TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Improvements Are Needed to Ensure That Puerto Rico Residents With Unreported and Underreported Self-Employment Tax Are Properly Identified and Examined

August 14, 2017

Reference Number: 2017-30-045

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.

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED TO ENSURE THAT PUERTO RICO RESIDENTS WITH UNREPORTED AND UNDERREPORTED SELF-EMPLOYMENT TAX ARE PROPERLY IDENTIFIED AND EXAMINED

Highlights

Final Report issued on August 14, 2017

Highlights of Reference Number: 2017-30-045 to the Internal Revenue Service Commissioner for the Large Business and International Division.

IMPACT ON TAXPAYERS

Internal Revenue Code Section 933 excludes from taxation the income of full-time residents of the Commonwealth of Puerto Rico when the income is derived within Puerto Rico. However, U.S. citizens and residents of Puerto Rico generally must still pay self-employment tax on net self-employment earnings of $400 or more. This law applies whether or not the earnings are excludable from gross income and whether or not a U.S. income tax return must otherwise be filed.

WHY TIGTA DID THE AUDIT

This audit was initiated as a follow-up to an IRS research report issued in June 2009 to determine if the IRS is improving tax compliance of self-employed residents of Puerto Rico. The 2009 research report identified a 33.8 percent nonfiler rate for Tax Year 2007. The nonfiler rate was the percentage of qualified self-employment income earners who did not file an IRS return, divided by the number expected to file based on self-employment income reported to the Commonwealth of Puerto Rico taxation authority (La Hacienda). The objective of this review was to determine how effectively the Large Business and International Division identifies and addresses noncompliance of residents of Puerto Rico who have self-employment income but fail to report or underreport their self-employment income to the U.S. Government.

WHAT TIGTA FOUND

Some improvements are needed to ensure that Puerto Rico residents with unreported and underreported self-employment tax are properly identified and examined. Specifically, 1) the Large Business and International Division is not effectively identifying Puerto Rico residents with unreported or underreported self-employment income and 2) some Puerto Rico residents with no requirement to report self-employment income were incorrectly selected for examination. TIGTA's review identified potential unreported self-employment tax of approximately $30 million for Tax Years 2012 and 2013. Additionally, TIGTA found potential underreported self-employment tax of approximately $60.3 million for Tax Years 2012 and 2013.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS 1) evaluate the data analysis process and methodology used to analyze the La Hacienda data and document the process to be used in the future; 2) work with La Hacienda for more timely receipt of the annual data file; 3) analyze and examine underreported Puerto Rico self-employment tax in addition to addressing nonfilers; 4) evaluate the examinations identified for Tax Year 2012 and correct any identified erroneous assessments; and 5) develop and implement written procedures to validate the data provided by La Hacienda.

In their response, IRS management agreed with TIGTA's recommendations and stated that corrective actions have been implemented to address the identified weaknesses.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

August 14, 2017

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed to Ensure That Puerto Rico Residents With Unreported and Underreported Self-Employment Tax Are Properly Identified and Examined (Audit # 201530038)

This report presents the results of our review to determine how effectively the Large Business and International Division identifies and pursues residents of Puerto Rico who have self-employment income but fail to report or underreport their self-employment income to the U.S. Government. This audit is included in our Fiscal Year 2017 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 Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Appendices

Abbreviations

CP&A	Compliance Planning and Analytics
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
SET	Self-Employment Tax
TE	Tax Examiner
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year
WIIC	Withholding and International Individual Compliance

Background

Internal Revenue Code (I.R.C.) Section (§) 933 excludes from taxation the income of full-time residents of the Commonwealth of Puerto Rico when the income is derived within Puerto Rico. However, U.S. citizens and residents of Puerto Rico generally must still pay self-employment tax (SET) on net self-employment earnings of $400 or more.[1] This law applies regardless of whether the earnings are excludable from gross income or whether a U.S. income tax return must otherwise be filed. Filing requirements for specific U.S. territories are explained in Internal Revenue Service (IRS) Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*. Puerto Rican residents must determine if they are a resident or a nonresident in accordance with I.R.C. § 937.[2] Depending on residency status and the source of the income earned, a resident of Puerto Rico may have to file a U.S. tax return only, a Puerto Rican tax authority return, or both returns. For example, bona fide residents of Puerto Rico would not be required to file a U.S. tax return if all their income was from Puerto Rico and not from self-employment or as a Federal employee. However, Puerto Rico residents with net earnings from self-employment of $400 or more (who are not otherwise required to file a Form 1040, *U.S. Individual Income Tax Return*) must file a Form 1040-SS, *U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*. Puerto Rico residents who wish to file in Spanish may use Form 1040-PR in lieu of Form 1040-SS. All paper Form 1040-SS and Form 1040-PR returns and Modernized E-File system[3] returns are processed at the IRS campus[4] in Austin, Texas.

U.S. citizens and residents of Puerto Rico must pay self-employment tax on net self-employment earnings of $400 or more, regardless of whether a U.S. income tax return must be filed.

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[1] 2014 Instructions for Form 1040-SS, *U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*; I.R.C. § 1402.

[2] I.R.C. § 937 defines a bona fide resident of Puerto Rico as a person who is present for at least 183 days during the taxable year in Puerto Rico and who does not have a tax home (determined under the principles of § 911(d)(3) without regard to the second sentence thereof) outside such specified possession during the taxable year and does not have a closer connection (determined under the principles of § 7701(b)(3)(B)(ii)) to the United States or a foreign country than to such specified possession.

[3] The Modernized e-File project develops the modernized, web-based platform for filing approximately 330 IRS forms electronically, beginning with the Form 1120, *U.S. Corporation Income Tax Return*, Form 1120S, *U.S. Income Tax Return for an S Corporation*, and Form 990, *Return of Organization Exempt From Income Tax*. The project serves to streamline filing processes and reduce the costs associated with a paper-based process.

[4] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Based on a 1989 Tax Coordination Agreement between the United States and the Commonwealth of Puerto Rico, the Puerto Rico Department of the Treasury, known as La Hacienda, annually provides information on individuals reporting self-employment income on returns filed with La Hacienda. The analysis of Puerto Rico residents with self-employment income by the IRS Large Business and International (LB&I) Division falls under the Information Sharing Agreements section of the LB&I Division Fiscal Year (FY)[5] 2016 program letter, which states that the IRS will assess information received under agreements with foreign banks and other service providers, including data received via treaty requests by the U.S. Competent Authority, and examine taxpayers who present the highest compliance risk. Each year, La Hacienda transmits a data file to the IRS containing information on Puerto Rican income tax filers who reported self-employment earnings on their Puerto Rico tax forms. Individuals with net self-employment earnings of $400 or more should have also reported their self-employment income to the IRS. The LB&I Division, Assistant Deputy Comissioner Compliance Integration's Compliance Planning and Analytics (CP&A) function, which is responsible for identifying high-risk returns and issues, compares the La Hacienda file to IRS filing information, with the goal of identifying self-employed Puerto Rico residents who did not file a Form 1040-SS or Form 1040-PR (nonfilers), as well as those who reported different amounts of self-employment income to La Hacienda and the IRS (underreporters).

A Small Business/Self-Employed Division Research report issued in June 2009[6] identified a 33.8 percent nonfiler rate for Puerto Rico residents in Tax Year (TY)[7] 2007. This nonfiler rate was the estimated number of Puerto Rico residents with self-employment income who did not file an U.S. self-employment tax return, divided by the number expected to file based on self-employment income reported by La Hacienda. The report concluded that $52.8 million in SET was unreported in TY 2007 and recommended that the IRS should continue efforts to improve the tax compliance of self-employed residents of Puerto Rico.

As shown in Figure 1, our evaluation of self-employment return data provided by La Hacienda compared to IRS filings for TYs 2012 and 2013 indicates that although the nonfiler rate declined slightly from TY 2012 to TY 2013, there were more than 48,000 nonfilers who failed to report more than $56 million in SET for TY 2013.

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[5] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

[6] *Identify Tax Year 2007 Puerto Rican Self-employed Nonfilers and Underreporters*, Small Business/Self-Employed Division Research report DAL0082, June 2009.

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

Figure 1: Puerto Rico Self-Employment Tax Nonfiling Data, TYs 2012 - 2013

	TY 2012	TY 2013
Number of Nonfilers	42,423	48,293
Nonfiling Rate	31%	30%
Nonfiler SET	$34,033,074	$56,288,126

Source: *Treasury Inspector General for Tax Administration's (TIGTA) analysis of Puerto Rico source data and IRS filing information.*

Figure 2 shows that when compared to other examinations conducted by LB&I Division Withholding and International Individual Compliance (WIIC) Practice Area's tax examiners (TE), Puerto Rico tax examinations have a lower no-change rate and examiner hours per return, but also result in lower assessed taxes per return.

Figure 2: Comparison of Selected Productivity Statistics for Puerto Rico SET Examinations to Other LB&I Division TE Examinations, FYs 2013 - 2015

	Puerto Rico SET TE Examinations	Other LB&I Division TE Examinations
Total Examinations	14,780	13,200
Total No-Changes	341	1,925
No-Change Rate	2.31%	14.6%
Total Assessed Taxes	$37,995,263	$72,890,713
Examiner Time (Hours)	39,569	47,291
Assessed Taxes Per Examiner Hour	$960	$1,541
Assessed Taxes Per Return	$2,571	$5,522
Examiner Hours Per Return	2.7	3.6

Source: *TIGTA's analysis of IRS examination data.*

This review was performed at the LB&I Division CP&A function in Washington, D.C., and the LB&I Division's WIIC Practice Area Campus Compliance Unit in Austin, Texas, during the period October 2015 through March 2017. 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.

Results of Review

The compliance rate of Puerto Rico residents with self-employment income reporting requirements has shown some improvement since a 2009 report by the Small Business/Self-Employed Division Research function found that 33.8 percent of Puerto Rico residents failed to report self-employment income. However, improvements are needed to ensure that Puerto Rico residents with unreported and underreported self-employment income are properly identified and examined. Specifically:

- The LB&I Division is not effectively identifying Puerto Rico residents with unreported or underreported self-employment income.
- Some Puerto Rico residents with no requirement to report self-employment income were incorrectly selected for examination.

The Large Business and International Division Did Not Effectively Identify Puerto Rico Residents With Unreported or Underreported Self-Employment Tax

The LB&I Division CP&A function matches the information received from La Hacienda with IRS data on individuals filing Forms 1040-SS or 1040-PR. Individuals with no record of filing Form 1040, Form 1040-SS, or Form 1040-PR for the tax year they reported self-employment earnings to La Hacienda are identified as potential nonfilers, while individuals who reported lower self-employment earnings on their Form 1040, Form 1040-SS, or Form 1040-PR than they reported to La Hacienda are identified as potential underreporters. Puerto Rico nonfilers and underreporters meeting a minimum dollar threshold of net income from self-employment are identified by the CP&A function and sent to its Classification group, which performs additional research on each identified individual and determines whether the case should be sent to the field for examination.

The LB&I Division WIIC Practice Area is responsible for administering the tax laws affecting individuals with international activity, including the Form 1040, Form 1040-SS, or Form 1040-PR filed by Puerto Rico residents. Those individuals selected for examination due to potential unreported or underreported SET are assigned to the TEs in a WIIC Practice Area Campus Compliance Unit in Philadelphia, Pennsylvania, or Austin, Texas, for examination. Puerto Rico SET examinations are typically limited in scope, meaning that the Campus Compliance Unit mails a notice to the identified individual with the proposed SET assessment and evaluates any responses received. The identified individual may: 1) agree with the SET assessment and make arrangements to pay the tax; 2) respond to the notice and agree to a different amount of self-employment income; or 3) dispute the entire SET liability. However, if the identified individual does not respond to the initial IRS notice, as well as subsequent follow-up notices, the examiner will close the case for issuance of a statutory notice of deficiency using the procedures found in Internal Revenue Manual Section 4.8.9.[8]

We reviewed the data provided by La Hacienda to the LB&I Division for TYs 2012 and 2013.[9] The process of obtaining and analyzing La Hacienda data for noncompliant taxpayers should be documented and consistently applied. However, the LB&I Division did not maintain any documentation of the methodology used to analyze the Puerto Rico data. Because of the lack of established procedures, as well as staffing changes, the data analysis process differed for TYs 2012 and 2013. However, as a result of this review the LB&I Division has begun documenting its procedures for obtaining and analyzing La Hacienda data.

In TY 2012, the data analysis was done jointly by the CP&A function and the LB&I Division International Data Management organization, now known as the LB&I Division Data Solutions organization. International Data Management was created to oversee implementation of the Foreign Account Tax Compliance Act,[10] and to improve the efficiency and flexibility of the data required for effective international tax administration. The TY 2013 data analysis was completed by the CP&A function's Data Analysis group using personnel unfamiliar with the process of receiving and analyzing data from La Hacienda. Because the TY 2013 data were not provided until May 2015, the Data Analysis group had a limited amount of time to analyze the TY 2013 La Hacienda data to provide examiners sufficient time to assess any taxes due.[11]

Nonfilers were not always identified

As shown in Figure 3, our review found 923 nonfilers for TY 2012 and 11,016 nonfilers for TY 2013 that the Data Solutions organization and the CP&A function did not identify in their data analyses. As a result of problems with the LB&I Division's analyses, we analyzed the La Hacienda data and identified potential underreported and unreported SET of $1,605,255 for TY 2012 and $28,399,252 for TY 2013. Applying the historical average no-change rate for Puerto Rico SET examinations of 2.31 percent, we estimate that the LB&I Division could have assessed $1,568,174 in TY 2012 and $27,743,229 in TY 2013.[12] When the results are forecasted for a total of five years, we estimate that approximately $112.4 million in SET may not have been identified.[13] The significant differences between the unidentified SET for TYs 2012 and

[8] Internal Revenue Manual 4.8.9 (Aug. 11, 2016).
[9] The LB&I Division had not received the La Hacienda data for TY 2014 at the time of our analysis.
[10] Pub. L. No. 111-147, Subtitle A, 124 Stat 97 (2010) (codified in scattered sections of 26 U.S.C.).
[11] Generally, the IRS must assess any taxes no later than three years from the date the tax return is filed. I.R.C. § 6501(a).
[12] See Figure 2 for the average no-change rate for Puerto Rico SET examinations.
[13] The five-year total consists of the potential unidentified SET for TY 2012 added to a four-year forecast of the potential unidentified SET for TY 2013 (TY 2013 potential unidentified SET multiplied by four), reduced by the 2.31 percent no-change rate for Puerto Rico examinations shown in Figure 2. The forecast assumes, among other considerations, that economic conditions and tax laws do not change. See Appendix IV.

2013 are due to the data analysis process being performed by completely different groups in each year. Additionally, the criteria used to identify records for potential examination was different for each year. In TY 2012, nonfilers were identified by ranking approximately 6,000 Puerto Rico residents. In TY 2013, all Puerto Rico residents with unreported SET above a certain threshold were identified for potential examination. We used the LB&I Division's criteria for each tax year to compute the potential underreported and unreported SET. The lack of documented standardized procedures allowed for inconsistent analyses, with notably different results and problems.

Figure 3: Puerto Rico Residents With Potential Unreported Self-Employment Tax Not Identified by the LB&I Division

	TY 2012	TY 2013
Unidentified Nonfilers	923	11,016
Potential Unidentified SET	$1,605,255	$28,399,252

Source: *TIGTA's analysis of Puerto Rico source data and IRS filing information.*

Problems with the data provided by La Hacienda were also part of the reason for the LB&I Division's incomplete identification of nonfilers. These problems included:

- Data format: The data initially provided by La Hacienda was not in a useable format. La Hacienda provided the IRS with a text file that was not delimited. The file required additional information to translate the data into a format that was useful for data analysis. The IRS encountered delays in obtaining the required information from La Hacienda to analyze the data.
- Primary and secondary filers: The primary and secondary filers in the La Hacienda list did not always correspond to a primary or secondary filer in IRS databases, making the identification of potential nonfilers more difficult.
- Delayed receipt of data: The Government of Puerto Rico has a mandatory filing calendar similar to the United States. However, the data is often delivered many months after the end of the tax year. For example, the TY 2012 data were provided to the IRS in December 2013, the TY 2013 data were provided in May 2015, and the TY 2014 data were provided in May 2016.

We also reviewed the methods used by the LB&I Division to analyze the La Hacienda data for TYs 2012 and 2013. Due to the lack of procedural documentation and staffing changes, we recreated the La Hacienda data analysis from the source files to the end results. Our data analysis consisted of:

- Formatting La Hacienda source data to prepare the data for analysis.
- Merging formatted La Hacienda data with filing data from the IRS to compare filing activity.
- Merging formatted La Hacienda data with self-employment income reported to the IRS to compare reported self-employment income and identify variances.
- Comparing our results to the LB&I Division's results and identifying variances.

For the TY 2012 data, the LB&I Division stated that it selected the "top" 6,078 taxpayer accounts by ranking the records by highest unreported SET. In some instances, spouses of ranked Puerto Rico residents were included despite having little or no unreported SET.[14] The criteria that the LB&I Division used to select these records was not documented and could not be determined by later analysis. We developed a list of the 6,000 records in the TY 2012 data with the highest total amount of potentially unreported SET. Our list contained 923 records that had greater potential unreported SET than the records on the LB&I Division's list, with a total of $1,605,255 in additional potential unreported SET. Applying the historical average no-change rate for Puerto Rico SET examinations of 2.31 percent, we estimate that the LB&I Division could have assessed additional SET of $1,568,174 in TY 2012.[15]

For the TY 2013 data, the LB&I Division identified Puerto Rico residents who were the primary filers with unreported SET above a certain threshold. The secondary filers (spouses) were identified using a lower threshold amount of unreported SET. We used the LB&I Division's threshold amount of unreported SET for primary filers and compared our results to LB&I Division's list, identifying an additional 11,016 nonfilers with potential unreported SET of $28,399,252. Applying the historical average no-change rate for Puerto Rico SET examinations of 2.31 percent, we estimate that the LB&I Division could have assessed additional SET of $27,743,229 in TY 2013. When the results for TYs 2012 and 2013 are forecasted over five years, we estimate that a total of approximately $112.4 million in SET may have been unreported.[16]

Management Actions

After reviewing our methodology for analyzing La Hacienda data that identified potentially noncompliant Puerto Rico residents, the LB&I Division reexamined the data for TY 2013 and

[14] Nonfiler cases for married couples must be closed separately unless the taxpayer responds to IRS correspondence because examiners cannot make elections for nonfiling taxpayers.
[15] See Figure 2 for the average no-change rate for Puerto Rico SET examinations.
[16] The five-year forecast is based on multiplying the TY 2013 base year by four and adding the TY 2012 base year. The forecast assumes, among other considerations, that economic conditions and tax laws do not change. See Appendix IV.

identified an additional 6,636 Puerto Rico nonfilers. Information on the additional taxpayers was sent to the Classification group for risk assessment and assignment to the field for examination.

Potential underreporters were not effectively identified or addressed

For TYs 2012 and 2013, the LB&I Division did not examine any of the potential SET underreporters identified by its analysis because the delay in receiving and analyzing the La Hacienda data limited the time remaining on the assessment statute of limitations.[17] The assessment statute of limitations for Form 1040, Form 1040-SS, and Form 1040-PR is three years after the due date of the return or the date the return was filed, whichever is later. However, for nonfilers, the three-year period of the assessment statute does not begin until the return is filed.

The IRS received the TY 2012 data in December 2013 and the TY 2013 data in May 2015, which gave the LB&I Division a limited amount of time to analyze the La Hacienda data and initiate examinations for underreporters. For example, the LB&I Division did not complete the analysis of the TY 2013 La Hacienda data until August 2015. Therefore, a TY 2013 return filed on the due date of April 15, 2014, would have only 20 months remaining on the assessment statute of limitations by the time the data analysis was complete.[18] Because the time period of the assessment statute of limitations has not begun for nonfilers of Form 1040, Form 1040-SS, and Form 1040-PR, the LB&I Division should prioritize the examination of Puerto Rico residents who may have underreported their SET.

As shown in Figure 4, our review of the La Hacienda data for TYs 2012 and 2013 identified 17,107 Puerto Rico residents in TY 2012 and 20,317 in TY 2013 who potentially underreported their SET. The potential underreported SET was $21,457,386 for TY 2012 and $38,805,335 for TY 2013. Applying the historical average no-change rate for Puerto Rico SET examinations of 2.31 percent, we estimate that the LB&I Division could have assessed $20,961,720 in TY 2012 and $37,908,932 in TY 2013.[19] When the results for TYs 2012 and 2013 are forecasted over five years, we estimate that a total of approximately $172.6 million in the SET may have been underreported.[20]

[17] The assessment statute of limitations is a time period established by law to review, analyze, and resolve taxpayer and/or IRS tax-related issues.
[18] A return filed on April 15, 2014 would have an assessment statute of limitations expiration date of April 15, 2017. Because April 2014 to August 2015 is 16 months, 20 months would be remaining on the statute of limitations.
[19] See Figure 2 for the average no-change rate for Puerto Rico SET examinations.
[20] The five-year forecast is based on multiplying the TY 2013 base year by four and adding the TY 2012 base year. The forecast assumes, among other considerations, that economic conditions and tax laws do not change. See Appendix IV.

Figure 4: Puerto Rico Residents With Underreported Self-Employment Tax, TYs 2012 - 2013

	TY 2012	TY 2013
Underreporters[21]	17,107	20,317
Underreported SET	$21,457,386	$38,805,335

Source: *TIGTA's analysis of Puerto Rico source data and IRS filing information.*

Recommendations

The Director, CP&A, LB&I Division, should:

Recommendation 1: Evaluate the data analysis process and methodology to analyze the La Hacienda data and document the process to be used in the future.

> ***Management's Response:*** IRS management agreed with our recommendation and stated that they have completed review and testing of the process and methodology used for analysis of La Hacienda data. The written process is documented within the LB&I Division's internal workload selection site and will be used to process La Hacienda data going forward.

Recommendation 2: Work with the Office of Privacy, Governmental Liaison, and Disclosure and La Hacienda for more timely receipt of the annual data file.

> ***Management's Response:*** IRS management agreed with our recommendation and stated that they will continue to follow the process and established procedures to request data from La Hacienda, including elevating issues to higher levels of the Puerto Rico Government when necessary.

Recommendation 3: Analyze and examine underreported Puerto Rico self-employment tax in addition to nonfilers, as permitted by resources and the assessment statute of limitations.

> ***Management's Response:*** IRS management agreed with our recommendation and stated that in response to TIGTA's identification of additional underreporter cases, the LB&I Division took prompt action to move this work into the examination workstream, contingent on existing statutes of limitations and available resources.
>
> IRS management did not agree with the outcome measures. They stated that they have already implemented the changes in their processes and, in light of these changes, it is more appropriate to measure the outcomes over the two years reviewed in the audit,

[21] Puerto Rico residents with a self-employment tax liability and a variance of more than $100 in tax liability from filed amount.

rather than the five-year projection used by TIGTA. IRS management also did not agree with the tolerances used by TIGTA to identify potential nonfilers and underreporters.

Office of Audit Comment: We stand by our outcome measures as presented. Although the IRS stated that it has made changes based on the results and recommendations in this report, the five-year forecasts are meant to show the value of our recommendations and quantify not only the results for the two years we reviewed, but also what may have happened in the following three years if we did not identify the weaknesses and make the recommendations. We also note that the $400 statutory liability mentioned by IRS management in their response is the minimum self-employment income required to file a return. The $100 amount used by TIGTA to calculate the outcome measure was for potential SET, which is approximately the amount of tax that would be assessed on $800 in self-employment income.

The Large Business and International Division Selected and Examined Some Puerto Rico Residents As Nonfilers Who Did Not Have a Filing Requirement

The Government Accountability Office defines data reliability as data that are reasonably complete and accurate, meet the intended needs of the user, and are not subject to inappropriate alteration.[22] Due to incomplete written procedures for data validation, staffing issues, and problems related to the data format (as discussed earlier in this report), the evaluation of the La Hacienda data by the CP&A function erroneously identified Puerto Rico residents without a filing requirement as taxpayers with unreported SET. Some of these residents were incorrectly selected for examination, which resulted in some erroneous SET assessments.

The primary reason for the incorrect assessments in TY 2012 was that some raw data from La Hacienda did not distinguish between positive and negative amounts. For this reason, some self-employed taxpayers with operating losses (expenses exceeding revenues) appeared to have taxable net income from self-employment. Simple validation checks, such as comparing calculated net self-employment income (revenue minus expenses) to reported net self-employment income, would have disclosed many of the errors in the data and avoided the unnecessary examinations of Puerto Rico residents.

Figure 5 shows that the LB&I Division incorrectly identified a total of 967 Puerto Rico residents as nonfilers for TYs 2012 and 2013 and evaluated the residents for potential examination. The 967 incorrectly identified residents either did not have a requirement to file a Form 1040, Form 1040-SS, or Form 1040-PR (due to having self-employment income below the filing requirement), or the residents had previously filed a Form 1040, Form 1040-SS, or

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[22] Government Accountability Office, GAO-09-680G, *Assessing the Reliability of Computer-Processed Data* (July 2009).

Form 1040-PR for the appropriate tax year. These residents should not have been identified as nonfilers because they were either compliant with filing requirements or were filers who should have been evaluated as underreporters. For the 756 residents incorrectly identified for TY 2012, the LB&I Division incorrectly initiated examinations on at least 111 Puerto Rico residents, even though the residents did not have a requirement to file a Form 1040, Form 1040-SS, or Form 1040-PR.

Figure 5: Incorrectly Identified and Examined Puerto Rico Residents (Did Not Have a Filing Requirement or Met Filing Requirement)

	TY 2012	TY 2013	Total
Incorrectly Identified Taxpayers	756	211	967
Incorrectly Examined Taxpayers	111	0	111

Source: *TIGTA's analysis of Puerto Rico source data, IRS data analysis results, and IRS filing information.*

The 111 residents incorrectly selected for examination had self-employment expenses exceeding self-employment revenue. However, the La Hacienda data showed a positive amount for net self-employment income in the exact amount that self-employment expenses exceeded revenue. Because their self-employment expenses exceeded revenue, the residents' net self-employment income was negative and they were not required to pay SET or file a Form 1040, Form 1040-SS, or Form 1040-PR. However, the LB&I Division calculated SET using the self-employment income amount reported by La Hacienda, and incorrectly assessed the 111 taxpayers a total of $286,548 in SET. Of these incorrectly initiated examinations, 81 residents were assessed $249,937 in SET using statutory notice of deficiency procedures because the residents did not respond to IRS contact letters or the contact letters were returned as undeliverable. As of February 2017, the IRS had collected at least $31,337 in SET from these incorrectly initiated examinations. However, an uncollected assessment can remain on the resident's tax account for 10 years and result in future tax refunds or other Government payments being used to offset the assessment.[23]

[23] Pursuant to I.R.C. § 6502, the collection statute of limitations is 10 years, although it can be longer depending on whether the running of the statute is suspended upon the occurrence of certain events.

Recommendations

The Director, CP&A, LB&I Division, should:

Recommendation 4: Evaluate the examinations identified for TY 2012 and correct any identified erroneous assessments.

> ***Management's Response:*** IRS management agreed with our recommendation and stated that the Data Analytics group identified those taxpayers erroneously assessed and prepared and submitted Form 3870, *Request for Adjustment*, to process the corrections and reverse the erroneous assessments.

Recommendation 5: Develop and implement written procedures to validate the data provided by La Hacienda.

> ***Management's Response:*** IRS management agreed with our recommendation and stated that the CP&A function has developed written policies and procedures to validate data provided by La Hacienda. The process outlined in the written documentation was used in the processing of TY 2014 data and will be used for TY 2015 and subsequent years upon receipt.

Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine how effectively the LB&I Division identifies and addresses noncompliance of residents of Puerto Rico who have self-employment income but fail to report or underreport their self-employment income to the U.S. Government. To accomplish our objective, we:

I. Identified the applicable policies, procedures, and controls to identify and classify Puerto Rico residents with unreported and underreported self-employment income.

   A. Reviewed applicable return processing procedures for returns filed by Puerto Rico residents and documented the flow of a filed return.

   B. Reviewed IRS procedures and interviewed IRS officials to determine what controls were in place to identify and classify Puerto Rico residents with unreported or underreported self-employment income.

   C. Documented and evaluated the WIIC Practice Area Data Analysis group's process for receiving the La Hacienda file and analyzing it for transmission to the Classification group.

   D. Determined the status of any additional ongoing IRS planning efforts and initiatives related to this area, including automated systems to identify nonfilers and underreporters, matching programs, and classification processes.

II. Identified prior external and internal reviews regarding SET nonfiling or underreporting by Puerto Rico residents.

III. Assessed the IRS's selection of returns with unreported or underreported SET by residents of Puerto Rico for audit.

   A. Obtained the La Hacienda data file for TYs 2012 and 2013 and the corresponding WIIC Practice Area Data Analysis files. We evaluated the completeness of the Data Analysis file by comparing it to the La Hacienda file. We validated the data in the Data Analysis file by randomly selecting 30 records and comparing them to the Integrated Data Retrieval System.[1]

   B. Determined whether the IRS followed the procedures identified in Step I.B. in selecting returns for audit.

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

C. Determined the number of returns in the WIIC Practice Area Data Analysis file selected for audit. We compared the characteristics of the returns chosen for audit to the selection guidelines identified in Step I.B.

D. Determined the IRS's reasoning for the number and characteristics of returns selected for audit from the TYs 2012 and 2013 data files by interviewing personnel involved with the selection.

IV. Assessed the effectiveness of the audits of returns with unreported or underreported SET by residents of Puerto Rico.

A. Obtained, validated, and evaluated closed Audit Information Management System[2] examination data for FY 2014 through FY 2015 for audits of individual returns by LB&I Division TEs.

1. Calculated overall productivity metrics such as the no-change rate, assessed dollars per hour, and assessed dollars per return.
2. Calculated productivity metrics for audits of Puerto Rico residents with unreported or underreported SET and compared to the metrics of similar LB&I Division TE audits for the same fiscal year.
3. Determined the disposition of the audits of Puerto Rico residents with unreported or underreported SET by disposal code, such as Disposal Codes 01 and 02 (no-change), Disposal Codes 03 and 04 (agreed), and Disposal Code 10 (default). We compared to the dispositions of similar LB&I Division TE audits for the same fiscal year.

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 and procedures for processing and analyzing data received from Puerto Rico, selecting Puerto Rico residents for examination, and examining selected Puerto Rico residents. We evaluated these controls by interviewing management and analysts responsible for executing the program, reviewing applicable documentation, and reviewing closed examination cases.

[2] A computer system used by the Small Business/Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.

Appendix II

Major Contributors to This Report

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Glen J. Rhoades, Director
Robert M. Jenness, Audit Manager
John Park, Lead Auditor
Debra Mason, Senior Auditor
William Tran, Senior Auditor
Ali Vaezazizi, Auditor

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Director, Compliance Planning and Analytics, Large Business and International Division
Director, Withholding and International Individual Compliance, Large Business and International 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.[1] These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

Total potential increased revenue of $112.4 million[2] in SET on 43,950 tax returns over five years,[3] as shown below.

- Increased Revenue – Potential; $1.6 million in SET on 902 tax returns for TY 2012 due to potentially noncompliant taxpayers who were not identified by the LB&I Division's analysis (see page 5).
- Increased Revenue – Potential; $27.7 million in SET on 10,762 tax returns for TY 2013 due to potentially noncompliant taxpayers that were not identified by the LB&I Division's analysis (see page 5).

Methodology Used to Measure the Reported Benefit:

We used data from La Hacienda to identify residents of Puerto Rico with self-employment income for TYs 2012 and 2013 and compared the results to IRS Individual Master File[4] data to obtain a list of Puerto Rico residents who were required to file a Form 1040, *U.S. Individual Income Tax Return*; Form 1040-SS, *U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*; or Form 1040-PR (for Puerto Rico residents who wish to file in Spanish) but failed to file. Our review found that the IRS did not identify all nonfilers in its data analyses. The potential assessment amount of $1,568,174 for TY 2012 was calculated by applying the average no-change rate for Puerto Rico SET examinations of 2.31 percent to the total potential unidentified SET for TY 2012 of $1,605,255.[5]

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[1] The numbers of tax returns and dollar values in this appendix were derived from analyses of historical data, and are thus considered potential barometers of the impact of audit recommendations. Actual results will vary depending on the timing and extent of management's implementation of the corresponding corrective actions, and the number of accounts affected as of the dates of implementation.
[2] Due to rounding, the total potential increased revenue may not equal the sum of the detailed calculations.
[3] The total five-year period consists of the potential increased revenue for TY 2012 and a four-year forecast of potential increased revenue for TY 2013.
[4] The IRS database that maintains transactions or records of individual tax accounts.
[5] The historical average no-change rate was calculated by dividing total no-change examinations by total exams closed for FYs 2013 through 2015. See Figure 2 in the report body.

The potential number of tax returns with assessments was also calculated by applying the average no-change rate of 2.31 percent to the 923 returns that were not identified by the LB&I Division's analysis. The SET amount calculated for TY 2012 was only used for that year because the data analysis process changed in TY 2013.

We calculated the SET owed by the potential nonfilers not identified by the process used in TY 2013 and forecast this amount for an additional three years. The potential assessment amount of $27,743,229 for TY 2013 was calculated by applying the average no-change rate for Puerto Rico SET examinations of 2.31 percent to the total potential unidentified SET for TY 2013 of $28,399,252. The potential number of tax returns with assessments was also calculated by applying the average no-change rate of 2.31 percent to the 11,016 returns that were not identified by the LB&I Division's analysis. The four-year forecast is $110.8 million (43,048 tax returns), computed by multiplying $27.7 million (10,762 tax returns) by four years.[6] Because the LB&I Division used a different process to identify noncompliant taxpayers for TY 2013, we did not include the TY 2012 outcome measure in this forecast, but added the TY 2012 amount to the four-year forecast amount to produce the total outcome measure.

Type and Value of Outcome Measure:

Total potential increased revenue of $172.6 million in SET on 96,104 tax returns over five years,[7] as shown below.

- Increased Revenue – Potential; $21.0 million in SET on 16,712 tax returns for TY 2012 due to potentially noncompliant taxpayers that were not placed under examination by the LB&I Division (see page 5).
- Increased Revenue – Potential; $37.9 million in SET on 19,848 tax returns for TY 2013 due to potentially noncompliant taxpayers that were not placed under examination by the LB&I Division (see page 5).

Methodology Used to Measure the Reported Benefit:

We used data from La Hacienda to identify residents of Puerto Rico with self-employment income for TYs 2012 and 2013 and compared the results to IRS Individual Master File data to obtain a list of Puerto Rico residents who filed a Form 1040, Form 1040-SS, or Form 1040-PR but underreported their tax liability. Because the IRS did not consider any underreporters for potential examination, all underreporters we identified were included in the forecast. Forecasted assessments were then decreased by the historical no-change rate of 2.31 percent.

[6] The four-year forecast is based on multiplying the base year by four and assumes, among other considerations, that economic conditions and tax laws do not change.
[7] The five-year forecast period consists of potential Increased Revenue for TY 2012 and four-year forecast of potential Increased Revenue for TY 2013.

The potential assessment amount of $20,961,720 for TY 2012 was calculated by applying the average no-change rate for Puerto Rico SET examinations of 2.31 percent to the total potential underreported SET for TY 2012 of $21,457,386. The potential number of tax returns with assessments was also calculated by applying the average no-change rate of 2.31 percent to the 17,107 returns that were not identified by the LB&I Division's analysis. The SET amount calculated for TY 2012 was only used for that year because the data analysis process changed in TY 2013.

The potential assessment amount of $37,908,932 for TY 2013 was calculated by applying the average no-change rate for Puerto Rico SET examinations of 2.31 percent to the total potential unidentified SET for TY 2013 of $38,805,335. The potential number of tax returns with assessments was also calculated by applying the average no-change rate of 2.31 percent to the 20,317 returns that were not identified by the LB&I Division's analysis. The four-year forecast is $151.6 million (79,392 tax returns), computed by multiplying $37.9 million (19,848 tax returns) by four years.[8] Because the LB&I Division used a different process to identify noncompliant taxpayers for TY 2013, we did not include the TY 2012 outcome measure in this forecast, but added the TY 2012 amount to the four-year forecast amount to produce the total outcome measure.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 111 taxpayer accounts incorrectly placed under examination (see page 11).

Methodology Used to Measure the Reported Benefit:

We used data from La Hacienda to identify residents of Puerto Rico with self-employment income for TYs 2012 and 2013 and compared the results to IRS Individual Master File data to obtain a list of Puerto Rico residents who did not have a filing requirement. The results were compared to lists of residents selected for examination. Using an extract of closed cases from the Audit Information Management System, we generated a list of Puerto Rico residents without a filing requirement who were selected for examination.

[8] The four-year forecast is based on multiplying the base year by four and assumes, among other considerations, that economic conditions and tax laws do not change.

Appendix V

Management's Response to the Draft Report

COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

July 11, 2017

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT
MICHAEL E. McKENNEY

FROM: Douglas W. O'Donnell Douglas W. O'Donnell
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2015-30-038, Improvements Are Needed To Ensure That Puerto Rico Residents With Unreported And Underreported Self-Employment Tax Are Properly Identified And Examined

Thank you for the opportunity to review and comment on the draft report: *Improvements Are Needed To Ensure That Puerto Rico Residents With Unreported and Underreported Self-Employment Tax Are Properly Identified And Examined (TIGTA 2015-30-038)*. We appreciate the collaborative effort between the TIGTA Audit team and the IRS Large Business and International (LB&I) personnel to identify opportunities for improvement of our processes.

The TIGTA report emphasizes the need for LB&I to better establish processes and methodologies for analysis of data received from La Hacienda and to document those procedures. LB&I has completed and tested revised policies and procedures developed to ensure accurate processing and equitable treatment of the taxpayer population. IRS will continue its outreach to La Hacienda to encourage timely submission of La Hacienda data, including elevating issues to higher levels of the Puerto Rico Government when necessary. In response to TIGTA's identification of additional underreporter cases, LB&I took prompt action to move this work into the examination workstream, contingent on existing statutes of limitations and available resources. LB&I is working to improve taxpayer compliance related to self-employment taxes due from Puerto Rico residents, including efforts involving taxpayer education and identifying and implementing improved efficiencies in the examination process. The goal is to ensure that taxpayers understand their filing obligations and comply voluntarily, reducing the need for compliance resources. The revised policies and procedures will be documented within LB&I's internal workload selection site.

We agree with the report's recommendations. We disagree with the outcome measures that are based on a five year impact. These measures are based on case identification procedures that have since been corrected and implemented in light of TIGTA's findings and recommendations in this report. The use of a $100 threshold in estimating the impact of the changes is inconsistent with current workload selection practices. The

$100 threshold used in estimating the Outcome Measures inflates the impact of TIGTA's findings and, if implemented, would result in an inefficient use of already limited resources.

We have attached a detailed response outlining our corrective actions and outcome measures.

If you have any questions, please contact me or members of your staff may contact John V. Cardone, Director, Withholding & International Individual Compliance Practice Area at (202) 317-8830.

Attachments (2)

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Attachment I

RECOMMENDATION 1:
The Director, Compliance Planning & Analytics (CP&A) LB&I Division, should evaluate the data analysis process and methodology to analyze La Hacienda data and document the process to be used in the future.

CORRECTIVE ACTIONS:
We agree with this recommendation. LB&I has completed review and testing of the process and methodology used for analysis of La Hacienda data. The written process and methodology is documented within LB&I's internal workload selection site and will be used to process La Hacienda data going forward.

IMPLEMENTATION DATE:
Completed

RESPONSIBLE OFFICIAL(S):
The Director, Compliance Planning & Analytics

CORRECTIVE ACTION(S) MONITORING PLAN:
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2:
The Director, Compliance Planning & Analytics (CP&A) LB&I Division, should work with the Office of Privacy, Governmental Liaison, and Disclosure (PGLD) and La Hacienda for more timely receipt of the annual data file.

CORRECTIVE ACTIONS:
We agree with this recommendation. We will continue to follow the process and established procedures to request the data from La Hacienda, including elevating issues to higher levels of the Puerto Rico Government when necessary.

IMPLEMENTATION DATE:
Completed

RESPONSIBLE OFFICIAL(S):
The Director, Compliance Planning & Analytics

CORRECTIVE ACTION(S) MONITORING PLAN:
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3:
The Director, Compliance Planning & Analytics (CP&A) LB&I Division, should analyze and examine underreported Puerto Rico self-employment tax in addition to non-filers, as permitted by resources and the assessment statute of limitations.

CORRECTIVE ACTIONS:
We agree with this recommendation. In response to TIGTA's identification of additional underreporter cases, LB&I took prompt action to move this work into the examination workstream, contingent on existing statutes of limitations and available resources.

IMPLEMENTATION DATE:
Completed

RESPONSIBLE OFFICIAL(S):
The Director, Compliance Planning & Analytics

CORRECTIVE ACTION(S) MONITORING PLAN:
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4:
The Director, Compliance Planning & Analytics (CP&A) LB&I Division, should evaluate the examinations identified for TY 2012 and correct any identified erroneous assessments.

CORRECTIVE ACTIONS:
We agree with this recommendation. The Data Analytics group identified those taxpayers erroneously assessed and prepared and submitted Form 3870, Request for Adjustment, to process these corrections and reverse the erroneous assessments..

IMPLEMENTATION DATE:
Completed

RESPONSIBLE OFFICIAL(S):
The Director, Compliance Planning & Analytics

CORRECTIVE ACTION(S) MONITORING PLAN:
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5:
The Director, Compliance Planning & Analytics (CP&A) LB&I Division, should develop and implement written procedures to validate the data provided by La Hacienda.

CORRECTIVE ACTIONS:
We agree with this recommendation. CP&A has developed written policies and procedures to validate data provided by La Hacienda. The process outlined in the written documentation was used in the processing of tax year 2014 data and will be used for 2015 and subsequent years upon receipt.

IMPLEMENTATION DATE:
Completed

RESPONSIBLE OFFICIAL(S):
The Director, Compliance Planning & Analytics

CORRECTIVE ACTION(S) MONITORING PLAN:
We will monitor this corrective action as part of our internal management control system.

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Attachment II

1. Type and Value of Outcome Measure:

Total potential increased revenue of $112.4 million in SET on 43,950 tax returns over five years, as shown below.

- Increased Revenue – Potential; $1.6 million in SET on 902 tax returns for TY 2012 due to potentially noncompliant taxpayers who were not identified by the LB&I Division's analysis (see page 5).
- Increased Revenue – Potential; $27.7 million in SET on 10,762 tax returns for TY 2013 due to potentially noncompliant taxpayers that were not identified by the LB&I Division's analysis (see page 5).

We disagree with using a five-year projection. As previously stated, we have already implemented these changes in our processes and identified the impact of the same in the years involved with this audit. In light of the changes made in response to the recommendations of the report, we think it is more appropriate to measure the outcomes over the two years reviewed by the auditors. Our recommended projection limits the Outcome Measures to the years involved with the audit (tax years 2012 and 2013) with an acknowledgment that these changes have been implemented and will not be repeated based on the safeguards implemented as a result of this audit. We are also concerned withthe use of a $100 threshold in determining the impact of these changes. Due to examination costs and significant resource constraints, P&WD would not identify, select, classify, or deliver work to the field with a potential adjustment of $100. The minimum statutory liability to require a filing is $400.

Type and Value of Outcome Measure:

Total potential increased revenue of $172.6 million in SET on 96,104 tax returns over five years, as shown below.

- Increased Revenue – Potential; $21.0 million in SET on 16,712 tax returns for TY 2012 due to potentially noncompliant taxpayers that were not placed under examination by the LB&I Division (see page 5).
- Increased Revenue – Potential; $37.9 million in SET on 19,848 tax returns for TY 2013 due to potentially noncompliant taxpayers that were not placed under examination by the LB&I Division (see page 5).

We disagree with using a five-year projection. As previously indicated, we have already implemented these changes in our processes and identified the impact of the same in the years involved with this audit. In light of the changes made in response to the recommendations of the report, we think it is more appropriate to measure the outcomes over the two years reviewed by the auditors. Our recommended projection limits the Outcome Measures to the years involved with the audit (tax years 2012 and 2013) with an acknowledgment that these changes have been implemented and will not be repeated based on the safeguards implemented as a result of this audit. We are also

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concerned with the use of a $100 threshold in determining the impact of these changes. Due to examination costs and significant resource constraints, P&WD would not identify, select, classify, or deliver work to the field with a potential adjustment of $100. The minimum statutory liability to require a filing is $400.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 111 taxpayer accounts incorrectly placed under examination (see page 10).

Changes in procedures and file layout identified during this audit and subsequent review of same have corrected this problem and should not be repeated again in identifying non-filer and under-reporter populations.