Improvements Have Been Made, but Controls Need to Be Strengthened to Detect Improper Self-Employed Retirement Deductions

December 10, 2020

Report Number: 2021-10-007

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HIGHLIGHTS: Improvements Have Been Made, but Controls Need to Be Strengthened to Detect Improper Self-Employed Retirement Deductions

Final Audit Report issued on December 10, 2020
Report Number 2021-10-007

Why TIGTA Did This Audit

TIGTA previously reported that the IRS did not have sufficient controls to identify taxpayers who deducted contributions made to self-employment retirement accounts but did not have evidence of self-employment activity. In response to our previous report, the IRS improved its process to detect unallowable self-employed retirement deductions. The overall objective of this audit was to determine whether the IRS has sufficient controls to prevent and detect improper deductions for contributions made by self-employed taxpayers to their self-employed retirement plans.

Impact on Taxpayers

Self-employed taxpayers may deduct contributions made to their own self-employed retirement accounts on their individual tax return under certain circumstances. Without effective controls to prevent or detect potentially improper deductions, self-employed individuals may claim unallowable or fraudulent deductions.

What TIGTA Found

The IRS improved internal controls to prevent self-employed retirement plan deductions for taxpayers who do not have evidence of self-employment. TIGTA previously reported that, in Tax Year 2011, 2 percent of tax returns filed claiming a self-employed retirement deduction did not have evidence of self-employment. In this review, TIGTA determined that, for Tax Year 2017, less than one-half of 1 percent of such returns did not have this evidence. The IRS's corrective actions resulted in an 84 percent improvement compared to the prior report. However, the IRS could further improve its process to confirm self-employment activity if it included Schedule SE, *Self-Employment Tax*, when processing tax returns.

The IRS could also make processing improvements to identify invalid deductions. For example, TIGTA determined that 42,991 tax returns potentially included deductions over permitted amounts. Additionally, 485 returns included deductions for Simplified Employee Pension plan contributions but did not report net earnings from self-employment. TIGTA estimates these potentially improper deductions resulted in an underpayment of approximately $178 million in taxes.

IRS studies have consistently demonstrated that compliance is higher when there is third-party information reporting. In contrast, reported amounts that have little or no information reporting, such as business income, have significantly lower compliance rates. Retirement plan administrators are not required to report contributions made to Defined Contribution and Defined Benefit Plans. TIGTA determined taxpayers deducted approximately $14.7 billion related to contributions for which third-party reporting for retirement contributions was not required.

When applicable, retirement plan administrators report contributions on Form 5498, *IRA Contribution Information*. However, unlike contributions made to traditional or Roth Individual Retirement Accounts, Form 5498 does not include all contributions made to self-employed retirement plans during the contribution window. For Tax Year 2017, TIGTA identified 193,985 tax returns with approximately $1.41 billion more in deductions than the amounts reported on Forms 5498. However, because Forms 5498 and the tax returns have different reporting periods, it is difficult for the IRS to identify any overstated deductions.

What TIGTA Recommended

TIGTA made six recommendations, including adding Schedule SE to processing controls, enhancing controls to determine the reasonableness of self-employed retirement deductions, assessing the need for additional third-party data to verify deductions, and changing Form 5498 instructions for consistency. In their response, IRS management agreed with two recommendations and plans to take corrective actions. However, the IRS did not agree to enhancing controls to determine the reasonableness of self-employed retirement deductions, assessing the need for additional third-party data, and changing the Form 5498 instructions. TIGTA believes these actions would improve tax compliance and potentially increase revenue by $890 million over the next five years.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 10, 2020

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

M. Weir for

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Have Been Made, but Controls Need to Be Strengthened to Detect Improper Self-Employed Retirement Deductions (Audit # 202010001)

This report presents the results of our review to determine whether the Internal Revenue Service has sufficient controls to prevent and detect improper deductions for contributions made by self-employed taxpayers to their self-employed retirement plans. This review is included in our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

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

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

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Background

Self-employed taxpayers are permitted to make contributions toward their own and their employees' retirement accounts through a variety of retirement plans. Self-employed individuals can make contributions to Simplified Employee Pension (SEP) plans, Savings Incentive Match Plan for Employees (SIMPLE) plans, Defined Contribution Plans, and Defined Benefit Plans. Figure 1 describes the basic rules associated with various self-employed retirement plans.

Figure 1: Summary of Self-Employed Retirement Plans

Type of Plan	Description of Plan
SEP	Under a SEP, self-employed taxpayers make contributions to a traditional Individual Retirement Arrangement (IRA) established for each eligible employee (employees own and control their SEP IRA).[1] To be eligible for a deduction for contributions to SEP retirement plans, taxpayers must have self-employed net earnings.
SIMPLE	SIMPLE plans allow the employees the option to defer income tax by making salary reduction contributions to the plan. Additionally, the employer can contribute matching or nonelective contributions. Employers have the option of setting up SIMPLE plans as an IRA or as part of a 401(k) plan.[2]
Defined Contribution Plan	Both employees and employers contribute to employees' individual accounts under Defined Contribution Plans. Generally, the contributions and earnings are not taxed until distribution. Examples of Defined Contribution Plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans. Third-party information reporting is not required for Defined Contribution Plans.
Defined Benefit Plan	Defined Benefit Plans provide fixed, preestablished benefits for employees. Contributions are based on the anticipated need to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Third-party information reporting is not required for Defined Benefit Plans.

Source: Tax Year (TY) 2017 Internal Revenue Service (IRS) Publication 560, Retirement Plans for Small Business; IRS.gov; and the Department of Labor.

Both SEP and SIMPLE plans are managed by financial institutions or entities approved by the IRS that serve as third-party trustees. These institutions annually notify employers, employees, and the IRS of contributions made to their SEP or SIMPLE plans via Form 5498, *IRA Contribution*

[1] An IRA is a tax-favored personal savings arrangement that allows individuals to set aside money for retirement.
[2] A 401(k) plan is a qualified plan that includes a feature allowing an employee to elect to have the employer contribute a portion of the employee's wages to an individual account under the plan.

Information.[3] Third-party trustees must provide Forms 5498 to taxpayers and the IRS each year by May 31.

For TY 2017, self-employed taxpayers claimed deductions for contributions to their SEP, SIMPLE, or other qualified retirement plans on Form 1040, *U.S. Individual Income Tax Return*, Line 28, *Self-employed SEP, SIMPLE, and qualified plans* (hereafter referred to as the self-employed retirement deduction).[4] Self-employed taxpayers report compensation[5] and net earnings on Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship);* Schedule E, *Supplemental Income and Loss;* or Schedule F, *Profit or Loss From Farming*.[6] For SEPs and all Defined Contribution Plans, the self-employed retirement deduction is limited to the lessor of $54,000 or 25 percent of the self-employed taxpayer's net earnings.[7]

Within the IRS, the Wage and Investment (W&I) Division compliance function addresses questionable refundable credits. As part of its oversight, the W&I Division checks for errors or improper refunds when it processes individual tax returns. For example, the Error Resolution units attempt to correct these errors or will correspond with taxpayers if more information is needed to do so.

In addition, the Small Business/Self-Employed (SB/SE) Division administers the Automated Underreporter (AUR) program that uses third-party data to identify taxpayers who have potentially understated or overstated entries on previously processed tax returns.

The Treasury Inspector General for Tax Administration (TIGTA) previously reported that the IRS had not implemented sufficient controls to prevent improper self-employed retirement deductions by self-employed taxpayers and that it could better use third-party data to detect potentially improper SEP self-employed retirement deductions.[8] In addition, TIGTA determined that the IRS could potentially detect additional improper self-employed retirement deductions if third-party reporting was required for all types of self-employed retirement plans that could be used to claim the deduction. As a result, TIGTA recommended that the IRS:

- Enhance existing validation programs to identify taxpayers whose retirement plan deductions are potentially improper based on other information reported on their individual tax return. This includes situations in which self-employed taxpayers did not provide evidence that they were self-employed.[9]

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[3] SEP and SIMPLE IRA plan contributions are reported on the Form 5498. See Appendix IV for a copy of the Form 5498.

[4] Since TY 2017, Form 1040 has been modified. For TY 2019, taxpayers claim the self-employed retirement deduction on Form 1040, Schedule 1, *Additional Income And Adjustments to Income,* Line 15, *Self-employed SEP, SIMPLE, and qualified plans*.

[5] Compensation is defined as the pay a participant received for personal services for a year, including wages, salaries, commissions, and bonuses. For self-employed individuals, compensation is a person's earned income, defined as the net earnings from self-employment (gross income from a trade or business minus allowable business deductions). For a self-employed individual, net earnings also include a partner's distributive share of partnership income or loss from Form 1065, *U.S. Return of Partnership Income*.

[6] Some taxpayers report self-employment income on the other income line on the tax return and file a Schedule SE. Although this is technically incorrect, the IRS indicated that it happens frequently.

[7] See Appendix III for more information. Married Filing Jointly taxpayers can deduct up to $108,000 if both taxpayers are self-employed.

[8] TIGTA, Ref. No. 2014-10-008, *Millions of Dollars in Potentially Improper Self-Employed Retirement Plan Deductions Are Allowed* (Mar. 2014).

[9] For this review, evidence of self-employment includes the presence of Schedule C, E, or F attached to the tax return.

- Use third-party data to detect potentially improper SEP deductions.
- Work with the Department of the Treasury to assess the cost effectiveness of recommending legislative changes expanding third-party information reporting currently required for SEPs, SIMPLEs, and other IRAs to other types of retirement plans that currently have no third-party information reporting requirement.

In their response, IRS management agreed to create controls during processing of the tax return to prevent taxpayers from claiming self-employed retirement deductions when there is no evidence of self-employment. Additionally, the IRS planned to have the AUR program begin identifying and resolving these discrepancies.

However, the IRS did not agree to the recommendation to work with the Department of the Treasury on a legislative change to require third-party information reporting for all self-employed retirement plans. IRS management stated that, although contributions for qualified retirement plans are not reported on Form 5498, such plans are subject to other types of reporting. IRS management further stated that, because the level of complexity affecting qualified plans is comparatively high while the volume of affected taxpayers is relatively low, they did not believe there were gains to be made by imposing additional reporting requirements on these plans. The IRS instead planned to determine if procedures could be revised to improve the examination referral process when the AUR program identifies questionable qualified plan issues.

Results of Review

Processing Changes Improved the Detection of Unallowable Self-Employed Retirement Deductions; However, More Improvements Can Be Made

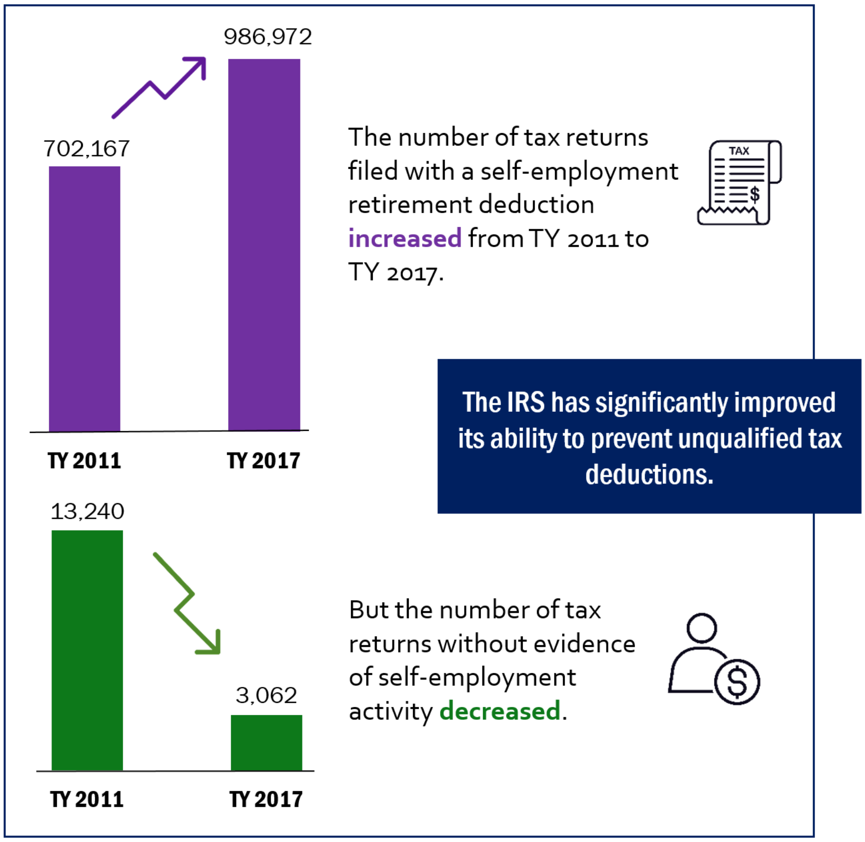
In response to TIGTA's prior report, the IRS created an error resolution code that identifies and selects for review electronic and paper tax returns for which taxpayers claim self-employed retirement deductions but the tax return is missing evidence of self-employment (*i.e.,* no attached Schedule C, E, or F). Tax examiners review the tax returns to determine if the taxpayer is entitled to the deduction and deny unallowable deductions.

TIGTA previously reported that 13,240 (2 percent) of 702,167 tax returns filed in TY 2011 included a self-employed retirement deduction but did not have evidence of self-employment. We estimated that this resulted in tax underpayment of more than $14 million.[10]

Our analysis of TY 2017 tax returns with self-employed retirement deductions identified that 3,062 (less than one-half of 1 percent) of 986,972 tax returns did not have evidence of self-employment activity. Figure 2 shows a comparison between TY 2011 and 2017 tax returns that did not have evidence of self-employment activity.

[10] The point estimate projection was based on a two-sided 95 percent confidence interval. We were 95 percent confident that the point estimate was between $6,562,922 and $22,000,546.

Figure 2: Tax Returns Without Evidence of Self-Employment Activity

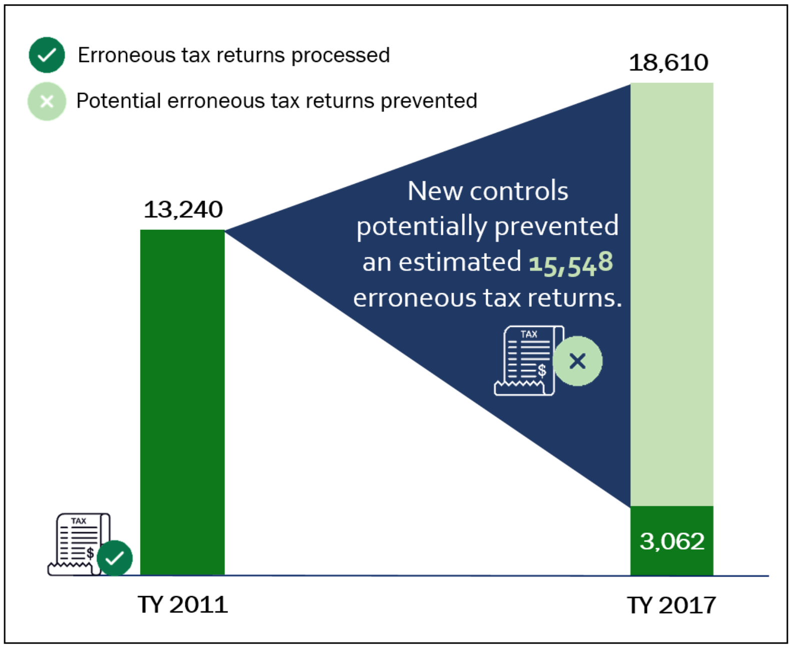


Source: TIGTA analysis of TY 2011 and TY 2017 individual tax returns.

These results represent an 84 percent improvement in detecting and preventing potentially unallowable deductions. The potentially overstated deductions resulted in approximately $5.8 million in underpaid taxes, which is less than half of the underpaid taxes estimated in the prior audit.[11] Although 3,062 TY 2017 returns included potentially unallowable self-employed retirement deductions, the number of such returns decreased by 10,178 from the previous TIGTA audit even though the number of returns with the deduction increased by approximately 285,000. If the controls had not been in place, and the error rate previously identified remained the same, we estimate the IRS may have processed 18,610 returns with potentially unallowable self-employment retirement deductions. Figure 3 shows that the new controls potentially resulted in the prevention of an estimated 15,548 erroneous tax returns during TY 2017.[12]

[11] All projections made as part of this review were calculated using TIGTA's tax simulator tool. The tax simulator tool was developed to recalculate a batch of individual tax returns when adjustments are made to certain line items. TIGTA uses this tool to identify the tax impact of the adjustments to the Form 1040, such as reducing wages or excluding credits, on both a "per return" and a batch level. We were able to calculate the tax effect for only 95 percent of the cases identified. There is a variance of ± $5 for each tax return's tax owed calculation.
[12] Our estimates are based on a mathematical calculation involving the changes in compliance rates.

Figure 3: Potentially Erroneous Tax Returns Prevented



Source: TIGTA analysis of TY 2011 and TY 2017 individual tax returns.

Although self-employed taxpayers generally report income from self-employment activities on Schedules C, E, and F, evidence of self-employment activities may also be available if self-employed taxpayers paid self-employment taxes, which they report on Schedule SE, *Self-Employment Tax*. For example, in TY 2017, a taxpayer could have mistakenly reported self-employment income on Line 21, *Other income*, of Form 1040 instead of on one of the self-employment schedules.[13] However, some of these taxpayers will report the income and employment taxes associated with the self-employment on Schedule SE. For the 3,062 tax returns, we identified 1,012 (33 percent) returns for which taxpayers attached a Schedule SE, indicating they paid self-employment taxes. Therefore, these taxpayers reported earning income from self-employment, which would permit them to claim self-employed retirement deductions. The inclusion of Schedule SE with Schedules C, E, and F in the error resolution code would have allowed these returns to be processed without manual review by tax examiners.

Recommendation 1: The Commissioner, W&I Division, should revise procedures for determining eligibility for the self-employed retirement deduction to include Schedule SE as evidence of self-employment.

Management's Response: The IRS agreed with this recommendation and will submit a Unified Work Request for programming to consider the presence of Schedule SE as evidence of self-employment when self-employed retirement deductions are claimed. The IRS will request the programming for implementation in January 2022; however, the work is subject to limited programming resources and competing priorities, and the IRS cannot provide an implementation date. In the interim, the IRS will update procedures

[13] For TY 2019, taxpayers report other income on Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, Line 8, *Other Income*.

to consider the presence of Schedule SE during pipeline processing and for those returns selected for additional review by the Error Resolution System.

Additional Improvements Are Needed to Identify Invalid Self-Employed Retirement Deductions

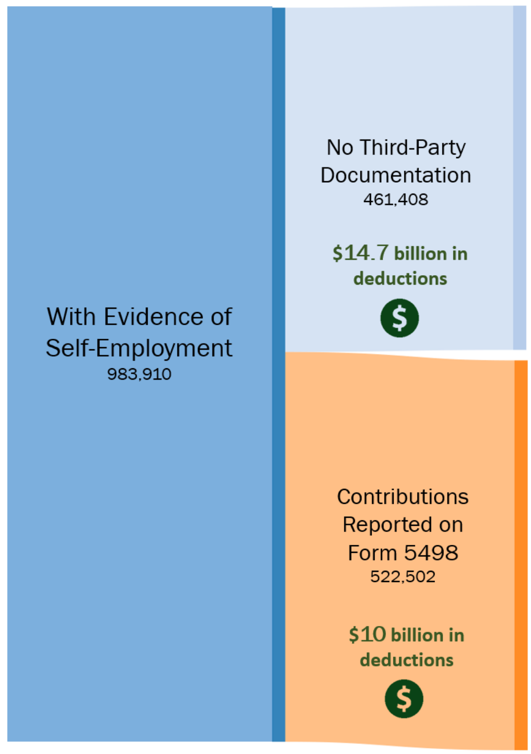
Analysis of TY 2017 tax returns and Forms 5498 data identified 983,910 tax returns with self-employed retirement deductions and evidence of self-employment activity, totaling approximately $24.7 billion.[14] Of the 983,910 tax returns, 43,476 (4 percent) included potentially improper self-employment retirement contribution deductions (either deductions that exceeded permitted amounts or tax returns that did not have the required net earnings from self-employment). In addition, we identified 193,985 tax returns with deductions that exceeded amounts reported by third parties on Forms 5498. However, current limitations to the Form 5498 make it difficult for the IRS to determine if these deductions were valid.[15] Tax returns with related improved Forms 5498 could allow for better validity analysis because third-party information could be compared to information reported by the taxpayer on his or her tax return. For the returns without third-party reporting, analysis is more limited, but some validity checks can be performed using alternative methods, such as compliance with the maximum deduction amounts.

Of the 983,910 tax returns, 522,502 (53 percent) had Forms 5498 for contributions made to a SEP or SIMPLE IRA account, totaling more than $10 billion. The remaining 461,408 tax returns (47 percent) did not have a Form 5498 reporting contributions to a SEP or SIMPLE IRA plan. Figure 4 shows that the returns without third-party information reporting involved approximately $14.7 billion (60 percent) of the $24.7 billion deducted by self-employed taxpayers.

[14] This analysis excludes the 3,062 tax returns for which the taxpayer had not attached Schedule C, E, or F. Additionally, the analysis considers only taxpayer contributions to his or her self-employed retirement plans up to December 31, 2017. Taxpayers may contribute to their self-employed retirement plans for the tax year up to the due date of the tax return.

[15] The limitations of Form 5498 are described on Page 13 of this report.

**Figure 4: Analysis of TY 2017 Tax Returns
With Self-Employment Deductions**



Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

Returns without third-party information reporting represent an information gap for the IRS's compliance oversight because taxpayers can claim deductions that cannot be verified. We reviewed both the returns with third-party information reporting and those without and identified potentially improper deductions in both populations.

The IRS could identify and prevent these potentially noncompliant tax returns if it made additional improvements to its procedures. In addition, if third-party data are improved and available for all retirement plans, the IRS could reduce or eliminate the information gap for the 461,408 tax returns that could not be verified by third-party documentation.[16] Without effective controls to prevent or detect potentially improper deductions, self-employed individuals may claim unallowable or fraudulent deductions.

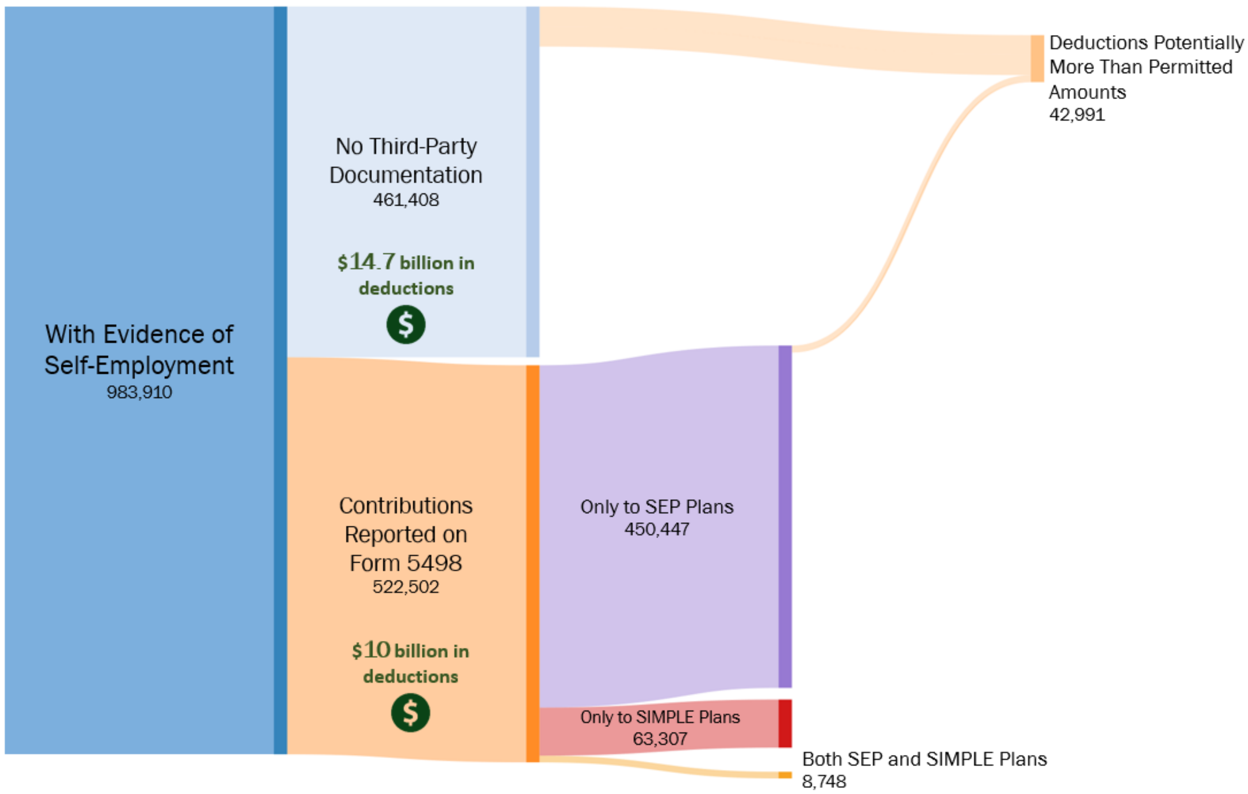
Taxpayers potentially claimed deductions in excess of permitted amounts

TIGTA identified 42,991 deductions (4 percent) that were potentially in excess of permitted amounts.[17] The maximum deduction is limited to the lessor of $54,000 or 25 percent of compensation from self-employment for both SEP and Defined Contribution Plans. For 35,097 (4 percent) tax returns, the self-employed retirement deductions were potentially in

[16] Our analysis identified 34,814 of the 461,408 tax returns without associated Forms 5498 that potentially exceeded the deduction limits. Internal Revenue Code Section 408(i) outlines third-party reporting requirements for IRAs.
[17] The 42,991 is comprised of 34,814 tax returns that did not have third-party documentation and 8,177 tax returns that had third-party documentation.

excess of 25 percent of self-employed compensation.[18] Additionally, 7,894 (1 percent) tax returns potentially exceeded the maximum $54,000 deduction allowed.[19] Figure 5 shows the 42,991 tax returns that included a deduction that potentially exceeded permitted amounts.

Figure 5: TY 2017 Self-Employment Deductions in Excess of Permitted Amounts



Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

These tax returns included more than $631 million in potentially overstated self-employed retirement deductions. Figure 6 shows the range of the dollar amounts of the deductions that potentially exceeded the maximum limits.

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[18] This analysis includes tax returns that did not have an associated Form 5498 and did not report net compensation. To calculate the 25 percent of compensation, we considered only tax returns that reported self-employment by filing only a Schedule C. We did not include tax returns that contained Schedules E or F because they could include passive income and these schedules could have losses (which could reduce the deduction amount) or could have income (which could increase the deduction amount).

[19] Percentage difference is due to rounding. These taxpayers could have Defined Benefit Plans, which would allow deductions over the $54,000 limit. Married Filing Jointly taxpayers can deduct up to $108,000 if both taxpayers are self-employed. We conservatively allowed $108,000 for all jointly filed returns in our analysis even though both taxpayers may not have been self-employed in this population.

Figure 6: Amount of Deductions Potentially in Excess of Limitations

Amount of Deduction Potentially in Excess of Limitations	Number of Tax Returns
$100,000+	805
$50,000 to $99,999	920
$10,000–$49,999	18,045
Under $10,000	23,221
Total	42,991

Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

Of the 42,991 tax returns, 19,770 (46 percent) were $10,000 or more over the maximum limit, including 805 (2 percent), involving over $150 million, that were over permitted limits by $100,000 or more. [redacted] maximum limit, [redacted] third-party reporting is required. [redacted]

Self-employed taxpayers can have more than one type of self-employed retirement plan. For example, a self-employed taxpayer may contribute to both a SEP plan and a Defined Benefit Plan, for which the deduction may exceed the maximum limit because Defined Benefit Plan deduction limits are based on actuarial assumptions and computations rather than self-employed net income. Although Defined Benefit Plans offer self-employed individuals many advantages, they are expensive, with high setup and annual fees. If the self-employed individual has employees, that fee will likely go up, and the employer would need to contribute on their behalf. These plans also carry a heavy administrative burden each year, and they require a commitment to fund the plan with a certain amount per year.[20] In general, Defined Benefit Plans are best suited for high-income self-employed taxpayers with few employees.

Most employers (including self-employed individuals, State and local governments, and large publically traded corporations) must report both Defined Benefit and Defined Contribution Plans to the Department of Labor on the Form 5500 series, which then provides the forms to the IRS.[21] The Form 5500 series is an important compliance, research, and disclosure tool for plan participants and beneficiaries because it allows the IRS to assess employee benefits, tax, and economic trends and policies. The IRS provided us the Form 5500 series for all 768,725 Employer Identification Numbers (EIN) that reported Defined Benefit and Defined

[20] Arielle O'Shea, *Retirement Options for the Self Employed* (March 25, 2020).

[21] The Form 5500 series includes Form 5500, *Annual Return/Report of Employee Benefit Plan;* Forms 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan;* and Form 5500 SF, *Short Form Annual Return/Report of Small Employee Benefit Plan.* Not all retirement plans are reported on the Form 5500 series; for example, Form 5500-EZ is not required for when total plan assets are valued under $250,000.

Contribution Plans for Plan Year 2017.[22] We determined that 79,557 (10 percent) EINs were for Defined Benefit Plans, while 689,168 (90 percent) were for Defined Contribution Plans.

Although the Form 5500 series provide valuable information, their usefulness is currently limited because neither the tax return nor all of the self-employment schedules require the EIN of the plan and not all the EINs on the Forms 5500 have associated Social Security Numbers. Without this information, the IRS cannot always associate self-employed individuals' tax returns with their retirement plans to determine if deductions for retirement plan contributions were appropriate. However, using business tax information, partnership tax information, and self-employment schedules, we were able to identify Social Security Numbers related to the Form 5500 series for 371,998 (48 percent) of the EINS, including 47,517 (60 percent) of the Defined Benefit Plans and 324,481 (47 percent) of the Defined Contribution Plans.

Our analysis showed that 18,816 tax returns had deductions over the dollar threshold but were for Defined Benefit Plans, which are not subject to the thresholds. We therefore excluded these returns from our estimate of 42,991 tax returns that potentially exceeded the threshold. However, our analysis also showed that 3,514 tax returns had deductions over the dollar threshold and were for Defined Contribution Plans, which are subject to the thresholds. Many of these returns had high-dollar deductions, including 119 returns with deductions over $200,000, and 16 returns with deductions over $400,000.[23] We referred the 16 high-dollar cases to the IRS for examination consideration.[24]

We estimate the IRS could potentially realize approximately $177 million in additional taxes associated with these potentially improper deductions if it created additional controls to identify and potentially prevent deductions that are over the maximum amounts permitted by law. For example, the IRS could create an error resolution code that would detect these types of tax returns during processing. To be effective, this change would need to be made in conjunction with changes to Form 1040, which are discussed in the next section of this report.

We could not match the EIN with a tax return for the remaining 396,727 (52 percent) Forms 5500. If the tax return required the EIN of the self-employed retirement plan, the IRS would be able to identify improper self-employed retirement deductions by matching Forms 1040 with Forms 5500.

Recommendation 2: The Commissioner, SB/SE Division, should consider for examination the 16 tax returns with retirement contribution deductions over $400,000 for which we identified only an associated Defined Contribution Plan.

> **Management's Response:** The IRS agreed with this recommendation and reviewed the 16 tax returns we identified. The IRS determined there was not enough time remaining on the statute of limitations to pursue compliance activity. However, the IRS reviewed the subsequent tax year for these 16 returns and determined that there were five tax returns with audit potential. The IRS plans to forward these returns to the appropriate function for classification and consideration for examination.

[22] A plan year is a 12-month period designated by a retirement plan for calculating vesting and eligibility, among other things. The plan year can be the calendar year or an alternative period, for example, July 1 to June 30.

[23] These tax returns were over the deduction limit of $54,000 ($108,000 for taxpayers filing jointly) for Defined Contribution Plans.

[24] It is possible that some of these deductions were valid because, in addition to a Defined Contribution Plan, some of these taxpayers could also have Defined Benefit Plans that we could not match.

Taxpayers claimed SEP deductions despite not having reported net earnings from self-employment

TIGTA determined that 485 of the 450,447 tax returns with third-party reporting showing contributions made to only a SEP did not report net earnings from self-employment.[25] These tax returns included more than $4.8 million in self-employed retirement deductions. To claim a SEP deduction, taxpayers must report net earnings from self-employment.[26]

Currently, the only way to determine if the deductions were made for contributions to SEP retirement plans is to review the Forms 5498 submitted by third-party trustees. However, these forms are generally not available when taxpayers submit their tax returns. In addition, Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, does not have lines or blocks to specify the type of retirement plans for which taxpayers are taking the deduction or the EIN of the self-employed retirement plan. Including this information on the form could allow the identification and prevention of improper deductions. For example, if the taxpayer reported that the deduction is for a SEP plan, the IRS could verify that the taxpayer reported net earnings from self-employment.

We estimate the IRS could potentially realize approximately $1.2 million in additional taxes associated with these potentially improper deductions if it created an error resolution code identifying SEP deductions with no self-employment net earnings and modified Form 1040 to include self-employed retirement plan information.

Recommendation 3: The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to evaluate the benefits of updating Form 1040, Schedule 1, and creating error resolution codes to identify and potentially prevent self-employed retirement deductions that are over the maximum amounts permitted by law or when taxpayers do not report self-employed net earnings. For example, Form 1040, Schedule 1, could be updated to include check boxes indicating the type of self-employed retirement plan for which taxpayers are claiming the deduction and a location to enter the EIN of the self-employed retirement plan. If it is determined to be beneficial, the Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to update Form 1040, Schedule 1, and create error resolution codes.

> **Management's Response:** The IRS disagreed with this recommendation, stating that the 485 returns identified by TIGTA represent 0.1 percent of the population. Due to this limited evidence of noncompliance, coupled with limited resources and competing priorities as outlined in the IRS's management response, the IRS is not proposing changes to Form 1040, Schedule 1.
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> > **Office of Audit Comment:** TIGTA identified 43,476 tax returns (not 485 returns) that included potentially improper deductions for self-employment retirement contributions. The 43,476 returns included 485 returns that claimed deductions when there was no evidence of net earnings plus an additional 42,991 returns

[25] We did not include any tax returns that had an associated Defined Benefit Plan.

[26] Taxpayers report income from self-employment on Schedules C, E, or F. However, our analysis considered only tax returns that reported self-employment income by filing a Schedule C. We did not include tax returns that contained Schedules E or F because they could include passive income. Additionally, some of these schedules could have losses, which could reduce the deduction amount, or could have income, which could increase the deduction amount. The actual amount of improper deductions could be higher than $5 million.

that claimed deductions in excess of the lesser of $54,000 or 25 percent of compensation. Within this population, 805 taxpayers took deductions that exceeded the maximum limit by $100,000 or more, including the five taxpayers for whom the IRS agreed had audit potential pursuant to Recommendation 2. Combined, these returns included potentially improper deductions totaling more than $635 million, and TIGTA estimated the tax impact as approximately $178 million each year.

Furthermore, TIGTA's analyses was limited to taxpayers who reported self-employment income only on Schedule C because we could not rule out passive income that taxpayers may report on the other self-employment schedules, *i.e.*, Schedules E and F. If IRS management took corrective actions, they would have the ability to segregate those returns and identify noncompliant taxpayers who submitted alternate schedules or more than one schedule. Including these self-employment schedules could increase the likelihood of detecting noncompliance.

Third-party documentation is not available to determine the reasonableness of deductions

Analyses identified 461,408 (47 percent) of 983,910 tax returns with self-employed retirement deductions and evidence of self-employment that did not have associated Forms 5498 reporting contributions to a SEP or SIMPLE IRA plan. These returns involved approximately $14.7 billion (60 percent) of the $24.7 billion retirement contributions deducted by self-employed taxpayers. Information reporting by third parties has a significant impact on compliance. Research has shown that, when the IRS uses complete information from independent third parties for income, compliance rates are extremely high. For example, IRS Tax Gap studies estimate that when third parties do not provide information to the IRS, 55 percent of income is misreported. In contrast, reported amounts that have little or no information reporting, such as business income, have significantly lower compliance rates.[27] The IRS does not have similar estimates or studies for deductions when third parties do not provide information.

The law does not require third-party reporting for certain self-employed retirement plans, including SIMPLE 401(k), Defined Contribution Plans, and Defined Benefit Plans; therefore, we were unable to perform additional validity checks for 426,594 (92 percent) of the 461,408 tax returns. Figure 7 shows the information gap for the IRS's compliance oversight because taxpayers claimed deductions that cannot be verified by third-party documentation or other deduction criteria.

[27] IRS, Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013* (Rev. 9-2019) (Sept. 2019).

Figure 7: Potential Information Gap for Noncompliance

Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

The lack of comprehensive third-party data increases the risk that improper or fraudulent deductions can be claimed for self-employed retirement plans without detection. Our analysis similarly identified potential noncompliance when third-party reporting is not required. For example, of the 42,991 tax returns that exceeded the deduction limits, 34,814 (81 percent) did not have third-party documentation.

In response to TIGTA's previous report, the IRS disagreed with the recommendation to work with the Department of the Treasury to assess the cost-effectiveness of recommending legislative changes expanding third-party information reporting currently required for SEPs, SIMPLEs, and other IRAs to other types of retirement plans that currently have no third-party information reporting requirement. The two main reasons for their disagreement were:

- These plans are subject to reporting on Form 5500-EZ, *Annual Return of One Participant (Owners and Their Spouses) Retirement Plan*, when the plans have assets that exceed $250,000 or the plan is reporting for its final year.
- The volume of affected taxpayers is relatively low.

As discussed earlier in this report, the IRS could better use Forms 5500 to determine the reasonableness of some deductions, such as identifying returns with deductions for contributions made to retirement plans that are subject to thresholds. However, not all retirement plans are subject to Form 5500 filing requirements. Additional third-party information would allow further compliance checks, such as ensuring that taxpayers deducted contributions made only to their own retirement account and not contributions made to employees' accounts.

Furthermore, there were nearly as many taxpayers not subject to third-party reporting as there were taxpayers subject to third-party reporting. The taxpayers not subject to third-party reporting represented 47 percent of all tax returns that had evidence of self-employment and deductions for contributions made to retirement accounts and involved $14.7 billion in deductions, or nearly 60 percent of the total dollar amount.

Recommendation 4: The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to assess the cost-effectiveness of expanding third-party information reporting currently required for SEPs, SIMPLEs, and other IRAs to other types of retirement plans that currently have no third-party information reporting requirement. If determined to be cost effective, work with the Department of the Treasury to recommend necessary legislative changes.

Management's Response: The IRS disagreed with this recommendation and stated that expansion of third-party reporting requirements for SEPs, SIMPLEs, and other retirement plans would not only require legislation but would also significantly increase burden to taxpayers and trustees. The IRS stated that identified cases would be highly complex and require diversion of field examination resources from other casework. According to the IRS, these facts, in combination with the limited evidence of noncompliance and low number of affected taxpayers, do not support expansion.

Office of Audit Comment: Assessing cost-effectiveness does not require legislation. However, such efforts help stakeholders make decisions about the benefits of pursuing legislative changes. Taxpayer burden is one component to consider, as is revenue. TIGTA determined that 461,408 returns were not subject to third-party reporting, which was nearly half of all tax returns with self-employed retirement deductions. These returns included $14.7 billion in deductions, which represented 60 percent of all self-employed retirement deductions taken by taxpayers.

Form 5498 does not allow for validation of self-employed taxpayers' retirement deductions

Unlike traditional and Roth IRA contributions, the IRS cannot use Forms 5498 to identify overstated self-employed retirement deductions because the form does not include all contributions made to self-employed retirement plans during the contribution window. For traditional and Roth IRA contributions, Form 5498 instructions require third parties to report contributions that are made up until the due date of the tax return (*i.e.,* January 1 of one year until April 15 of the next year).[28] However, the instructions for contributions made to SEP and SIMPLE IRA plans limit reporting to contributions made only between January 1 and December 31.[29] IRS management could not explain why the requirements were different.

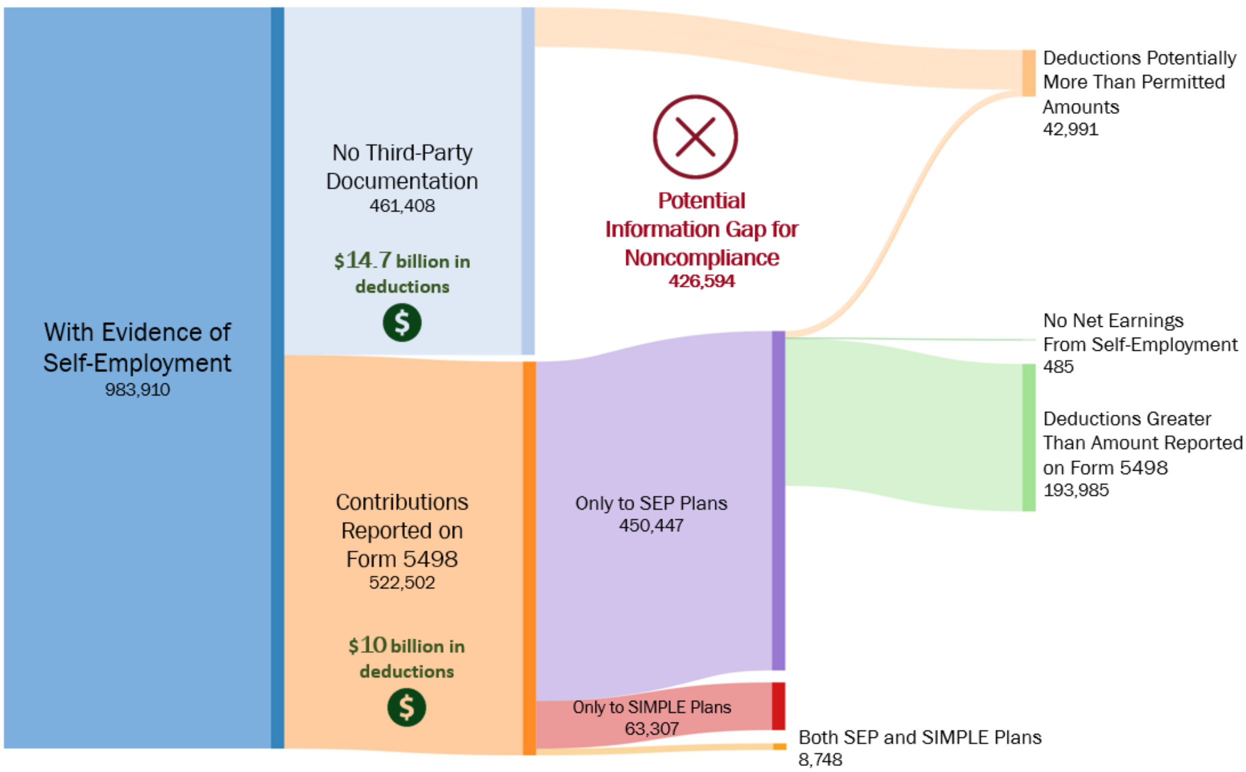
We determined that 193,985 (43 percent) of the 450,447 tax returns included self-employed retirement deductions that exceeded what was reported on Form 5498.[30] Figure 8 shows our complete analysis of the 983,910 taxpayers who reported a self-employed retirement deduction and had evidence of self-employment, including those who had deductions that exceeded what was reported on Form 5498.

[28] Traditional IRA contributions are reported in Box 1*, IRA Contributions (other than amounts in box 2-4, 8-10, 13a, and 14a)* and Roth IRA contributions are reported in Box 10, *Roth IRA Contributions*. The instructions state to enter contributions to a traditional IRA or to a Roth IRA made in 2017 and through April 17, 2018, designated for 2017.

[29] SEP contributions are reported in Box 8, *SEP Contributions,* and SIMPLE Contributions are reported in Box 9, *SIMPLE Contributions.* The instructions state to enter employer contributions made to a SEP or SIMPLE IRA during 2017, including contributions made in 2017 for 2016 but not including contributions made in 2018 for 2017.

[30] Some of these deductions may be valid because not all self-employed retirement plans are reported on Form 5498 (*i.e.,* SIMPLE 401(k), Defined Contribution Plans, and Defined Benefit Plans). Additionally, TIGTA's analysis considered only contributions reported between January 1 and December 31, 2017. Contributions made after December 31, 2017, were not considered because Form 5498 does not break out the tax year for which the contributions were intended. We did not include any tax returns that had an associated Defined Benefit Plan.

Figure 8: Analysis of TY 2017 Self-Employed Retirement Deductions



Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

These tax returns included approximately $1.41 billion more in self-employed retirement deductions than what was reported on Forms 5498. Some deductions may be valid because third-party reporting is not required for all types of self-employed retirement plans.[31] Figure 9 shows the dollar amounts of the deductions.

Figure 9: Range of Deductions in Excess of Third-Party Documentation

Range of Deductions in Excess of Limitations	Number of Tax Returns
$50,000+	1,763
$10,000–$49,999	43,351
Under $10,000	148,871
Total	193,985

Source: TIGTA analysis of TY 2017 individual tax returns and Forms 5498.

Of the 193,985 tax returns, 45,114 (23 percent) were $10,000 or more over what was reported on the Form 5498. However, the IRS cannot compare the amounts deducted by taxpayers with the

[31] For example, a taxpayer could potentially have both a SEP and Defined Benefit Plan that would allow the self-employed retirement deduction to exceed the amounts reported on Form 5498.

amounts reported by third parties on Forms 5498 because the instructions for Form 5498 limits third-party reporting to contributions made during the calendar year. Meanwhile, the law allows taxpayers to deduct contributions made up until the date the return is filed (*i.e.,* April 15 of the next calendar year).[32] For example, if a taxpayer made $10,000 in retirement contributions in Calendar Year 2018, and an additional $5,000 in retirement contributions between January 1 and April 15, 2019, the entire $15,000 could be deducted on the TY 2018 tax return. However, the third party responsible for reporting the contributions would report only the $10,000 contribution made in Calendar Year 2018.

The IRS relies on the AUR program to identify and resolve noncompliance issues related to deductions for retirement contributions made by self-employed taxpayers. The AUR program uses the Form 5498 during its case selection process by matching the self-employed retirement deduction with the Form 5498 to identify any discrepancies. However, the AUR program selects [redacted] performed during processing.[33] In addition, the AUR program works few cases involving retirement deductions by self-employed taxpayers. For example, we identified 193,985 TY 2017 cases for which taxpayer deductions were more than the amount reported on Forms 5498; meanwhile for TY 2016, the AUR program selected to work 299 cases.[34]

The AUR program cannot currently use Forms 5498 to help make determinations about the acceptability of the taxpayers' deductions. Updating the instructions to report contributions that were made up until the due date of the tax return could improve the IRS's ability to identify overstated deductions and would make the reporting requirements for self-employed retirement contributions consistent with the requirements for traditional and Roth IRA contributions.

Recommendation 5: The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to update the instructions for Form 5498 to report contributions made for self-employed retirement plans up until the due date of the tax return, as required for other types of retirement plans.

> **Management's Response:** The IRS disagreed with this recommendation and stated that this recommendation is more complex than updating instructions, as it requires legislative change. The IRS believes the findings of this report indicate the extent of noncompliance is not significant and would not justify the resources or the burden generated.
>
> > **Office of Audit Comment:** The findings in the report do not indicate insignificant noncompliance. Instead, they indicate an information gap that prevents identifying the extent of noncompliance. TIGTA identified potential anomalies in the population of returns with self-employed retirement deductions and related Forms 5498, including 193,985 (43 percent) returns with deductions that exceeded the Forms 5498 amounts by a total of $1.41 billion. Without corrective actions, some plan trustees will continue to be burdened each year

[32] IRS, Publication 560, *Retirement Plans for Small Business* (Mar. 2018).

[33] Although there is an error resolution code to prevent the processing of these types of tax returns, there are instances in which some tax returns may be processed because of error by the tax examiner or the tax examiner identified another potential source of self-employed income. For example, taxpayers may have reported other income on the tax return or attached Schedule SE.

[34] TY 2016 is the most current year in which there was not any open inventory.

when preparing and submitting Forms 5498 that the IRS cannot use to verify taxpayers' self-employment retirement deductions.

Recommendation 6: The Commissioner, SB/SE Division, should consider updating programming to use existing third-party data to detect potentially overstated deductions. For example, if the instructions for Form 5498 are revised pursuant to Recommendation 5, the IRS could better compare the deduction amounts reported on the tax returns with the amounts reported on Forms 5498.

Management's Response: The IRS disagreed with this recommendation. The IRS stated that, for non-IRA plans, there is currently no third-party data about plan contributions on behalf of individuals. The Form 5500 series data demonstrate that some plans exist, but not all plans are required to file these forms. The IRS stated that no clear quantitative compliance benefit has been presented to outweigh the substantial costs to update programming, and no justification has been presented to indicate why this should be a priority for Information Technology organization resources in the current environment of modernization and other competing priorities.

Office of Audit Comment: TIGTA determined that taxpayers' deductions exceeded the Forms 5498 amounts for 43 percent of all self-employment retirement deductions, including 1,763 tax returns for which the deduction was at least $50,000 more than the amounts reported on the Forms 5498. However, without changes to the Form 5498 instructions, the IRS cannot determine the extent of noncompliance because the tax return may include deductions made after the Form 5498 reporting period.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS has sufficient controls to prevent and detect improper deductions for contributions made by self-employed taxpayers to their self-employed retirement plans. To accomplish our objective, we:

- Determined if the IRS has adequately addressed concerns raised in the prior TIGTA report and evaluated whether existing processes and procedures are sufficient to prevent and detect improper deductions for contributions made by self-employed taxpayers to their self-employed retirement plans.
- Identified TY 2017 deductions for contributions made by self-employed taxpayers to their self-employed retirement plans that are inconsistent with other items reported on Form 1040 and Form 5498.
    - Identified all taxpayers who reported a deduction on Line 28, *Self-employed SEP, SIMPLE, and Qualified plans,* on Form 1040 for TY 2017. We determined the number of taxpayers who are self-employed by matching to TY 2017 Form 1040 Schedule C, Schedule E, or Schedule F.
    - Obtained TY 2017 Form 5498 data to identify taxpayers who contributed to a SEP plan or SIMPLE plan.
    - Performed analysis of the data to identify taxpayers who potentially reported an inappropriate or fraudulent deduction for contributions to self-employed retirement plans in TY 2017.
    - Requested from the IRS all Forms 5500, 5500-EZ, and 5500 SF and identified all Defined Benefit and Defined Contribution Plans.
    - Matched the data provided by the IRS to the data identified above to determine how many of the self-employed retirement deductions that were over the limit were Defined Benefit Plans.

Performance of This Review

This review was performed at the SB/SE Division AUR program in Fresno, California, and the Tax Exempt and Government Entities Division in Washington D.C., and with information obtained from the W&I Division Submission Processing function during the period October 2019 through April 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Heather Hill, Assistant Inspector General for Audit (Management Services and Exempt Organizations); Carl Aley, Director; David Bueter, Audit Manager; Jeremy Berry, Lead Auditor; Richard Kemble, Senior Auditor; and Laura Haws, Information Technology Specialist (Data Analytics).

Validity and Reliability of Data from Computer-Based Systems

We obtained Form 5500 series data from the IRS and extracts from the IRS's Individual Master File, Individual Return Transaction File, Business Master File, and Information Returns Master File for TY 2017 that were available on TIGTA's Data Center Warehouse and performed tests to assess the reliability of data. We reviewed the data and ensured that each file contained the specific data elements we requested. Additionally, we compared random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System. We also performed analyses to ensure the validity and reasonableness of our data, such as minimum/maximum analysis of dollar values, transaction dates, and tax periods. We determined that the information extract from TIGTA's Data Center Warehouse was sufficiently reliable for the purposes of this report.

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: W&I Division and SB/SE Division AUR program policies, procedures, and practices related to the self-employed retirement deduction. We evaluated these controls by reviewing source documents, interviewing IRS management and employees, and conducting data analyses.

Appendix II

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; $176,781,116 ($884 million over five years) in estimated additional taxes owed for 42,991 tax returns that claimed deductions in excess of the lessor of $54,000 or 25 percent of compensation (see Recommendations 2 and 3).[1]

Methodology Used to Measure the Reported Benefit:

To determine the amount of additional tax due for taxpayers who claimed potentially improper self-employed retirement deductions, we analyzed 983,910 TY 2017 tax returns that had evidence of self-employment with self-employed retirement plan deductions. We determined that 35,097 (3.5 percent) of these returns claimed self-employed retirement plan deductions totaling $362,158,961 in excess of 25 percent of self-employed compensation.[2] Additionally, we determined that 7,894 (0.8 percent) tax returns totaling $269,275,407 exceeded the maximum deduction allowed.[3] The maximum deduction is limited to the lessor of $54,000 or 25 percent of the self-employed taxpayer's compensation. By disallowing these deductions, the IRS could potentially realize $176,781,116 in additional taxes each year ($883,905,580 over five years).

To determine the additional taxes owed, we used a tax simulator tool that enabled us to recalculate a tax return based on adjustments to specific line items on a tax return. For example, for tax returns on which the taxpayer claimed a Line 28 deduction greater than the allowed limit, we input the maximum limit of the self-employed retirement deduction allowed for the taxpayer. This enabled us to recalculate the tax returns to show the effect of reducing the self-employed retirement deduction to the maximum allowed amount. The tax simulator tool recalculates the recipient's tax return with the decreased deduction.

The tax simulator tool performs two iterations. The first attempts to recalculate the tax as shown on the original return (before auditor adjustments) to determine if the tax simulator tool can accurately recreate the tax and summary items on the original return. An accurate recalculation consists of the tax simulator tool being within ±$5.00 on seven summary lines. If

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

[2] This analysis includes tax returns that did not have an associated Form 5498 and did not report net compensation. To calculate the 25 percent of compensation, we considered only tax returns that reported self-employment income by filing a Schedule C. We did not include tax returns that contained Schedules E or F because they could include passive income and these other schedules could have losses (which could reduce the deduction amount) or could have income (which could increase the deduction amount).

[3] These taxpayers could have Defined Benefit Plans, which would allow deductions over the $54,000. The IRS provided Defined Benefit Plan information and we removed them from the outcome. Married Filing Jointly taxpayers can deduct up to $108,000 if both taxpayers are self-employed. We conservatively allowed $108,000 for all jointly filed returns in our analysis, even though both taxpayers may not have been self-employed in this population.

the tax simulator tool cannot produce an accurate recalculation, the tax return is removed, and it will not continue to the second iteration. This first iteration reduced our population of taxpayers claiming deductions in excess of $54,000 or 25 percent of net earnings from 42,991 to 41,272 tax returns.

The second iteration recalculates the tax effect based on adjustments to the Line 28 deduction. We determined the potential outcome of additional taxes owed that should have been assessed as the difference between the total income tax on the recipient's original tax return and the total income tax calculated by the tax simulator tool. This is the difference in Form 1040, Line 63, *Add lines 56 through 62. This is your total tax*.

The tax simulator tool recalculates significant summary lines on the Forms 1040. The simulator records the original amount and the adjusted amount. When the tax return does not have amounts reported for qualified dividends or capital gains, the tax simulator tool will apply the tax table to tax returns with taxable income less than $100,000 and will apply the Tax Computation Worksheet when taxable income is greater than or equal to $100,000. The tax simulator tool does have limitations. For example:

- The tax simulator tool does not recalculate every line item on the tax return.
- If an amount was not included on the original return, the tax simulator tool will not create an amount.
- The tax simulator tool does not recalculate every line item based on the adjustments, and in these instances, it will accept the taxpayer's figures from the original return.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $1,185,081 ($5.92 million over five years) in estimated additional taxes for the 485 tax returns on which taxpayers reported contributions to only SEP plans but did not report net earnings from self-employment (see Recommendation 3).[4]

Methodology Used to Measure the Reported Benefit:

To determine the amount of additional tax due for taxpayers who claimed potentially improper self-employed retirement deductions, we analyzed 450,447 tax returns that reported contributions to only a SEP plan and had evidence of self-employment. We determined that 485 of the 450,447 tax returns did not report net earnings from self-employment.[5] These returns included more than $4.8 million in self-employed contribution retirement deductions.[6] To claim a SEP deduction, taxpayers must report net earnings from self-employment. By preventing these deductions, the IRS could potentially realize $1,185,081 in additional taxes each year ($5,925,405 over five years).

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

[5] We did not include any tax returns that had an associated Defined Benefit Plan.

[6] Taxpayers report income from self-employment on Schedules C, E, or F. However, our analysis only considered tax returns that reported self-employment by filing only a Schedule C. We did not include tax returns that contained Schedules E or F because they could include passive income. Additionally, some of these schedules could have losses, which could reduce the deduction amount, or could have income, which could increase the deduction amount. The actual amount of improper deductions could be higher than $5 million.

In order to determine the additional taxes owed, we used a tax simulator tool that enabled us to recalculate a tax return based on adjustments to specific line items on a tax return. For example, for tax returns on which the taxpayer claimed a Line 28 deduction greater than zero, we set the self-employed retirement deduction amount to zero. This allowed us to recalculate the tax returns to show the effect of reducing the self-employed retirement deduction to zero. The tax simulator tool recalculates the recipient's tax return with the decreased deduction. The first iteration reduced the population of tax returns that reported contributions to only a SEP plan and did not report net earnings from self-employment from 485 to 459 tax returns.

Management's Response: The IRS disagreed with the potential revenue protection amounts of $176,781,116 and $1,185,081. Although the IRS understood TIGTA's methodology of limiting the analysis to tax returns that included a Schedule C, it believes the amount of potential revenue protection is likely overstated because IRS examiners would be required to consider other sources of self-employment income, which could affect the allowable deduction. The accuracy of the stated potential revenue protection cannot be definitively determined without examining the 43,476 returns. Due to limited IRS resources, competing priorities, and significant opportunity costs, the IRS cannot complete examinations on these 43,476 returns. The IRS will pursue the consideration of examinations on five returns related to Recommendation 2. The subsequent year returns have a cumulative total of $2,091,445 in deductions. If the IRS applies the maximum tax rate applicable for TY 2018 (37 percent), the IRS estimates the maximum potential revenue to be $562,329, which has been reduced by IRS opportunity cost of $211,505.[7]

Self-employment retirement plan deductions involve complex issues that can be addressed only by IRS field examiners. Many of these returns, even if fully adjusted in the amounts identified by TIGTA, would not yield tax assessments justifying the use of such expensive and limited resources. For example, the first outcome measure includes 23,221 (54 percent) returns that have an excess deduction of $10,000 or less. Finally, the five-year projections are dependent on the unlikely assumption that the following five years will match the single-year observation. This assumption does not hold in this case; effective January 1, 2018, the tax laws changed to significantly decrease the marginal tax rates, which means that the projected tax effect of over-claimed SEP deductions would be less in years after TY 2017.

Office of Audit Comment: TIGTA appreciates the extra steps the IRS took to research the subsequent tax year for the referred cases. However, TIGTA also believes the outcome measures are conservative because they included self-employment income reported only on Schedule C and excluded any taxpayers who reported income on other sources such as Schedules E and F. For example, we did not include in our analyses any taxpayers who took self-employment retirement deductions and earned income from partnerships or farming. The inclusion of all taxpayers who took self-employment retirement deductions would potentially identify more noncompliance.

Additionally, to determine the additional taxes owed, we used a tax simulator tool that enabled us to recalculate a tax return based on adjustments to specific

[7] The IRS stated that opportunity cost was calculated by multiplying the five returns by the average Revenue Agent Discriminant Index Function assessment per primary return with Activity Code 281 closed in Fiscal Year 2019.

line items on a tax return. If the tax simulator tool cannot produce an accurate recalculation, the tax return is removed, and the tool will not recalculate the tax return. We were able to recalculate the tax return for 41,731 of the 43,476 exception cases, which further reduced the outcome measure.

Although 54 percent of the deductions were below $10,000, 46 percent were $10,000 or above, including 1,725 taxpayers who potentially took deductions that exceeded the permitted amounts by $50,000 or more.

TIGTA's methodology for projecting an outcome for five years assumes that, if TIGTA had not performed the audit and identified the condition which led to the outcome, the condition would have existed for up to five years without correction. These taxpayers would not have been subjected to a compliance activity that would have led to improved compliance. The estimates are intended to provide stakeholders a general measure of the cost of noncompliance in order to help inform decision-making.

Appendix III

Summary of Tax Year 2017 Contribution and Deduction Limits for SEP, SIMPLE, Defined Contribution, and Defined Benefit Plans

Type of Plan	Maximum Contribution	Maximum Deduction
SEP	Smaller of $54,000 or 25 percent of net earnings from self-employment.	25 percent of net earnings from self-employment up to $270,000.
SIMPLE IRA and SIMPLE 401(k)	**Employee contribution:** Salary reduction contribution up to $12,500, $15,500 if age 50 or over. **Employer contribution:** Either dollar-for-dollar matching contributions, up to 3 percent of employee's compensation up to $270,000, or fixed nonelective contributions of 2 percent of compensation.	Same as maximum contribution.
Defined Contribution Plan	**Money Purchase Pension Plan**: Smaller of $54,000 or 100 percent of net earnings from self-employment. **Profit-Sharing**: Smaller of $54,000 or 100 percent of net earnings from self-employment.	25 percent of net earnings from self-employment up to $270,000.
Defined Benefit Plan	Amount needed to provide an annual benefit no larger than the smaller of $215,000 or 100 percent of the participant's average compensation for the highest three consecutive calendar years.	Based on actuarial assumptions and computations.

Source: TY 2017 IRS Publication 560.

Appendix IV

Tax Year 2017 Form 5498, *IRA Contribution Information*

☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code	1 IRA contributions (other than amounts in boxes 2–4, 8–10, 13a, and 14a) $	OMB No. 1545-0747 **2017** Form **5498**	**IRA Contribution Information**
	2 Rollover contributions $		
	3 Roth IRA conversion amount $	4 Recharacterized contributions $	**Copy B**
TRUSTEE'S or ISSUER'S federal identification no. / PARTICIPANT'S social security number	5 Fair market value of account $	6 Life insurance cost included in box 1 $	**For Participant**
PARTICIPANT'S name	7 IRA ☐ SEP ☐	SIMPLE ☐ Roth IRA ☐	This information is being furnished to the Internal Revenue Service.
	8 SEP contributions $	9 SIMPLE contributions $	
Street address (including apt. no.)	10 Roth IRA contributions $	11 If checked, required minimum distribution for 2018 ☐	
	12a RMD date	12b RMD amount $	
City or town, state or province, country, and ZIP or foreign postal code	13a Postponed contribution $	13b Year / 13c Code	
	14a Repayments $	14b Code	
Account number (see instructions)	15a FMV of certain specified assets $	15b Code(s)	

Form **5498** (keep for your records) www.irs.gov/form5498 Department of the Treasury - Internal Revenue Service

Source: IRS, Form 5498.

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

November 13, 2020

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton Eric C. Hylton Digitally signed by Eric C. Hylton Date: 2020.11.13 13:56:02 -05'00'
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements Have Been Made, but Controls Need to Be Strengthened to Detect Improper Self-Employed Retirement Deductions (Audit # 202010001)

Thank you for the opportunity to review and comment on the above subject draft audit report. Self-employed taxpayers have a variety of self-employment plan options through which they may be permitted to make contributions: Simplified Employee Pension (SEP) plans, Savings Incentive Match Plan for Employees (SIMPLE) plans, Defined Contribution Plans, and Defined Benefit Plans. Third-party trustees report contributions to SEP and SIMPLE plans on Forms 5498*, IRA Contributions Information*, while most employers, including self-employed individuals, report information about Defined Contribution and Defined Benefit on Forms 5500 series, *Annual Return/Report of Employee Benefit Plan*, filed with the Department of Labor, which provides those forms to the IRS.

Since TIGTA's last report on this issue, the IRS improved internal controls and reduced improper self-employed retirement plan deductions by more than eighty-four percent. In addition, your report indicates that fewer than 0.05% of returns claiming deductions to self-employed retirement plans lack evidence of self-employment income.

As you noted, the IRS faces challenges in maximizing the use of Form 5498 for SEP and SIMPLE enforcement activities because contributions to those plans are permitted well after the end of the tax year (for example, for calendar-year taxpayers, contributions are permitted until October 15 of the next year). Despite these challenges, we remain committed to using all available information to continue identifying invalid self-employment retirement deductions. However, due to current budget and staffing limitations we must make difficult decisions regarding priorities and the types of enforcement actions we pursue and the service we provide. Your report highlights the significant improvements we have made and the current low rate of non-compliance in this area. Pursuing implementation of all your recommendations would require a significant diversion of resources that are best applied to issues with a higher risk for noncompliance.

Attached is a detailed response to address your recommendations and outcome measures. If you have any questions, please contact me or Scott Irick, Director, Examination Operations, SB/SE Division.

Attachment

Attachment

RECOMMENDATION 1:
The Commissioner, W&I Division, should revise procedures for determining eligibility for the self-employed retirement deduction to include Schedule SE as evidence of self-employment.

CORRECTIVE ACTION:
We will submit a Unified Work Request for programming to consider the presence of Schedule SE, *Self-Employment Tax*, as evidence of self-employment when self-employed retirement deductions are claimed. We will request the programming for implementation in January 2022; however, the work is subject to limited programming resources and competing priorities and we cannot provide an implementation date. In the interim, we will update procedures to consider the presence of Schedule SE during pipeline processing and for those returns selected for additional review by the Error Resolution System.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
Director, Submission Processing, Customer Account Services, Wage and Investment Division

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

RECOMMENDATION 2:
The Commissioner, SB/SE Division, should consider for examination the 16 tax returns with retirement contribution deductions over $400,000 for which we identified only an associated Defined Contribution Plan.

CORRECTIVE ACTION:
We reviewed the sixteen tax returns identified by TIGTA and determined there was not enough time remaining on the statute of limitations to pursue a compliance activity. We did, however, review the subsequent tax year for these sixteen returns and determined there were five taxpayers that had audit potential. These returns will be forwarded to the appropriate function for classification and consideration for examination.

IMPLEMENTATION DATE:
October 15, 2022

RESPONSIBLE OFFICIAL:
Director Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

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

RECOMMENDATION 3:
The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to evaluate the benefits of updating the Form 1040, Schedule 1 and creating error resolution codes to identify and potentially prevent self-employed retirement deductions that are over the maximum amounts permitted by law or when taxpayers do not report self-employed net earnings. For example, the Form 1040, Schedule 1 could be updated to include check boxes indicating the type of self-employed retirement plan for which taxpayers are claiming the deduction and a location to enter the EIN of the self-employed retirement plan. If it is determined to be beneficial, the SB/SE Commissioner should work with the W&I Commissioner to update the Form 1040, Schedule 1 and to create error resolutions codes.

CORRECTIVE ACTION:
The 485 returns identified by TIGTA represent 0.1% of the population. Due to this limited evidence of non-compliance, coupled with our limited resources and competing priorities, as outlined in our management response, we are not proposing changes to Form 1040, Schedule 1.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 4:
The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to assess the cost effectiveness of expanding third-party information reporting currently required for SEPs, SIMPLEs, and other IRAs to other types of retirement plans that currently have no third-party information reporting requirement. If determined to be cost effective, work with the Department of the Treasury to recommend necessary legislative changes.

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CORRECTIVE ACTION:
Expansion of third-party reporting requirements for SEPs, SIMPLEs, and other retirement plans would not only require legislation but would also significantly increase burden to taxpayers and trustees. In addition, identified cases would be highly complex and require diversion of field examination resources from other casework. These facts, in combination with the limited evidence of non-compliance and low number of affected taxpayers, do not support expansion.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 5:
The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to update the instructions for the Form 5498 to report contributions made for self-employed retirement plans up until the due date of the tax return, as required for other types of retirement plans.

CORRECTIVE ACTION:
This recommendation is more complex than updating instructions, as it requires legislative change. The findings of the report indicate the extent of non-compliance is not significant and would not justify the resources or the burden generated.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 6:
The Commissioner, SB/SE Division, should consider updating programming to use existing third-party data to detect potentially overstated deductions. For example, if the instructions for Form 5498 are revised pursuant to Recommendation 5, the IRS could

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better compare the deduction amounts reported on the tax returns with the amounts reported on Forms 5498.

CORRECTIVE ACTION:
For non-IRA plans, there is currently no third-party data about plan contributions on behalf of individuals. The Form 5500 series data demonstrate that some plans exist, but not all plans are required to file these forms. No clear quantitative compliance benefit has been presented to outweigh the substantial costs to update programming, and no justification has been presented to indicate why this should be a priority for information technology (IT) resources in the current environment of modernization and other competing priorities.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

OUTCOME MEASURE 1:
Revenue Protected – Potential; $176,781,116 ($884 million over five years) in estimated additional taxes owed for 42,991 tax returns that claimed deductions in excess of the lessor of $54,000 or 25 percent of compensation.

OUTCOME MEASURE 2:
Revenue Protected – Potential; $1,185,081 ($5.92 million over five years) in estimated additional taxes for the 485 tax returns in which taxpayers reported contributions to SEP plans only but did not report net earnings from self-employment.

IRS RESPONSE TO OUTCOME MEASURES:
We disagree with your increased revenue potential amounts of $176,781,116 and $1,185,081. We understand TIGTA's methodology of limiting the analysis to tax returns that include a Schedule C. Nonetheless, we believe the amount of increased potential revenue is likely overstated because our examiners would be required to consider other sources of self-employment income, which could impact the allowable deduction. The accuracy of the stated increased potential revenue cannot be definitively determined without examining these 43,476 returns. Due to our limited resources, competing priorities, and significant opportunity costs, we cannot complete examinations on those 43,476 returns. We will pursue the consideration of examinations on five returns related to recommendation 2. The subsequent year returns have a cumulative total of

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$2,091,445 in deductions. If we apply the maximum tax rate applicable for tax year 2018 (37%) we estimate the maximum potential revenue to be $562,329, which has been reduced by our opportunity cost of $211,505[1].

Self-employment retirement plan deductions involve complex issues that can only be addressed by our field examiners. Many of these returns, even if fully adjusted in the amounts identified by TIGTA, would not yield tax assessments justifying the use of such expensive and limited resources. For example, outcome measure one includes 23,221 (54%) returns that have an excess deduction of $10,000 or less. Finally, the five-year projections are dependent on the unlikely assumption that the following 5 years will match the single-year observation, an assumption that does not hold in this case; effective January 1, 2018, the tax laws changed to significantly decrease the marginal tax rates, which means that the projected tax effect of overclaimed SEP deductions would be less in years after 2017.

[1] Opportunity cost was calculated by multiplying the 5 returns by the average Revenue Agent DIF assessment per primary return with activity code 281 closed in FY 2019.

Appendix VI

Abbreviations

AUR	Automated Underreporter
EIN	Employer Identification Number
IRA	Individual Retirement Arrangement
IRS	Internal Revenue Service
SEP	Simplified Employee Pension
SIMPLE	Savings Incentive Match Plan for Employees
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year
W&I	Wage and Investment

To report fraud, waste, or abuse,
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Treasury Inspector General for Tax Administration

P.O. Box 589

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Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.