TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Actions Can Be Taken to Better Address Potential Noncompliance for Roth Individual Retirement Arrangement Conversions

August 30, 2016

Reference Number: 2016-10-054

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:
1 = Tax Return/Return Information
2 = Risk Circumvention of Agency Regulation or Statute

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ACTIONS CAN BE TAKEN TO BETTER ADDRESS POTENTIAL NONCOMPLIANCE FOR ROTH INDIVIDUAL RETIREMENT ARRANGEMENT CONVERSIONS

Highlights

Final Report issued on August 30, 2016

Highlights of Reference Number: 2016-10-054 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

For Tax Year 2011, IRS records show that approximately 400,000 taxpayers converted more than $10 billion in assets from Traditional to Roth Individual Retirement Arrangements (IRA). The IRS uses its Automated Underreporter (AUR) Program to systemically match third-party documents with tax returns to identify potential retirement plan discrepancies, such as tax noncompliance issues associated with Roth IRA conversions. Underreported taxes due on these conversions result in lost revenue to the Government.

WHY TIGTA DID THE AUDIT

This audit was initiated to assess whether the IRS has sufficient processes in place to address taxpayers who underreport taxes due when converting assets to Roth IRAs.

WHAT TIGTA FOUND

The IRS has processes in place to address taxpayers who underreport taxes due when converting assets to Roth IRAs; however, AUR Program employees did not always follow these processes, and improvements can be made to lessen taxpayer burden. TIGTA identified a population of 18,382 potential Roth IRA conversion compliance cases worked by the AUR Program in Tax Year 2011 and reviewed a random sample of the cases. The IRS correctly followed its processing guidance in the Internal Revenue Manual for 335 (87 percent) of 383 sampled cases. For the remaining cases, the procedures that are designed to ensure accuracy and consistency in working Roth IRA conversion cases were not followed. The resulting 13 percent error rate for these Roth IRA conversion cases is higher than the 7.4 percent error rate estimated by the IRS for all types of cases worked by the AUR Program. This occurred because, in some instances, guidance for processing Roth IRA conversions was unclear and, in others, the guidance was not followed by AUR Program personnel. In addition, IRS management stated that Roth IRA conversions are one of the more complex issues handled by AUR Program personnel.

TIGTA also determined that the IRS could improve its procedures to reduce taxpayer burden by eliminating unnecessary notices. For 97 (25 percent) of the 383 sampled cases, the IRS could have researched information on IRS systems that would have enabled AUR Program personnel to correctly conclude that minimal or no taxes were due on the Roth IRA conversions. However, the Internal Revenue Manual did not require AUR Program personnel to consider this information. As a result, the IRS issued unnecessary notices to taxpayers who owed minimal to no taxes on their Roth IRA conversions.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) clarify guidance and educate AUR Program personnel on Roth IRA conversion issues; and 2) update processes and procedures to consider available information prior to issuing notices to taxpayers.

In its response, the IRS agreed with the first recommendation and plans to update procedures, develop education materials, and provide training. The IRS disagreed with the second recommendation stating that much of the information TIGTA recommends reviewing is unavailable when AUR personnel initially review cases. In addition, matches are performed using a single tax year. TIGTA continues to believe that alternatives exist to adjust processes to reduce the number of unnecessary notices that result in minimal or no taxes due.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 30, 2016

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Actions Can Be Taken to Better Address Potential Noncompliance for Roth Individual Retirement Arrangement Conversions (Audit # 201510021)

This report presents the result of our review to assess whether the Internal Revenue Service (IRS) has sufficient processes in place to address taxpayers who underreport taxes due when converting assets to Roth Individual Retirement Arrangements. This review is included in our Fiscal Year 2016 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

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

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

Table of Contents

Abbreviations

AUR	Automated Underreporter
CP	Computer Paragraph
IDRS	Integrated Data Retrieval System
IRA	Individual Retirement Arrangement
IRS	Internal Revenue Service
SEP	Simplified Employee Pension
SIMPLE	Savings Incentive Match Plan for Employees
TY	Tax Year

Background

There are many types of retirement vehicles available to U.S. taxpayers including pension plans, 401(k) plans,[1] 403(b) plans,[2] and the Federal Government's Thrift Savings Plan, as well as Individual Retirement Arrangements (IRAs). Tax treatment of IRAs varies by IRA type.

Traditional IRAs are typically taxable upon distribution.[3] Any amounts contributed to a Traditional IRA account that were pretax contributions or were deductions claimed on Form 1040, *U.S. Individual Income Tax Return*, and all earnings are considered taxable distributions in the year of the distribution. Any contributions made after taxes were paid or nondeductible contributions are not subject to taxes upon distribution. This differs from a Roth IRA in that qualified distributions from Roth IRAs are tax free. Unlike a Traditional IRA, all contributions to a Roth IRA are nondeductible and are subject to taxes in the year of the contribution.

Legislative changes effective in Tax Year[4] (TY)[5] 2010 allowed all taxpayers to convert assets maintained in a Traditional IRA into a Roth IRA by paying all taxes due on converted assets.[6] Underreported taxes due on these conversions result in lost revenue to the Government. According to Internal Revenue Service (IRS) records, in TY 2011, approximately 400,000 taxpayers converted more than $10 billion[7] in assets from Traditional IRAs to Roth IRAs. The law permits taxpayers to later decide that they do not want to convert their assets, as long as they reverse the conversion through what is known as a recharacterization before October 15 of the following tax year.

IRS records show an estimated 400,000 taxpayers converted more than $10 billion in assets from a Traditional IRA to a Roth IRA in TY 2011.

A Form 8606, *Nondeductible IRAs*, is required to be attached to the Form 1040 series when taxpayers convert Traditional IRA assets to Roth IRA assets. Form 8606 is used to determine

[1] 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.
[2] Plan designed for public education and tax-exempt entities. Both the plan sponsor and employees can make pretax contributions.
[3] For the purposes of this review, a Traditional IRA refers to all non-Roth IRAs including Traditional, Simplified Employee Pension (SEP), or Savings Incentive Match Plan for Employees (SIMPLE) IRAs.
[4] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 365 & 366, § 512.
[5] The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[6] For TY 2010 Roth IRA conversions only, taxpayers were allowed to report the Roth IRA conversion amount over a two-year period. However, beginning with TY 2011 Roth IRA conversions and going forward, taxpayers must report the full Roth IRA conversion amount as additional income in the year of the conversion.
[7] We analyzed TY 2011 Forms 5498, *IRA Contribution Information*, to calculate this figure.

the taxable amount of income due to the conversion.[8] Third-party trustees report Roth IRA conversions (as well as recharacterizations) to taxpayers and to the IRS on Forms 5498, *IRA Contribution Information*. In addition, because the Roth IRA conversion is considered a taxable distribution, third-party trustees also report the amounts converted to taxpayers and the IRS on Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*.

The IRS Automated Underreporter (AUR) Program matches the amounts reported by IRA trustees on Forms 1099-R to the amounts that taxpayers report on Lines 15a and 15b (IRA distributions) and Lines 16a and 16b (Pensions and annuities) of the Form 1040 to identify retirement income discrepancies. The AUR Program does not identify Roth IRA conversions specifically, but rather as part of all retirement income[9] discrepancies between amounts reported by third parties and amounts shown on Lines 15 and 16 of individual tax returns. If a discrepancy between amounts reported by third parties as taxable distributions and amounts reported by taxpayers as taxable distributions meets select threshold criteria, the discrepancy may then be worked by AUR Program personnel to assess whether the discrepancy can be resolved through analysis of other items on the tax return or information maintained on IRS systems. When the discrepancy cannot be resolved internally, AUR Program personnel send a Computer Paragraph (CP) 2000 Notice, *Request for Verification of Unreported Income, Payments, or Credits,*[10] by mail to alert taxpayers that a discrepancy was identified and that additional taxes may be owed. In response, taxpayers may provide supporting documentation that fully or partially resolves the discrepancy or agree to pay additional taxes.

This review was performed at the Small Business/Self-Employed Division AUR Program Office in Atlanta, Georgia, during the period June 2015 through May 2016 using AUR Program data for TY 2011 discrepancies.[11] We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[8] TY 2011 Form 8606 has four parts: Nondeductible Contributions to Traditional IRAs and Distributions From Traditional SEP, and SIMPLE IRAs (Part I); Conversions From Traditional, SEP or SIMPLE IRAs to Roth IRAs (Part II); Distributions From Roth IRAs (Part III); and Certain Distributions from Designated Roth Accounts (Part IV).

[9] Retirement income includes line items 15 and 16 from the Form 1040, which includes distributions from pensions, annuities, retirement, profit-sharing plans, IRAs, insurance contracts, *etc*.

[10] In some cases, a CP 2501 Notice, *Initial Contact to Resolve Discrepancy Between Income, Credits, and/or Deductions Claimed on Return and Those Reported by Payer*, will be issued prior to issuance of a CP 2000 Notice. The CP 2501 Notice is sent prior to the CP 2000 Notice when the taxpayer is owed a refund or when the discrepancy identified by the AUR Program will result in the taxpayer owing $10,000 or more in additional taxes.

[11] TY 2011 was the latest year that the AUR Program had completed when we started our audit.

Results of Review

The Error Rate Associated With Resolving Underreported Roth Conversions Exceeded the Estimated Error Rate Associated With Other Types of Cases

The IRS has processes in place to address taxpayers who underreport taxes due when converting assets to Roth IRAs; however, AUR Program employees did not always follow these processes, and improvements can be made to lessen taxpayer burden. Identifying potential discrepancies between amounts reported by taxpayers on individual tax returns and amounts reported by third-party financial institutions for Traditional IRAs being converted to Roth IRAs is crucial to ensuring that the Federal Government receives the correct amount of taxes that are due. We identified a population of 18,382 potential Roth IRA conversion compliance cases worked by the AUR Program in TY 2011 and reviewed a random sample of the cases.[12] The IRS correctly followed its processing guidance in the Internal Revenue Manual for 335 (87 percent) of 383 sampled cases. The IRS did not follow established procedures for the remaining 48 discrepancies, which resulted in an estimated error rate that was higher than the error rate estimated by the IRS for all types of discrepancy cases worked by the AUR Program. Figure 1 describes the specific errors we identified for the 48 discrepancies.

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

Figure 1: AUR Personnel Errors in Working Roth IRA Conversion Discrepancies

Description of Error Type	Number of Cases
AUR Program personnel incorrectly closed the discrepancy without sending a CP 2000 Notice or did not include the discrepancy on the CP 2000 Notice sent.	25
AUR Program personnel did not assess the correct amount of tax as a result of examiners' not appropriately evaluating documentation or receiving a reasonable explanation for resolving the discrepancy.	14
AUR Program personnel did not ensure that taxpayers who converted nondeductible (nontaxable) IRA contributions provided missing Form 8606 information, which is needed to determine the correct tax assessment.	9
Total	**48**

Source: Treasury Inspector General for Tax Administration case review.

Before sending CP 2000 Notices, AUR Program personnel manually review tax return information, along with third-party documents received by the IRS, to determine if taxpayers reported the correct amount of income. As part of their review, AUR Program personnel attempt to resolve the discrepancies by determining whether taxpayers reported the amount shown on Form 1099-R on the tax return or completed Form 8606 showing how they arrived at the taxable amount of the Roth IRA conversion.

If AUR Program personnel cannot resolve discrepancies internally, a CP 2000 Notice is sent to alert taxpayers that a discrepancy was identified and that additional taxes may be owed. AUR Program personnel will not assess additional tax if taxpayers provide a response that resolves the discrepancy. For example, taxpayers who provide evidence that a Roth IRA conversion has been recharacterized would not be assessed additional taxes.

The 13 percent error rate for Roth IRA conversion cases we sampled was higher than the overall estimated error rate of 7.4 percent[13] reported by the IRS for all AUR Program cases. In some instances, the errors were due to unclear AUR Program guidance for processing Roth IRA conversions, and in other cases the guidance was not followed by AUR Program personnel. For example, we found instances in which AUR Program personnel did not send CP 2000 Notices to

[13] In addition to retirement income discrepancies, other frequently identified cases that are worked by AUR Program personnel and are part of the AUR Program's quality review are underreported securities sales, wages, unemployment compensation, and nonemployee compensation.

taxpayers when required by guidelines. In these cases, IRS officials stated that AUR Program personnel had likely incorrectly considered some Roth IRA conversions to be IRA rollovers, which are nontaxable events. We also found instances in which AUR Program personnel incorrectly closed TY 2011 discrepancies with guidance that was applicable only for discrepancies processed in TY 2010. In addition, IRS officials stated that some AUR Program personnel did not manually add standard language to the CP 2000 Notice requesting that the taxpayer provide a Form 8606. Lastly, IRS officials stated that Roth IRA conversions are one of the more complex issues handled by AUR Program personnel, which could contribute to a higher error rate.

Following established procedures is critical to providing reasonable assurance that the correct amount of taxes that are potentially owed as a result of Roth IRA conversions are appropriately assessed. This is significant because Roth IRA earnings grow tax-free and are not subject to the payment of any income taxes upon distribution. Therefore, once the Roth IRA conversion is complete, the IRS loses the ability to collect income tax from the Roth IRA conversion. Improving processes in a manner that would correct common mistakes by AUR Program personnel could enable the IRS to collect some of the approximately $11 million[14] of estimated revenue that is being lost annually.

Recommendation

Recommendation 1: The Director, Exam Field and Campus Policy, Small Business/ Self-Employed Division, should clarify guidance and educate AUR Program personnel on Roth IRA conversion issues.

> ***Management's Response:*** The IRS agreed with this recommendation and plans to review the Internal Revenue Manual and update it as necessary, provide continuing professional education on this topic, and develop education materials on researching Forms 8606.

Taxpayers Were Sent Unnecessary Notices for Roth Conversions

The IRS could change some existing practices and procedures for researching discrepancies and reduce the burden on taxpayers by not issuing unnecessary notices. Our review found that 97 (25 percent) of the 383 sampled cases had information that could have been researched on IRS systems that would have enabled AUR Program personnel to correctly conclude that minimal or no taxes were due on discrepancies resulting from Traditional IRAs being converted to Roth IRAs. In each of the 97 discrepancies, taxpayers received CP 2000 Notices. However, after correspondence with the taxpayer, little or no additional tax was assessed. Existing

[14] See Appendix IV. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between $7,504,906 and $14,280,936.

procedures only require AUR personnel to research information on Form 8606 when it is available in the case file and do not require research of information that is readily available on IRS systems when Form 8606 is not included with the case file. Changing procedures to require AUR Program personnel to research this information could annually eliminate the need for more than 3,000 taxpayers[15] to unnecessarily respond to notices sent by the IRS. In addition, it would enable AUR Program personnel to focus their efforts on more productive cases. We determined there were two scenarios that resulted in unnecessary notices being issued.

1. **Taxpayers who recharacterized their Roth IRA conversion were sent unnecessary notices –** Taxpayers may change their decisions to convert to Roth IRAs, which is permitted under certain conditions. Our analysis determined that 92 of our sample of 383 cases involved taxpayers who recharacterized their Roth IRA conversion. Taxpayers are allowed up to the due date of the tax return (including extensions) to recharacterize, or change their mind, and move the assets from the Roth IRA back to a Traditional IRA. In these situations, no tax is due on the Roth IRA conversion. However, the IRS sent notices to these taxpayers indicating additional taxes may be due. For example, ***1** ***************************************1********************************* *****************1*****************

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[15] See Appendix IV. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 2,337 and 3,752.

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IRS officials stated that the AUR Program's policy does not require personnel to research IRS's Integrated Data Retrieval System (IDRS),[16] which is the IRS computer system that is needed to successfully resolve some recharacterizations. They further stated access to the IDRS is not available to all AUR Program personnel. However, the IDRS remains a tool that can be made available to all tax examiners working retirement discrepancies, and we noted that tax examiners we interviewed had access to the IDRS, which was used when needed to resolve AUR Program cases. We also determined that some cases could have been resolved prior to sending the taxpayer a CP 2000 Notice by researching recharacterization information available on the AUR Program Case Management System. In instances for which the information on recharacterizations is unavailable on the AUR Program Case Management System, AUR Program personnel would need to research the IDRS for the information.[17]

IRS officials agreed that process changes could have prevented 27 of 92 taxpayers from receiving unnecessary notices; however, IRS officials believe that process changes would not enable the IRS to resolve 65 of the 92 recharacterizations because of the following:

[16] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
[17] The Case Management System contains only one year of tax information. AUR Program personnel working TY 2011 cases would have to research the IDRS if taxpayers recharacterize their Roth IRA conversions after December 31, 2011.

- IRS officials stated that Forms 1099-R, which document recharacterizations, were not available to the IRS for 21 cases at the time AUR Program personnel started their processing of the cases. In each of these cases, the Forms 1099-R became available after AUR Program personnel processed the cases but before the notices were sent to taxpayers.

  The reason this occurred is that AUR Program personnel begin reviewing income discrepancies before Forms 1099-R are due.[19] IRS officials stated they had begun processing AUR Program cases earlier in the year due to complaints by taxpayers that notices were being received too long after tax returns were filed. Delaying the processing of cases associated with retirement income until Forms 1099-R are due could prevent compliant taxpayers from receiving unnecessary notices.

- IRS officials stated that issues associated with recharacterizations could not be resolved for 44 cases because the amount recharacterized was different from the Roth IRA conversion amount. However, market fluctuations frequently impact the value of the assets associated with Roth IRA conversions between the time taxpayers convert to a Roth IRA and the time the Roth IRA is recharacterized. IRS management also explained that IRAs, in general, are a complex area and that AUR Program personnel are trained to compare reported amounts with information documents on a dollar-for-dollar basis. However, ***********2********** ********************************2********************************** ********************************2******************************* ***************************2**********************.

2. **Taxpayers were unnecessarily sent notices when a Form 8606 showed their Roth IRA conversion was not a taxable event –** For five taxpayers, information from the Form 8606, which is used to calculate the taxable portion of the Roth IRA conversion, was incomplete. However, IRS officials stated that, if a Form 8606 is incomplete but clearly shows the nontaxable amount of the conversion, a CP 2000 Notice does not need to be sent to the taxpayer. Our research found that, when responding to the notices, the majority of the five taxpayers provided the same documentation as was originally provided with their tax return, which ************2****************** and resulted in no change to the taxes owed.

   We also determined that, in each of these instances, Forms 8606 were not included in the case file established on the AUR Program's system, which is used to manage case work and document actions taken to resolve discrepancies. IRS officials stated this was due to operational issues associated with the AUR Program's system. When Forms 8606 are not

[19] Forms 1099-R that are electronically filed are due by March 31; however, the filing date may extend beyond March 31 for the following reasons: any approved 30-day filing extensions, late-filed information returns, or processing information return error corrections.

included with the AUR Program case file, some AUR Program personnel may be unaware that the information is available on the IDRS, resulting in a CP 2000 Notice being sent to taxpayers who have actually included it with their tax return.

Recommendation

Recommendation 2: The Director, Exam Field and Campus Policy, Small Business/ Self-Employed Division, should update processes and procedures to consider all information that is readily available on IRS systems for Roth IRA conversions prior to issuing notices to taxpayers.

Management's Response: The IRS disagreed with this recommendation. The IRS stated that it already utilizes readily available information when screening AUR workload. In order to reduce the burden on taxpayers of a prolonged resolution of their tax issues, and to facilitate the success of the AUR Program, the IRS must begin screening cases as soon as possible after the conclusion of the filing season. Much of the information that may become available to the IRS is not available at the time screening begins. Therefore, the IRS is not able to incorporate the additional information into its process.

Office of Audit Comments: While we acknowledge that it is important to timely identify potential discrepancies to ensure Roth IRA conversions are accurately reported, we continue to believe that alternatives may exist that the IRS has not fully considered. For example, staging workload in a manner that allows time for complete third-party information to be available to examiners would reduce the number of unnecessary notices that result in minimal or no taxes due.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to assess whether the IRS has sufficient processes in place to address taxpayers who underreport taxes due when converting assets to Roth IRAs. To accomplish our objective, we:

I. Determined whether AUR Program personnel were working Roth IRA conversion cases consistent with IRS guidance.

A. Matched AUR Program data to the Roth IRA conversion amounts reported by third parties on Forms 5498, *IRA Contribution Information*, to identify potential TY 2011 Roth IRA conversion cases that were worked by AUR Program personnel. This identified 18,382 discrepancies between what was reported on Forms 5498 and tax returns related to conversions of Traditional IRAs to Roth IRAs.[1]

B. Selected and reviewed a statistically valid sample of 383[2] taxpayer accounts that were stratified based on the population of 18,382 discrepancies[3] identified in Step I.A. We relied on TIGTA's contract statistician to verify our sampling methods. We selected our sample using a 95 percent confidence level, a ± 5 percent precision rate, and a 50 percent estimated error rate. Each discrepancy within our sample was evaluated to determine whether AUR Program personnel correctly followed guidance when working the Roth IRA conversion cases.

C. Analyzed information maintained in closed case files from the Federal Records Center, the AUR Program Case Management System, and the IDRS for the sampled Roth IRA conversion cases to determine whether AUR Program personnel appropriately assessed the correct amount of tax resulting from the Roth IRA conversion.

[1] To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration Office of Strategic Data Services validated Form 5498 data. To provide additional assurance that the data received were supported by external sources, we verified the accuracy of Forms 5498 by researching the IRS's IDRS, which is the IRS computer system capable of retrieving and updating stored taxpayer account information, for a nonrepresentative selection of 10 accounts. We also validated a nonrepresentative selection of 25 of the 18,382 discrepancies by researching the IDRS to ensure the accuracy of the data from the IRS. Based on our tests, we concluded the data were sufficiently reliable and complete for our audit.
[2] We requested 402 cases; however, we only received 383 case files.
[3] We stratified the population of Roth IRA discrepancies into four strata in which the potential difference between what was reported on the tax return and the Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, was as follows: $10,000 or less, $10,001-$50,000, $50,001-$100,000, and more than $100,000.

D. Met with IRS representatives to discuss the 48 taxpayers for which the IRS did not follow established procedures in assessing taxes on Roth IRA conversions and the 97 taxpayers we identified who were potentially sent unnecessary notices after being identified as having a Roth IRA conversion discrepancy when information on IRS systems indicated a discrepancy did not exist.

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 the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for systemically matching third-party data to tax return data to identify retirement income discrepancies, such as tax noncompliance issues associated with Roth IRA conversions, and reviewing taxpayer responses to notices to determine if responses or documentation provided are adequate. We evaluated these controls by reviewing policies and procedures, interviewing IRS management, and reviewing a statistical sample of 383 closed AUR cases to determine if taxpayers were assessed the correct amount of tax due when taxpayers converted Traditional IRA assets to a Roth IRA.

Appendix II

Major Contributors to This Report

Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Troy D. Paterson, Director
James V. Westcott, Audit Manager
Jeffrey R. Stieritz, Lead Auditor
John M. Jarvis, Senior Auditor
Ejan Addy, Information Technology Specialist

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Commissioner, Wage and Investment Division
Director, Exam AUR Policy, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Office of Audit Coordination

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:

- Revenue Protection – Potential; $10,892,921 for TY 2011 due to the IRS not following established procedures, or $54,464,605 over five years (see page 3).

Methodology Used to Measure the Reported Benefit:

We matched AUR Program retirement income discrepancies to the Roth IRA conversion amounts reported by third parties on TY 2011 Forms 5498, *IRA Contribution Information*, and identified 18,382[1] potential Roth IRA conversion compliance cases worked by the AUR Program in TY 2011. We reviewed a statistically valid sample of 383[2] cases that were stratified based on the amount of the potential discrepancy and determined that the IRS did not follow established procedures for 48 of these cases. Our contract statistician calculated the potential taxes that could have been assessed had AUR Program employees followed established procedures by multiplying the number of errors for each stratum by the average potential tax assessment for the 48 cases that did not follow established procedures. Our contract statistician then used the results of each stratum, which were then applied, to the universe of 18,382 discrepancies. As a result, we estimate the IRS loses $10,892,921[3] in potential revenue to the Federal Government annually by not following established procedures. Improving processes in a manner that would correct common mistakes made by AUR Program personnel could enable the IRS to collect a portion of the approximately $54,464,605 in underreported taxes that is lost over a five-year period.[4]

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[1] We stratified the population of Roth IRA discrepancies into four strata in which the potential difference between what was reported on the tax return and the Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, was as follows: $10,000 or less, $10,001-$50,000, $50,001-$100,000, and more than $100,000.
[2] We selected our sample using a 95 percent confidence level, a ± 5 percent precision rate, and a 50 percent estimated error rate.
[3] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between $7,504,906 and $14,280,936.
[4] The five-year forecast for the potential for revenue protection is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 3,044 taxpayers for TY 2011 who unnecessarily received notices (see page 5).

Methodology Used to Measure the Reported Benefit:

We found that 97 (25 percent) of our statistically valid sample of 383 cases could have been researched on IRS systems that would have enabled AUR Program personnel to correctly conclude that minimal or no taxes were due on discrepancies resulting from Traditional IRAs being converted to Roth IRAs, which would have prevented notices from being sent to taxpayers. Our contract statistician calculated the potential number of taxpayers who received unnecessary notices by multiplying the sample error rate for each stratum by the stratum population. Our contract statistician then applied the results of each stratum to the universe of 18,382 discrepancies. Changing procedures to require AUR Program personnel to research this information could annually eliminate the need for 3,044 taxpayers[5] to respond to unnecessary notices sent by the IRS.

[5] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 2,337 and 3,752.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

AUG 11 2016

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Actions Can Be Taken to Better Address Potential Noncompliance for Roth Individual Retirement Arrangement Conversions (Audit # 201510021)

Thank you for the opportunity to review and comment on the subject draft audit report which examined the Automated Underreporter (AUR) program's efforts to address potential noncompliance related to Roth Individual Retirement Account (IRA) conversions. The purpose of the AUR Program is to address noncompliance by annually matching single-year information submitted by third parties to amounts reported on individual income tax returns. The AUR program initiates between 4 and 5 million taxpayer contacts per year in an attempt to touch as many categories or segments of non-compliant taxpayers as resources allow. In fiscal year (FY) 2013, the AUR Program assessed $7.84 billion in additional taxes. This program achieves the dual results of identifying amounts due to the Government and ensuring fairness to all taxpayers through uniform application of the tax code.

Although the AUR program does not specifically identify Roth IRA conversion income discrepancies, one sub-set of AUR workload involves matching information from third parties (i.e., trustees) and taxpayers to identify a variety of retirement income discrepancies. As you acknowledge, cases involving the conversion of traditional IRA assets to Roth IRA assets are complex. We have extensive processes in place to address taxpayers who underreport taxes due when making such conversions. AUR Program personnel manually review tax return information, along with third-party documents received by the IRS, to determine if taxpayers have correctly calculated and reported the taxable amount of the Roth IRA conversion they reported.

We agree that it is important that our AUR personnel follow these established procedures, and we will review the Internal Revenue Manual (IRM) and clarify as needed; provide Continuing Professional Education (CPE) on this topic; and develop educational material on researching Forms 8606, *Nondeductible IRAs*. However, much of the information which you are suggesting we review as part of our procedures is

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unavailable at the time AUR cases are screened. The Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* are not due to be filed until after the AUR screening process begins. In addition, the taxpayer election you suggest we research (the "recharacterization election") can be made any time before October 15 of the year following the conversion. In other words, the election can be made in a tax year subsequent to the conversion tax year. As noted previously, the AUR program performs matches within a single tax year. Moreover, we are unable to identify and separate Roth conversion cases from the other cases being screened. Thus, your recommendation would require that we delay processing all AUR cases for a significant period of time. This delay would burden taxpayers by prolonging the resolution of their tax issues and is counter to our interest in contacting taxpayers sooner regarding a discrepancy or error on their return.

Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at 240-613-2849.

Attachment

Attachment

The Director, Exam - Field and Campus Policy, Small Business/Self-Employed Division, should:

RECOMMENDATION 1:
Clarify guidance and educate AUR Program personnel on Roth IRA conversion issues.

CORRECTIVE ACTION:
We will review the IRM and update, as necessary; provide CPE on this topic; and develop education materials on researching Forms 8606.

IMPLEMENTATION DATE:
March 15, 2017

RESPONSIBLE OFFICIALS:
Director, Exam - Field and Campus Policy, Small Business/Self-Employed Division

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

RECOMMENDATION 2:
Update processes and procedures to consider all information that is readily available on IRS systems for Roth IRA conversions prior to issuing notices to taxpayers.

CORRECTIVE ACTION:
Currently, we do utilize readily available information when we screen our AUR workload. In order to reduce the burden on taxpayers of a prolonged resolution of their tax issues, and to facilitate the success of the AUR program, we must begin screening cases as soon as possible after the conclusion of the filing season. Much of the IRS information that may become available to IRS is not available at the time AUR screening begins. Therefore, we are not able to incorporate the additional information you suggest into our process.

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IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A