \$2.1 billion in additional taxes for FYs 2018 to 2020. Although Specialty ET examinations have higher average dollars assessed per return when compared to overall SB/SE Division employment tax examinations, these examinations also have a higher no-change rate, indicating that the IRS may not be selecting the most productive cases. We observed problematic issues related to the classification process,

## Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential

including: (i) lack of effective managerial reviews of the classification process, (ii) instances of failure to consistently document classification decisions, and (iii) failure to follow IRS procedures for classification. In addition, the IRS does not have a method to track taxpayers who were granted relief from Section 530 provisions, which provides a safe harbor for businesses that may have incorrectly treated workers as independent contractors. Finally, IRS examiners are not adequately documenting their work in the electronic case management system, which will hamper the IRS's efforts to move to paperless examination files.

Employment tax examinations are primarily worked by the SB/SE Division's Specialty ET Examination and the SB/SE Division's Combined Annual Wage Reporting functions, with Specialty ET Examination responsible for approximately 83 percent of the total proposed assessments from employment tax issues worked by the SB/SE Division. Figure 3 presents the total number of employment tax examinations closed in FYs 2018 through 2020 by the Specialty ET Examination function.

**Figure 3: Closed Specialty ET Examination Results for FYs 2018 to 2020**

	FY 2018	FY 2019	FY 2020
Returns Examined	24,564	21,318	17,208
Total Dollars Assessed	\$521,060,601	\$879,970,167	\$368,029,643
Average Hours per Return	11.9	11.7	9.9
Average Dollars per Hour	\$1,783	\$3,528	\$2,154
Average Dollars Assessed per Return	\$21,212	\$41,278	\$21,387
No-Change Rate	15.3%	15.6%	12.1%

Source: TIGTA's analysis of the Audit Information Management System database for FYs 2018 to 2020.

### **The Small Business/Self-Employed Division's Employment Tax Classification Process Could Be Improved to Identify More Productive Cases**

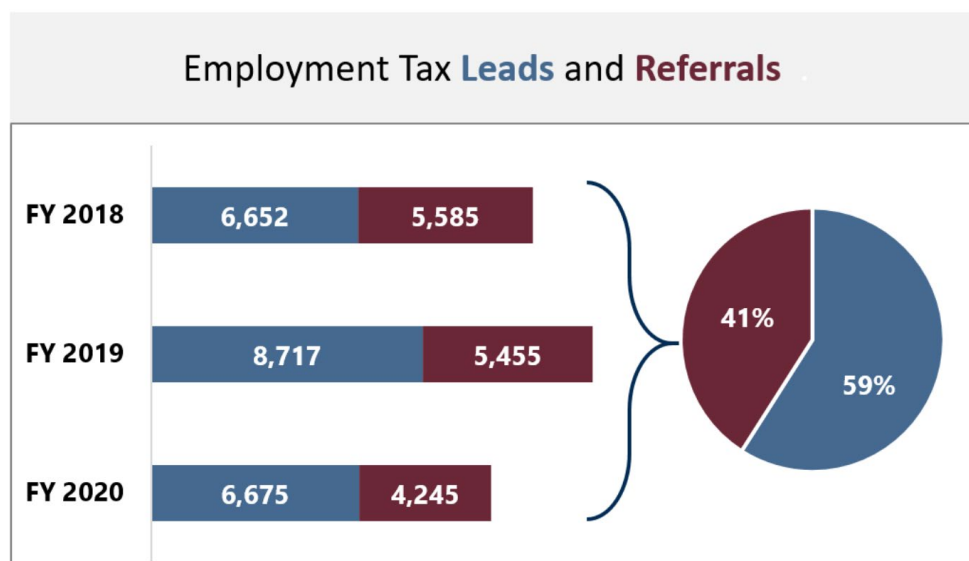
We identified concerns with the classification process, including inadequate managerial reviews, failure to consistently document classification decisions, and failure to follow IRS procedures for classification. Within the SB/SE Division's Exam Case Selection function, the ET-WSD group is responsible for the classification and selection of employment tax returns for examination. The ET-WSD manages the classification, prioritization, and inventory assignment processes to maximize program resources while achieving annual employment tax examination work plan goals. Classification is an important step in the examination selection process, involving the review of filed employment tax returns, referrals, and nonfiler leads to determine potential examination issues. Returns that meet certain screening criteria go through a technical review during classification to determine whether they should be selected for potential examination.

Employment tax returns generally do not contain sufficient information to provide a basis for identifying issues with examination potential. As a result, the Specialty ET Examination Program

## Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential

workstreams are identified through leads and referrals.<sup>15</sup> We reviewed the classification process for 37,329 cases that were classified in FYs 2018 through 2020. As shown in Figure 4, 22,044 cases (59 percent) were derived from leads, while 15,285 cases (41 percent) were derived from referrals.

**Figure 4: Employment Tax Leads and Referrals for FYs 2018 to 2020**



Source: TIGTA's analysis of ET-WSD classification efforts for FYs 2018 to 2020.

All employment tax workstreams are designed to focus on known or probable areas of noncompliance to identify cases with high potential for audit adjustments. However, there is no computer program to score and prioritize employment tax returns; therefore, determination of compliance levels must be made through review of various items researched by classifiers including, but not limited to:<sup>16</sup>

- Research of key Employer Identification Numbers.
- Review of related income tax returns.
- Research of owners and employees of identified businesses.
- Internet research of company websites or other websites appropriate to help identify potential issues.

<sup>15</sup> IRM 4.23.23.3.4(1) (June 29, 2021). A lead is a data-driven approach to case selection involving the filtering and analyzing of electronically stored information from taxpayer forms and returns, searching for anomalies that may raise employment tax compliance issues. IRM 4.23.23.3.1(1) (June 29, 2021). Referrals are received externally from other IRS functions, Federal/State agencies, and taxpayers.

<sup>16</sup> Other examination functions review returns scored by the Discriminant Function and determine which returns should be sent for potential examination based on the Discriminant Function score and issues identified on the return.

There are various sources to assist in detecting taxpayers who are not complying with the employment tax laws, including:

- IRS employees who are in constant contact with taxpayers and are aware of possible noncompliance.<sup>17</sup>
- Other Federal and State Government agencies (*e.g.*, Social Security Administration, Department of Labor, State Departments of Unemployment).
- Market segment studies.
- Compliance initiatives.

Cases are prioritized for examination by an IRS analyst in the position of ET-WSD Gatekeeper (Gatekeeper) who uses a tiered list of prioritization factors including:<sup>18</sup>

- The historical productivity of workstreams.
- Progress on current case inventory.
- Time sensitivity.
- Data on selection rates by classifiers.

Referrals are received from external functions including other IRS functions, Federal and State agencies as well as from taxpayers. Because referrals are received from external sources, the ET-WSD does not have control over the amount or quality of referrals received. Generally, the ET-WSD will receive referrals by mail (which are scanned) or e-mail and are logged for documentation by the tax examiner. Research is conducted to verify that the taxpayer information is correct and an electronic case file is created. If the referral does not contain enough information to determine its audit potential, it is sent back to its originator. Adequate referrals with correct taxpayer information are documented on a tracking spreadsheet that is used during meetings between the manager and the Gatekeeper to determine if the referral warrants classification. If approved, the referral will be sent to classifiers for review.

Unlike referrals, leads are internally generated, and the ET-WSD can control and affect the types of leads identified and sent for potential examinations. In deciding the timing and volume of leads for classification, the ET-WSD considers the progress made on the annual new starts and closures plan, the current inventory, and work requested by Specialty ET Examination. The process for identifying leads begins with the Gatekeeper submitting a request to the data analysts, who may specify workstreams based upon the annual work plan or requests from Specialty ET Examination. Once the leads are identified by the data analyst, they are sent back to the Gatekeeper. Both the data analyst and the Gatekeeper can apply filters based on their perception of the highest risk and limit the number of cases that are eventually sent to the classifiers. The data analyst applies filters based on established thresholds and criteria to limit the number of cases that are sent to the classifiers. The Gatekeeper will further limit the number of cases sent to the classifiers based on location and number of cases needed to be sent to ET Examination. The Gatekeeper then forwards these leads to the classifiers, which is when the

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<sup>17</sup> Employment tax managers and examiners may receive referrals from Collection, Taxpayer Assistance Centers, Criminal Investigation, Examination, Automated Collection System call sites, and campuses. Leads received from these sources must be forwarded to the ET-WSD for evaluation and selection for audit, if warranted.

<sup>18</sup> The Gatekeeper prioritizes cases based on workstream issues and the ET Work Plan.

ET-WSD begins to track the leads. The ET-WSD does not track or review any of the leads filtered out by the data analysts or Gatekeeper prior to being sent to the classifiers. Because leads are not tracked when initially identified (prior to the classification process), there is no effective way to determine whether the IRS is working cases with the highest audit potential. Further, there is no way to know if a certain taxpayer was intentionally removed from the list of potential cases. With this lack of oversight, there is a potential for possible unfairness in the selection of taxpayers for examination.

### **Managerial reviews continue to be inadequate**

A December 2015 report by the Government Accountability Office (GAO) included a recommendation that the IRS should develop and implement consistent documentation requirements to clarify the reasons for selecting a return for audit and identify who reviewed and approved the selection decision.<sup>19</sup> The IRM was updated in June 2021 to incorporate the controls recommended by the GAO report.<sup>20</sup> These controls included tasking the group manager or manager's designee to complete a monthly review of 10 percent of the classification efforts and survey decisions. The reviews should include feedback to employees on their selection decisions, documented with a digitally signed memorandum and stored on the ET-WSD's secured shared network drive.

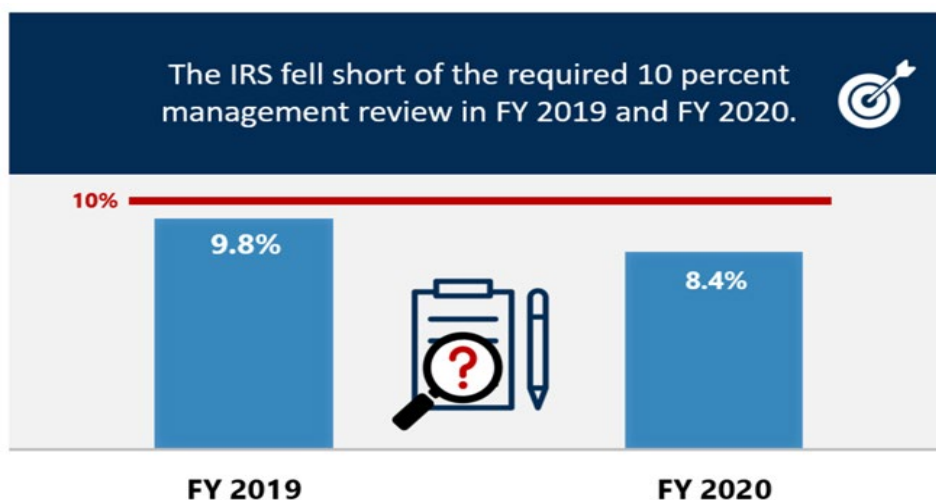
The IRS implemented managerial reviews of the classification process in FY 2018. However, the lack of documentation of completed managerial reviews continued in FYs 2019 and 2020. As shown in Figure 5, the IRS fell short of the required 10 percent review in these years, with 9.8 percent of classified cases reviewed in FY 2019 and 8.4 percent reviewed in FY 2020. Managers from the classification function stated that the managerial review was delegated to a program analyst. During an interview with this delegated reviewer, we were informed that highlighted rows in a completed classification spreadsheet signified that the case was reviewed. However, we found that these highlighted cases did not have any additional documentation or comments to substantiate that the cases were reviewed. Further, the delegated reviewer stated that they have never disagreed with a classifier's decision to select or non-select a case for examination since the review requirement was implemented.

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<sup>19</sup> GAO, GAO-16-103, *Certain Internal Controls for Audits in the Small Business and Self-Employed Division Should Be Strengthened* (Dec. 2015).

<sup>20</sup> IRM 4.23.23.1.4 (June 29, 2021).

**Figure 5: ET-WSD Managerial Reviews  
of Classified Cases for FYs 2019 and 2020**



Source: TIGTA's analysis of ET-WSD classification efforts for FYs 2019 and 2020.

In November 2021, the IRS stated that the program analyst responsible for the managerial reviews of the classification process had retired in September 2021. We were informed that the current Gatekeeper had taken over the review responsibilities since the program analyst's retirement. Therefore, in addition to working with the data analyst to identify and assign leads and referrals to classifiers for classification, the Gatekeeper now reviews the work assigned to the classifiers. This lack of segregation of duties can hinder the effectiveness of the managerial review requirements. GAO's *Standards for Internal Control in the Federal Government* specifically states that when management incorporates a segregation of duties, the risk for error, misuse, and fraud is reduced.<sup>21</sup> With only supervision of classifier activities by the Gatekeeper, it is uncertain if classifiers are selecting cases efficiently and effectively for examination.

### **The IRS did not follow procedures when documenting reasons for not selecting some cases**

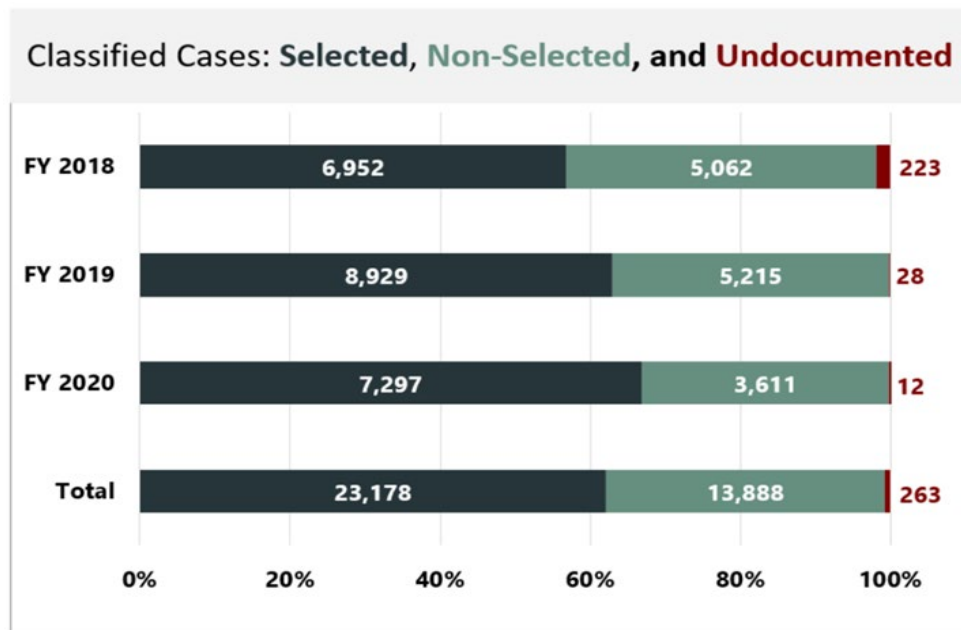
The IRM states that when a case is not selected by the classifier, the reason for non-selection should be documented.<sup>22</sup> As shown in Figure 6, of the 37,329 cases classified between FY 2018 and FY 2020, 23,178 (62.1 percent) were selected for examination, 13,888 (37.2 percent) were not selected for examination, and 263 (0.7 percent) lacked documentation of whether or not the case was selected for examination.

<sup>21</sup> GAO, *Standards for Internal Control in the Federal Government*, Section 10.13 (Sept. 2014).

<sup>22</sup> IRM 4.23.23.5.2 (June 29, 2021).



**Figure 6: ET-WSD Classified Cases for FYs 2018 to 2020**



Source: TIGTA's analysis of ET-WSD classification efforts for FYs 2018 to 2020.

To obtain a better understanding of why some cases were not selected for examination, we conducted a detailed review of 241 non-selected cases that lacked appropriate documentation of the reason for non-selection. Of the 241 cases:

- 167 cases did not have a reason for why the case was non-selected for examination. Despite the introduction of the managerial review requirement mentioned previously, this issue went unnoticed by classifiers as well as by ET-WSD management.
- 24 cases had a non-selection reason of "Other" with no additional explanation. The IRM states that cases not selected due to "Other" must provide additional explanation for support.<sup>23</sup>
- 50 cases had "prior audit" as the reason for non-selection. IRS management stated that a "prior audit" is a non-selection reason if the prior audit was closed with no tax adjustment and no major changes to the business were identified or, if there was a tax adjustment in the prior year to allow the taxpayer to come into compliance. Of these 50 cases:
  - 26 cases were closed with no tax adjustment (considered a no-change audit). When a prior audit has not resulted in a tax adjustment, the classifier should conduct research to identify changes in operations and determine if the case should be selected for examination. For the 26 cases, there was no documentation that the classifier conducted the required research. Moreover, we identified 16 of the 26 cases that had a prior no-change audit more than five years previously, with tax periods dating back to 2004.
  - 24 cases resulted in a tax adjustment in a prior audit. Generally, when there is a prior audit in the previous year with an adjustment, the IRS will pause examination activity

<sup>23</sup> Interim Guidance for IRM 4.23.23, issued Aug. 19, 2019.

to allow the taxpayer to voluntarily come into compliance. However, we found that seven of the 24 cases had a prior audit that was older than one year, meaning the taxpayer might not have taken the opportunity to come into tax compliance, and therefore could be subject to examination.

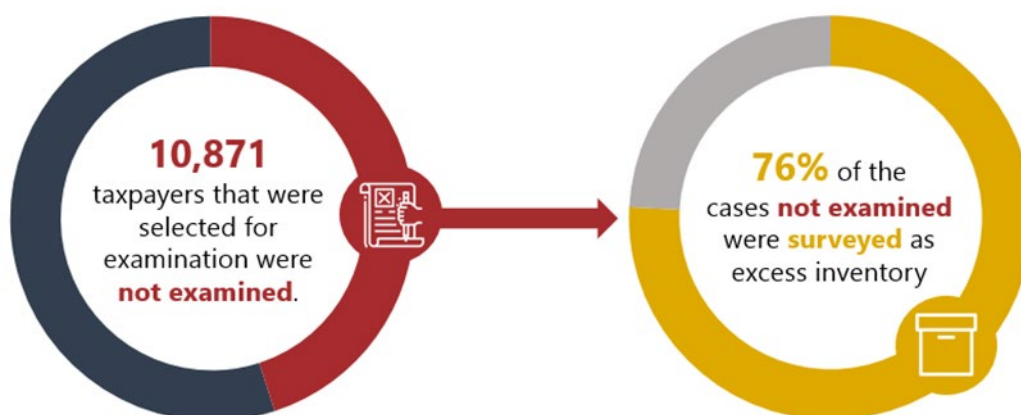
A lack of oversight and review of the ET-WSD's work has led to incomplete documentation of the classification of cases. If IRS employees fail to adhere to published guidance, inaccuracies could occur with case selection. Failing to document a non-selection reason or having an inadequate selection reason could result in a high audit potential case not being selected for examination. This further emphasizes the importance of an adequate review process with proper procedures in place to ensure accuracy and fairness among the classification process. Although our review focused on the cases with no reason for non-selection and the cases that had the reason of "prior audit" and "other," the problems we observed may also be present in the other non-selected cases.

### **A significant number of cases that were classified as selected for examination were not examined**

For FYs 2018 through 2020, the ET-WSD function classified 75,898 returns for examination, involving 24,074 unique taxpayers. The larger number of returns, compared to the number of unique taxpayers, is due to the selection of related returns for a given taxpayer, such as different quarters and tax years, during the examination. When a case is classified for selection, it is placed into inventory to be potentially selected for examination. The only way to remove the case from inventory is to either work the case (examination) or survey the case.

As shown in Figure 7, for the 24,074 unique taxpayers selected for a Specialty ET examination, the IRS opened examinations for 13,203 (55 percent) taxpayer cases and closed 10,871 (45 percent) taxpayer cases without an examination.

**Figure 7: Unique Taxpayers With a Closed Specialty ET Examination for FYs 2018 to 2020**



*Source: TIGTA's analysis of Specialty ET Examination efforts for FYs 2018 to 2020.*

Of the 10,871 taxpayer cases closed as not examined, 8,245 (76 percent) were closed as "Surveyed - Excess Inventory," meaning that classifiers determined that the taxpayers' returns had audit potential but were not examined. There are many reasons a case can be surveyed as excess inventory, such as time constraints, limited resources, or implementation of new

legislation (such as various Coronavirus Disease 2019 pandemic relief initiatives). However, given that almost half of the cases selected for audit were not examined, it is critical that the IRS improve its classification process to ensure that the most productive cases are identified.

The Commissioner, SB/SE Division, should:

**Recommendation 1:** Require that quality reviews of the ET-WSD Gatekeeper be documented and create a segregation of duties for managerial reviews to provide effective oversight of the Gatekeeper function.

**Management's Response:** IRS management agreed with this recommendation, stating that they will create a desk guide for the Gatekeeper that details the requirements and guidelines for the ET-WSD Gatekeeper function. They will also remove the Gatekeeper from the process of filtering returns and will include this guidance in the ET-WSD Gatekeeper desk guide.

**Recommendation 2:** Ensure that all required managerial reviews are properly conducted and documented.

**Management's Response:** IRS management agreed with this recommendation, stating that they would develop a review form to properly document the required ET-WSD managerial reviews.

## **The IRS Does Not Track or Properly Document Closing Forms With Section 530 Relief**

As noted earlier, Section 530 is a relief provision that must be considered as the first step in any case involving worker classification; however, our review determined that the IRS does not track which taxpayers have been granted Section 530 relief, and documentation provided to taxpayers receiving said relief was inadequate.

According to IRS officials, the IRS does not have a method to track taxpayers that were granted relief from Section 530 provisions, and it is unable to estimate the tax effects of Section 530 relief. In the past, the IRS has tried various approaches, such as sending Section 530 cases to Specialty Exam Policy and requiring employment tax examiners to submit Section 530 issues to the ET-WSD, but the IRS noted that guidance was followed inconsistently by examiners and that very few cases were granted Section 530 relief.

Because the IRS does not track cases that were granted Section 530 relief, TIGTA was unable to identify a population of Section 530 cases for review. Instead, we selected a statistically valid random sample of 291 SB/SE Division Specialty ET examinations closed in FYs 2018 through 2020 that were identified and coded with a worker classification issue, in an attempt to identify cases that were granted Section 530 relief.<sup>24</sup> We reviewed case data in the IRS's Issue Management System (IMS) to identify cases for which Section 530 relief was considered and granted by examiners. The IMS is designed to:

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<sup>24</sup> To select the statistically valid samples, we used an anticipated error rate of occurrence of 50 percent, a precision rate of  $\pm 7$  percent, and a confidence interval of 90 percent.

## Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential

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- Support remotely located examiners.
- Enhance issue identification.
- Improve issue tracking and reporting.
- Share information through a centralized data repository.
- Capture data in support of performance measures.
- Collect reliable and comprehensive issue data to prepare strategies.
- Establish a risk-based and issue-driven examination plan.
- Monitor the execution of the examination plan.

We also ordered the physical case files for cases without sufficient information on the IMS.<sup>25</sup>

In our review, we identified 13 (4.5 percent) cases with Section 530 relief granted by the examiner.<sup>26</sup> Specifically, we reviewed whether employment tax examiners issued Form 4666, *Summary of Employment Tax Examination*, which is required to be sent to all taxpayers at the conclusion of an Employment Tax audit to summarize any adjustments. This is the only evidence the taxpayer receives that explains when Section 530 relief is granted. We found the following documentation issues for the 13 cases in which Section 530 relief was granted:

- In [REDACTED] of the 13 cases, [REDACTED]  
[REDACTED]<sup>27</sup>.
- In [REDACTED] of the 13 cases, [REDACTED]  
[REDACTED]<sup>28</sup>.
- In [REDACTED] of the 13 cases, [REDACTED]  
[REDACTED]<sup>29</sup>.
- In five of the 13 cases, the examiner did not check the applicable issue boxes or issued an obsolete/outdated version of Form 4666 to the taxpayer.<sup>30</sup>

When procedures for reporting the results of worker classification examinations are not properly followed, taxpayers may be granted Section 530 relief for subsequent years, even when

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<sup>25</sup> We ordered a total of 81 physical case files: 12 physical cases that were identified on the IMS as being granted Section 530 and an additional 69 physical cases that did not have enough information on the IMS to make a determination. Of those 81 cases, we received 54 cases that had enough information to make a determination of whether Section 530 relief was granted.

<sup>26</sup> [REDACTED] cases were identified through the IMS as granted Section 530 relief and [REDACTED]

<sup>27</sup> IRM 4.23.10.10.3.1(2) (May 21, 2018).

<sup>28</sup> IRM 4.23.10.10.3.1(1) (May 21, 2018).

<sup>29</sup> IRM 4.23.10.10.3(4) (May 21, 2018).

<sup>30</sup> IRM 4.23.10-1-Exhibit (May 21, 2018).

ineligible. The IRS noted that the likely cause of some of these issues was due to the examiners improperly entering information when preparing the Employment Tax Examination Report spreadsheets used for all Specialty ET examinations, which automatically generated incorrect language for the Form 4666. Additionally, the IRS noted that some incorrect language was being generated by the Employment Tax Examination Report spreadsheets, which was identified and updated by the IRS in February 2020.

### **Section 530 legislative change needed**

We reviewed whether the IRS took action regarding TIGTA's prior recommendation to pursue a legislative change for Section 530 with the Treasury Department's Office of Tax Policy, which, at a minimum, would allow the IRS to take prospective action to enforce the law against employers who incorrectly treat workers as independent contractors.<sup>31</sup> We determined that the Treasury Department and the IRS have taken steps seeking a legislative change regarding Section 530, including for periods prior to our recommendation. The Treasury Department releases the *General Explanations of the Administration's Revenue Proposals*, also known as the Green Book, which accompanies the Administration's budget annually. For FYs 2011 through 2017, the Green Book included proposals for changes related to Section 530.<sup>32</sup> In December 2018, following TIGTA's prior audit, the IRS provided a copy of TIGTA's recommendation for a legislative change relating to Section 530 to the Department of Treasury Assistant Secretary for Tax Policy. In February 2021, the IRS sent an e-mail to the Treasury Acting Assistant Secretary for Tax Policy containing a number of draft legislative suggestions, including a legislative change related to Section 530. Although the IRS can make suggestions for legislation, the Treasury Department's Office of Tax Policy is responsible for formulating legislative proposals and sending them to Congress as recommendations for further congressional action. If Section 530 is amended, the IRS will be better able to facilitate future employment tax compliance, improve tax administration, and promote fairness for taxpayers.

The Commissioner, SB/SE Division, should:

**Recommendation 3:** Create a tracking mechanism for cases that were granted Section 530 relief.

**Management's Response:** IRS management partially agreed with this recommendation, stating that they will explore whether a tracking mechanism is feasible. IRS management stated that there are both technical and systemic barriers to implementing a tracking mechanism for cases that were granted Section 530 relief. They stated that reliance on a tracking mechanism could result in the erroneous exclusion of taxpayers for examination consideration, as entitlement to Section 530 relief is determined on a year-by-year and worker-by-worker basis.

**Office of Audit Comment:** The goal of a tracking mechanism is to provide information to IRS management and outside stakeholders, such as Congress, to assess the scope of cases that are receiving Section 530 relief. Tracking cases

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<sup>31</sup> TIGTA, Report No. 2018-30-077, *Improvements to the SS-8 Program Are Needed to Help Workers and Improve Employment Tax Compliance* (Sept. 2018).

<sup>32</sup> U.S. Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, FYs 2011 through 2017, available at Revenue Proposals | U.S. Department of the Treasury.

would not relieve examiners from the responsibility of properly assessing Section 530 relief for each case on a year-by-year and worker-by-worker basis. Although we recognize the IRS's commitment to look into the feasibility of a tracking mechanism, implementing a tracking mechanism for Section 530 cases would not only help the IRS to make more informed decisions about cases that have been granted Section 530 relief, but would also provide information on Section 530 cases so that Congress can make appropriate decisions regarding possible legislative changes to Section 530.

**Recommendation 4:** Issue a policy alert to remind examiners of the procedures and guidance on the proper language/information that should be included on Form 4666.

**Management's Response:** IRS management agreed with this recommendation, stating that they will issue a policy alert with guidance to examiners that provides clear, standard language to explain the results of worker classification examinations.

### **Issue Management System Documentation Guidelines Were Not Always Followed**

Our review of the information contained in the IMS case management system identified missing documents needed to support conclusions reached by examiners. These types of deficiencies must be resolved to allow the IRS to effectively transition to electronic recordkeeping. The Federal Government spends hundreds of millions of taxpayer dollars and thousands of hours annually to create, use, and store Federal records in analog (paper and non-electronic) formats. In November 2011, the Presidential Memorandum *Managing Government Records* was signed, marking the beginning of an Executive Branch-wide effort to reform records management policies and practices as well as to develop a modernized framework for the management of Government records.<sup>33</sup> In August 2012, in response to the Presidential Memorandum, the Office of Management and Budget issued a memorandum requiring all executive agencies to eliminate paper files and use electronic recordkeeping to the fullest extent possible, without regard to security classification or any other restriction.<sup>34</sup> In June 2019, the Office of Management and Budget and the National Archives and Records Administration issued Implementation Guidance for all agencies requiring that all permanent records are to be managed electronically by December 31, 2022.<sup>35</sup> The IRS stated that it is following the Office of Management and Budget/National Archives and Records Administration directive regarding record maintenance.<sup>36</sup>

Due to the Coronavirus Disease 2019 pandemic, the National Archives and Records Administration's Federal Records Centers experienced staffing issues, which resulted in minimal

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<sup>33</sup> Presidential Memorandum, *Managing Government Records* (November 2011).

<sup>34</sup> Office of Management and Budget/National Archives and Records Administration Memorandum (M-12-18), *Managing Government Records Directive* (Aug. 2012).

<sup>35</sup> Office of Management and Budget/National Archives and Records Administration Memorandum (M-19-21), *Transition to Electronic Records* (June 2019).

<sup>36</sup> IRM 1.15.6.1.1(5) (Mar. 18, 2021).



to no staff at certain Federal Records Centers. Due to this staffing issue, TIGTA was unable to timely receive physical case files for our case review and, as a result, TIGTA performed an initial case review using the IMS. According to IRS officials, the purpose of the IMS is to help IRS management improve strategic decisions and make informed decisions on resource allocations. Many IRS functions and employees rely on these workpapers for support, analysis, or decision-making after a case is completed.

As mentioned previously, TIGTA selected a statistically valid random sample of 291 SB/SE Division Specialty ET examinations closed from FYs 2018 through 2020 that were identified and coded with a worker classification issue. We reviewed the sample cases to determine if the minimum mandatory items required by the IRM were included/uploaded into the IMS, such as:<sup>37</sup>

- Case activity records.
- Supporting workpapers for any issues adjusted.
- Closing letters and forms, including all signed agreements.

We identified documents missing from the IMS in 111 (38 percent) of the 291 sample cases reviewed. The missing documents included mandatory items, such as lead sheets, workpapers, or closing documents used to support the examiners' audit trail and conclusions reached.



**38 percent** of the cases we reviewed were missing documentation, including lead sheets, workpapers, and closing documents.

The use of the IMS is mandatory for certain examiner groups to capture specific information from their examinations. For example, the IRM requires all documents that support conclusions reached or provide detail on the audit trail must be added to the IMS by the IRS examiner.<sup>38</sup> The IRM provides a comprehensive list of IMS documentation, including specific requirements for all Employment Tax examiners.<sup>39</sup> The IRM states that lead sheets and supporting workpapers are important to:

- Effectively explain the issues addressed during the audit.
- Provide the evidence to reflect the scope and depth of the audit.
- Support the determination of the tax liability.
- Reflect the audit trail, allowing a subsequent reviewer to trace a transaction or event and related information from beginning to end.

When IMS workpapers are incomplete, there is insufficient evidence to determine the results and adequacy of the examination, without requesting the physical case files. As the Coronavirus Disease 2019 pandemic has shown, electronic case files, such as the IMS, are beneficial because they can be quickly accessed and reviewed when needed without having to locate and mail a hard copy case file. Specialty ET Examination and Specialty Exam Policy were not aware of any changes or improvements being considered for the IMS to ensure that Specialty ET examination documents are uploaded correctly.

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<sup>37</sup> IRM 4.23.4.4.1 (May 23, 2019).

<sup>38</sup> IRM 4.23.4.4.1(2) (May 23, 2019).

<sup>39</sup> IRM 4.23.4.1 (May 4, 2021).



**Improvements to the Employment Tax Examination Process Are Needed  
to Increase Taxpayer Compliance and Collection Potential**

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**Recommendation 5:** The Commissioner, SB/SE Division, should ensure that Employment Tax examination managers are verifying that all required and applicable documentation is included in the IMS case file prior to case closure, such as by completing a Manager's Quality Checklist.

**Management's Response:** IRS management agreed with this recommendation, stating that they will issue an Interim Guidance Memorandum to provide a quality checklist for managers to verify that all required and applicable documentation is included in the IMS case file prior to case closure.

## **Appendix I**

### **Detailed Objective, Scope, and Methodology**

The overall objective of this audit was to assess the IRS's controls over the selection and examination of employment tax examination efforts, including relief from employment tax obligations that may be provided under Section 530 of the Revenue Act of 1978. To accomplish our objective, we:

- Determined the applicable policies, procedures, and controls that are in place for the selection and work processes of employment tax examinations and the status of the IRS's efforts related to Section 530.
- Determined how employment returns are prioritized by the ET- WSD for examination.
- Determined if Specialty ET examiners appropriately followed employment tax return examination guidance in worker classification examinations. From a universe of 11,528 worker classification examinations closed as no-change, agreed, and default during FYs 2018 through 2020, we reviewed a statistically valid sample of 291 worker classification examinations. To select the statistically valid sample, we used an expected error rate of 50 percent, a precision rate of  $\pm 7$  percent, and a confidence interval of 90 percent. TIGTA's contracted statistician assisted with developing the sampling plan.<sup>1</sup>

### **Performance of This Review**

This review was performed with information obtained from the IRS's SB/SE Division's Employment Tax Program during the period August 2020 through August 2022. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Robert Jenness, Director; Michele Jahn, Audit Manager; Tina Fitzsimmons, Lead Auditor; Kelly Loeffler, Lead Auditor; Antony Shang, Lead Auditor; and Jonathan Lee, Auditor.

### **Validity and Reliability of Data from Computer-Based Systems**

We reviewed and analyzed computerized information obtained from IRS systems to include the Individual Return Transaction File, Individual Master File, and Audit Information Management System. We evaluated the data by: 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

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<sup>1</sup> We used a statistically valid sample in the event that we needed to project the results to the population; however, we did not project because there were no outcome measures identified.

## **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: IRS policies, procedures, and practices to identify, select, and process employment tax examinations. We evaluated these controls by reviewing and analyzing relevant data, interviewing IRS management, performing analysis on the classification process for employment tax examinations, and reviewing employment tax cases.

## Appendix II

### Management's Response to the Draft Report



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

January 23, 2023

MEMORANDUM FOR HEATHER M. HILL  
DEPUTY INSPECTOR GENERAL FOR AUDIT  
Amalia C.  
FROM: Lia Colbert Colbert  
Commissioner, Small Business/Self-Employed Division  
SUBJECT: Draft Audit Report – Improvements to the Employment Tax  
Examination Process Are Needed to Increase Taxpayer  
Compliance and Collection Potential (Audit #202030005)

Digitally signed by Amalia  
C. Colbert  
Date: 2023.01.23  
08:28:16 -05'00'

Thank you for the opportunity to review and comment on the above subject draft audit report. Employment taxes (ET) are a significant source of revenue for the government; approximately two out of every three dollars collected by the IRS comes from required withholding and tax on employment tax returns. Every employer and every worker in the United States is impacted by employment taxes which are the primary source of funding for Social Security, Medicare, and Unemployment Insurance trust funds. In 2021, IRS received and processed more than 33 million employment tax returns filed by over 6 million employers. Employment tax examinations conducted by the Small Business/ Self Employed Division (SB/SE) resulted in over \$2.1 billion in proposed additional taxes for Fiscal Years 2018 to 2020.

Specialty ET examinations focus classification and compliance resources on those returns and issues having the most compliance risk and thus the highest audit potential. Employment tax selection criteria are continuously evaluated and adjusted based on results, the changing environment, and emerging issues. The report mentions a higher no change rate for Specialty ET compared to ET returns originating from other examinations. Comparing no change rates across different divisions is not reasonable and should not be relied upon as they are not like-kind comparisons. Specifically, the Specialty ET no change rate should not be compared to the no change rate for ET returns examined by other areas because when an ET examination originates in another area it is generally because specific information has been seen during the examination that indicates a potential ET issue, making a no change determination much less likely.

**Improvements to the Employment Tax Examination Process Are Needed  
to Increase Taxpayer Compliance and Collection Potential**

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Your report also notes that IRS examiners are not adequately documenting their work in the electronic case management system, which will hamper the IRS's efforts to move to paperless examination files. We agree that we can make some improvements in this area and plan to issue guidance to examiners that provides clear, standard language to explain the results of worker classification exams. In addition, we have developed a case quality checklist that managers will use to verify that all required and applicable documentation is included in the Issue Management System (IMS) case file prior to case closure.

Attached is a detailed response to address your recommendations. If you have any questions, please contact me or Richard Tierney, Director, Examination Operations, SB/SE Division.

Attachment

## **Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential**

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Attachment

### **Recommendation 1:**

The Commissioner, SB/SE Division, should require that quality reviews of the ET-WSD Gatekeeper be documented and create a segregation of duties for managerial reviews to provide effective oversight of the Gatekeeper function.

### **Planned Corrective Action:**

We will create a desk guide for the Gatekeeper that details the requirements and guidelines for the ET WSD Gatekeeper function. We will remove the Gatekeeper from the process of filtering returns and will include this guidance in the ET WSD Gatekeeper desk guide.

### **Implementation Date:**

November 15, 2023

### **Responsible Official:**

Director, Exam Case Selection

### **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 ensure that all required managerial reviews are properly conducted and documented.

### **Planned Corrective Action:**

We will develop a review form to properly document the required ET WSD managerial reviews.

### **Implementation Date:**

November 15, 2023

### **Responsible Official:**

Director, Exam Case Selection

### **Corrective Action Monitoring Plan:**

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

### **Recommendation 3:**

The Commissioner, Small Business/Self-Employed Division, should create a tracking mechanism for cases that were granted Section 530 relief.

## **Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential**

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### **Planned Corrective Action:**

There are both technical and systemic barriers to implementing a tracking mechanism for cases that were granted Section 530 relief that could be relied upon during examinations. Reliance on a tracking mechanism could result in the erroneous exclusion of taxpayers for examination consideration as entitlement to Section 530 relief is determined on a year by year and worker by worker basis.

Whether or not a taxpayer has maintained their Section 530 relief for the specific class of workers, and whether or not they have other classes of misclassified workers not covered by Section 530 is a facts and circumstances determination that cannot be made by reviewing the Integrated Data Retrieval System or some other system. Fact gathering interaction with the taxpayer is required. For example, while in a prior year, a taxpayer may have met all three of the statutory requirements for Section 530 relief, in a subsequent year the taxpayer may not have issued information returns to some or all of the same category of workers which would cause a failure to meet the reporting consistency test. Additionally, it is possible that the job duties and/or relationship of the parties of the category of workers for which the service provider was granted Section 530 relief may have significantly changed in a subsequent year or for specified tax periods the taxpayer temporarily reclassified workers as employees, then reverted back to independent contractor status. Any of these examples would negate the taxpayer's continuing entitlement to Section 530 relief with respect to specific categories of workers.

In addition, even if the employer satisfies both the reporting consistency and substantive consistency tests, Section 530 relief will only apply to the class of workers and similarly situated employees addressed during the examination. The employer will not have Section 530 relief for any class of workers that were not addressed in a prior examination.

Although a tracking mechanism for cases granted Section 530 relief offers minimal utility in the examination process, the IRS will explore whether such tracking is feasible in a way that would benefit tax administration as a whole.

### **Implementation Date:**

N/A

### **Responsible Official:**

N/A

### **Corrective Action Monitoring Plan:**

N/A



## **Improvements to the Employment Tax Examination Process Are Needed to Increase Taxpayer Compliance and Collection Potential**

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### **Recommendation 4:**

The Commissioner, Small Business/Self-Employed Division, should issue a policy alert to remind examiners of the procedures and guidance on the proper language/information that should be included on Form 4666.

### **Planned Corrective Action:**

We will issue a policy alert with guidance to examiners that provides clear, standard language to explain the results of worker classification exams.

### **Implementation Date:**

November 15, 2023

### **Responsible Official:**

Director, Specialty Exam Policy

### **Corrective Action Monitoring Plan:**

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

### **Recommendation 5:**

The Commissioner, Small Business/Self-Employed Division, should ensure that Employment Tax examination managers are verifying that all required and applicable documentation is included in the IMS case file prior to case closure, such as by completing a manager quality checklist.

### **Planned Corrective Action:**

We will issue an Interim Guidance Memo to provide a manager quality checklist for managers to verify that all required and applicable documentation is included in the Issue Management System (IMS) case file prior to case closure.

### **Implementation Date:**

November 15, 2023

### **Responsible Official:**

Director, Specialty Exam Policy

### **Corrective Action Monitoring Plan:**

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

## Appendix III

### Glossary of Terms

Term	Definition
Classification Process	The process during which classifiers determine which tax returns will be sent to the field for potential examination based on certain risk factors.
Employee Plans Examinations	Examinations that determine if a retirement plan is qualified under I.R.C. 401, Qualified Pension, Profit-Sharing, and Stock Bonus Plans, and the underlying regulations.
Gross Employment Tax Gap	The amount of true tax liability that is not paid voluntarily and timely. The Tax Gap "Employment taxes" include Social Security and Medicare taxes under the Federal Insurance Contribution Act and the Self-Employment Contributions Act payments for Federal unemployment insurance under the Federal Unemployment Tax Act, and railroad retirement and railroad unemployment repayment taxes under the Railroad Retirement Tax Act and the Railroad Unemployment Repayment Tax.
Independent Contractor	A self-employed individual who provides a service to a service recipient and is responsible for the self-employment taxes earned on their business income. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.
Information Management System	The IMS is an electronic examination case management system used by the SB/SE Division Specialty ET examiners to manage their case workload.
Innovation Lab	Employment Tax facilitates partnerships between subject matter experts and data science experts to leverage new technologies and data sources to develop a data-driven process to learn more about employment tax compliance and noncompliance to place each taxpayer in the most effective treatment stream. The goal of this Innovation Lab is to enable the IRS to increase compliance, create efficiencies, and integrate data insights into its processes. The IRS will use this Innovation Lab to establish a Service-wide, data-driven approach to allocating employment tax work.
No-Change Audit	A no-change audit is an examination for which the examiner closed the case with no recommended tax change.
No-Change Rate	The percentage of examinations in which the IRS does not make an adjustment to the taxpayer's tax return.
SS-8 Worker Classification Function	IRS function that allows firms and workers to request a determination of the status of a worker under the common law rules for purposes of Federal employment taxes and income tax withholding.
The Treasury Department's Office of Tax Policy	Develops and implements tax policies and programs, reviews regulations and rulings to administer the I.R.C., negotiates tax treaties, and provides economic and legal policy analysis for domestic and international tax policy decisions.

## Appendix IV

### Abbreviations

ET	Employment Tax
ET-WSD	Employment Workload Selection and Delivery
FY	Fiscal Year
GAO	Government Accountability Office
I.R.C.	Internal Revenue Code
IMS	Issue Management System
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



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