TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Millions of Dollars in Potentially Erroneous Qualified Business Income Deductions Are Not Being Verified

January 13, 2021

Reference Number: 2021-40-009

TIGTACommunications@tigta.treas.gov | www.treasury.gov/tigta | 202-622-6500

HIGHLIGHTS: Millions of Dollars in Potentially Erroneous Qualified Business Income Deductions Are Not Being Verified

Final Audit Report issued on January 13, 2021
Reference Number 2021-40-009

Why TIGTA Did This Audit

This audit was initiated because the Tax Cuts and Jobs Act created Internal Revenue Code Section 199A, which provides individuals with a new tax deduction for business income called the Qualified Business Income (QBI) Deduction.

This audit evaluated whether the IRS is ensuring that taxpayers claim the correct QBI Deduction.

Impact on Taxpayers

A QBI Deduction is claimed on Form 1040, *U.S. Individual Income Tax Return*, and reduces the taxpayer's taxable income. The determination of the amount of the deduction is complex. The deduction is for owners of domestic businesses operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. In addition to individual taxpayers, some estates and trusts can also take the Section 199A deduction.

Starting with Tax Year (TY) 2019, the IRS developed the following two forms for taxpayers to use when computing their QBI Deduction: Form 8995, *Qualified Business Income Deduction Simplified Computation*, and Form 8995-A, *Qualified Business Income Deduction.*

What TIGTA Found

Processes do not ensure that filers [redacted] for a QBI Deduction claimed. Our analysis of Processing Year 2020 tax returns as of April 16, 2020, identified 12,980 TY 2019 tax returns claiming about $57 million in QBI Deductions for which the filer [redacted] of the qualified business income. In response to a recommendation in our prior report, the IRS established a process to identify tax returns with QBI Deductions for which the claimant did not [redacted] and did not [redacted].

Although the IRS identifies these types of claims, once identified, the IRS is [redacted] and meets the requirements for the deduction.

Further analysis of the 12,980 TY 2019 tax returns determined that the taxpayers reported [redacted], which increases the likelihood that their [redacted] may be [redacted] as [redacted] for the deduction.

Finally, TIGTA identified that employees in the Submission Processing Code and Edit function did not correctly process paper-filed tax returns claiming millions of dollars in QBI Deductions. Our review of more than 2.8 million paper-filed tax returns identified 31,196 that included a QBI Deduction. Further analysis of the 31,196 identified 5,193 paper-filed tax returns with QBI Deductions totaling $45.3 million that were incorrectly processed.

What TIGTA Recommended

TIGTA made five recommendations to the IRS to improve its ability to verify QBI Deductions. These recommendations included updating internal guidelines to require that tax examiners review [redacted] on tax returns identified [redacted], and for those claims that involve the [redacted]; and revising Forms 8995 and 8995-A to include a cautionary statement reminding taxpayers of the [redacted] to claim the QBI Deduction.

The IRS agreed or partially agreed with two recommendations and disagreed with the other three recommendations. The IRS plans to update Forms 8995 and 8995-A as recommended, and plans to evaluate TY 2020 returns that claimed a QBI Deduction [redacted] to determine if there is an increasing compliance risk that warrants additional compliance actions.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

January 13, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Millions of Dollars in Potentially Erroneous Qualified Business Income Deductions Are Not Being Verified (Audit # 202040008)

This report presents the results of our review to determine whether the Internal Revenue Service is ensuring that taxpayers claim the correct Qualified Business Income Deduction. This review was part of our Fiscal Year 2020 Annual Audit Plan and addresses the major management and performance challenge of *Implementing Tax Law Changes*.

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

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 Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

Table of Contents

Appendices

Background

Section (§) 11011 of the Tax Cuts and Jobs Act[1] created Internal Revenue Code § 199A, which provides individuals with a new tax deduction for business income called the Qualified Business Income (QBI) Deduction. The deduction is generally for owners of domestic businesses operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. In addition to individual taxpayers, some estates and trusts can also take the § 199A deduction. A QBI Deduction is generally claimed on Form 1040, *U.S. Individual Income Tax Return*, and reduces the taxpayer's taxable income. The IRS developed two forms for taxpayers to use when computing their QBI Deduction: Form 8995, *Qualified Business Income Deduction Simplified Computation*, and Form 8995-A, *Qualified Business Income Deduction.*

In general, the deduction is for taxable years beginning after December 31, 2017, of up to 20 percent of an individual's domestic qualified business income plus 20 percent of qualified real estate investment trust dividends and qualified publicly traded partnership income from taxable income. Qualified business income is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Depending on the taxpayer's taxable income, the QBI Deduction may be subject to limitations based on the type of trade or business, the amount of Form W-2, *Wage and Tax Statement*, wages paid with respect to the qualified trade or business, and the unadjusted basis immediately after acquisition of qualified property held by the trade or business. For purposes of the deduction, there are two business categories:

- **Specified service trade or business:** Any domestic trade or business, other than a C corporation, involving, for example, the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business whereby the principal asset is the reputation of its employees or owners.
- **Qualified trade or business:** Any domestic trade or business, other than a C corporation, that is not a specified service trade or business and does not perform services as an employee.[2]

A QBI Deduction is not available for wage income[3] or for business income earned by a C corporation.

[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017). Officially known as "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for Fiscal Year 2018."
[2] For taxpayers whose income is at or below the threshold or in the phase-in range, some or all of their specified service trade or business may be considered a qualified trade or business.
[3] There is one exception for wage income for statutory employees. A statutory employee is an independent contractor who is treated as an employee for certain employment tax purposes if meeting certain conditions.

Results of Review

The Internal Revenue Service (IRS) developed and implemented an additional 17 new business rules[4] for use in Processing Year[5] 2020 to identify potentially erroneous QBI Deductions. The 17 new rules are in addition to the two rules[6] previously developed and used in Processing Year 2019. Our review of these newly developed rules found that 16 of the 17 rules were working correctly by identifying and rejecting tax returns with the specific error condition as set forth in the programming for the rules. For the remaining rule, the IRS disabled the rule from February 23 through March 22, 2020, because it was erroneously rejecting tax returns that did not have the specified error condition. The IRS corrected programming for this business rule on March 22, 2020, and we confirmed that the revised programming was working as intended.

In addition, in response to a prior finding, the IRS has been consistently conducting outreach across various platforms to inform and educate taxpayers, tax professionals, *etc.* on the benefits of and requirements for a QBI Deduction. However, our review identified that the IRS's processes do not ensure that filers who [redacted] qualify for the QBI Deduction and that employees in the Submission Processing Code and Edit function correctly process paper-filed tax returns with QBI Deductions.

Processes Do Not Ensure That Filers Who Claim a Qualified Business Income Deduction [redacted]

Our analysis of Processing Year 2020 tax returns as of April 16, 2020, identified 12,980 Tax Year (TY) 2019 tax returns claiming about $57 million in QBI Deductions for which the filer [redacted] of the qualified business income. In response to a recommendation in our prior report, the IRS established a process to identify tax returns with QBI Deductions for which the claimant did not [redacted], and did not [redacted].[7]

However, although the IRS identifies these types of claims, once identified, the IRS is taking no action at the time tax returns are processed to [redacted] reported. Such action is needed to ensure that these filers are in fact [redacted] the QBI Deduction. Tax examiners in the IRS's Error Resolution function reviewing these returns are [redacted]. For example, an input error could be that the

[4] Business rules are used to validate information included on electronically filed tax returns for acceptance into tax return processing. The IRS will reject electronically filed tax returns from processing if the tax return does not meet a business rule. See Appendix III for list of Modernized e-File Business Rules related to QBI Deductions.

[5] A processing year is the calendar year in which the tax return or document is processed by the IRS.

[6] The two business rules developed for the 2019 Filing Season were disabled and added as error codes. A filing season is the period from January through mid-April when most individual income tax returns are filed.

[7] Treasury Inspector General for Tax Administration, Ref. No. 2020-44-007, *Results of the 2019 Filing Season* (Jan. 2020).

taxpayer inadvertently entered his or her standard deduction amount on the line for the QBI Deduction.[8]

The IRS does flag the above-mentioned returns to be potentially selected for a post-processing examination with a focus on [redacted] to support the QBI Deduction. For example, of the 12,980 TY 2019 tax returns we identified, 12,480 with QBI Deductions totaling nearly $37 million met IRS dollar tolerances and were "flagged." However, our review found that the dollar tolerances the IRS has established to ultimately select one of these types of returns for an examination results in the majority of these returns not being examined. Our analysis determined that 11,897 (95.3 percent) of the 12,480 tax returns did not meet the IRS's dollar tolerance to be selected for post-processing compliance treatment. As such, the claim is allowed and not reviewed to ensure that it is valid. These 11,897 tax returns had [redacted] and claimed $28.2 million in QBI Deductions.

The IRS not selecting the majority of the returns we identified for post-processing compliance treatment is despite the IRS denying QBI Deductions for 58 (85.3 percent) of 68 TY 2018 tax returns that were examined, as of May 2020, totaling more than $4.3 million. According to the IRS's examination results, the taxpayers agreed with the change to the QBI Deduction, *i.e.*, that they did not qualify, in 57 (98.3 percent) of the 58 cases.

Returns that the Treasury Inspector General for Tax Administration (TIGTA) identified report [redacted] which increases the likelihood the [redacted] for the QBI Deduction

In addition to the high examination adjustment rate, all of the 12,980 TY 2019 tax returns we identified were taxpayers who were [redacted], which increases the likelihood that their [redacted] for the QBI Deduction [redacted]. For example:

- 4,170 tax returns for which the taxpayer reported [redacted]. Taxpayers must [redacted] to be eligible for a QBI Deduction. Our review of these returns did not identify [redacted] for these taxpayers.
- 8,810 tax returns for which the taxpayer reported [redacted]. Payments made to [redacted], as defined by Internal Revenue Code [redacted] and are considered [redacted] for the purpose for the QBI Deduction.[9] However, for each of these returns, our review of the [redacted] found that the [redacted], that these were [redacted]

[8] Our analysis identified 3,040 tax returns with QBI Deductions totaling $63 million with a transcription or input error. These returns were excluded from our analysis before we identified the number of tax returns with a QBI Deduction that did not [redacted].

[9] Internal Revenue Code provides that… [redacted].

[redacted].[10] [redacted].

Figure 1: [redacted]

[redacted]

Source: Excerpt of [redacted]

Another indicator that the income reported on these returns does not qualify for the QBI Deduction is that these taxpayers did not report the [redacted]. According to the Form 1040 instructions, [redacted].[11] None of these returns [redacted]. According to IRS management, many taxpayers appear to be reporting their [redacted]. As such, we believe that these taxpayers are incorrectly [redacted].

Although tax examiners could identify that [redacted] for these 12,980 returns may not qualify for the QBI Deduction, internal guidelines [redacted], and as a result, no actions were taken on the part of the IRS during processing to address these potentially erroneous claims.

Sending soft notices and adding a cautionary statement could prevent potentially erroneous QBI Deduction claims made by taxpayers

When we discussed our results with IRS management, they indicated they do not have the authority to adjust these types of returns. We agree. However, apart from examining a small number of tax returns, the IRS has taken no other actions in an attempt to reduce the erroneous QBI Deduction claims we identified. The IRS uses soft notices to address noncompliance in other areas of the tax system. These notices commonly provide individuals with information specific to the eligibility or reporting requirements related to the potential error and suggest the filing of a Form 1040X, *Amended U.S. Individual Income Tax Return*, if an error has occurred. The use of soft notices could significantly expand the IRS's ability to address instances when

---

10 [redacted].

11 [redacted].

taxpayers claim the QBI Deduction and tax examiner review of these returns identifies that [redacted] likely does not qualify for the qualified business income deduction.

Furthermore, we recognize the complexities regarding the requirements for claiming the QBI Deduction. As such, it would prove beneficial if the IRS added a cautionary statement, similar to what it is included on Schedule EIC, *Earned Income Credit*, attached to the Form 1040, reminding taxpayers of the eligibility requirements (see Figure 2).

Figure 2: Excerpt of Schedule EIC, Caution Statements

CAUTION

- *You can't claim the EIC for a child who didn't live with you for more than half of the year.*
- *If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See the instructions for details.*
- *It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.*

Source: Excerpt of Schedule EIC.

A statement similar to Figure 3 could be added to the Forms 8995 and 8995-A as another way to inform filers of the [redacted] for the QBI Deduction.

Figure 3: Example of Caution Statements

CAUTION

- *You cannot claim the QBI Deduction if you did not earn* [redacted]
- *If you take the QBI Deduction without supporting documentation, the IRS may request additional information before processing your claim.*
- *It will take the IRS longer to process your tax return if you do not provide sufficient documentation to support your QBI Deduction.*
- *If you received a* [redacted] *you may not be entitled to a QBI Deduction* [redacted] *defined under Internal Revenue Code* [redacted]

Source: TIGTA example.

Requiring filers to include [redacted] would allow the IRS to correct erroneous claims at the time tax returns are processed

In response to our raising this same concern in our prior review, IRS management provided its Office of Chief Counsel with different hypothetical scenarios to review to determine if the IRS could use its math error authority to address the type of QBI claim[12] included in its scenarios. One scenario involved a taxpayer who submitted a tax return claiming a QBI Deduction that [redacted]. In their response, Counsel noted that because a taxpayer who [redacted]

[12] Internal Revenue Code Section 6213(b)(1) gives the IRS the authority to adjust tax returns to correct math or clerical errors without performing an audit. Math or clerical errors (referred to as math errors) include arithmetic type errors, missing or incorrect Social Security Numbers, missing documentation, and claims for tax credits above the allowable amounts.

[redacted].

IRS management further noted that [redacted], is not a proper indication of a taxpayer's eligibility for the QBI Deduction. Further, [redacted] will not provide the information needed to consistently determine eligibility of the QBI Deduction or assist with addressing potentially erroneous QBI Deductions. We disagree, as these are not [redacted], these are [redacted], that are often used to [redacted] which is the [redacted] for claiming the QBI Deduction. Despite the fact that [redacted] are often used to [redacted], IRS management indicated that [redacted].

The Deputy Commissioner for Services and Enforcement should:

Recommendation 1: Update internal guidelines to require tax examiners to review [redacted] tax returns identified [redacted], and for those claims that involve [redacted], develop and send a soft notice to these taxpayers.

> **Management's Response:** The IRS disagreed with this recommendation and the related outcome measure (see Appendix II for more detailed information on the reported outcome measure). IRS management stated that determining the correct QBI Deduction can be extraordinarily complex. Because a taxpayer who [redacted]. IRS management also stated that many of the taxpayers that TIGTA identified with its criteria could be [redacted]. The IRS already has post-processing procedures in place to review returns that claim a QBI Deduction [redacted]. IRS management believes that pursuing soft notices for this issue would not be a good use of resources due to the complexity of the issue and would likely create unnecessary confusion and taxpayer burden.
>
> > **Office of Audit Comment:** We agree that determining the correct QBI Deduction can be extraordinarily complex. The purpose of the soft notice is to serve as an educational tool, encourage self-correction, and improve voluntary compliance. As such, our recommendation is designed to help the taxpayer determine eligibility. Furthermore, soft notices generally do not require the taxpayer to provide a response to the IRS.

Recommendation 2: Revise Forms 8995 and 8995-A to include a cautionary statement reminding taxpayers of the [redacted] to claim the QBI Deduction.

> **Management's Response:** The IRS agreed with this recommendation and plans to update Forms 8995 and 8995-A to include a statement that provides [redacted] to claim the QBI Deduction.

Recommendation 3: Identify the [redacted] that [redacted] and revise the Form 1040 filing instructions to [redacted] in support of qualified business income deduction claims.

Management's Response: The IRS partially agreed with this recommendation. IRS management stated that a taxpayer can claim the QBI Deduction and [redacted]. Taxpayers are [redacted] required to support any QBI Deduction claims on existing Forms 8995 and 8995-A by identifying [redacted]. However, IRS management plans to evaluate TY 2020 returns that claimed a QBI Deduction [redacted] to determine if there is an increasing compliance risk that warrants additional compliance actions.

Employees in Code and Edit Did Not Correctly Process Paper-Filed Tax Returns Claiming Millions of Dollars in Qualified Business Income Deductions

Our review of more than 2.8 million tax returns filed via paper and processed by the IRS as of March 2020 identified 31,196 TY 2019 tax returns that included a QBI Deduction. Further analysis of these 31,196 returns identified 5,193 tax returns with QBI Deductions totaling $45.3 million whereby the taxpayer did not include Forms 8995 or 8995-A and that were incorrectly processed because tax examiners did not correspond with the taxpayer in an attempt to obtain the form or move misplaced entries to the correct line of the tax return, as required.

When we brought our concerns to IRS management's attention, management agreed that the tax examiners were not always corresponding with taxpayers to request the missing forms as required. IRS management reviewed 959 (18.5 percent) of the 5,193 tax returns we identified and found that:

- Tax examiners did not correctly edit the tax return in 710 (74 percent) of the returns reviewed by the IRS when the taxpayer misplaced entries such as the standard deduction amount or taxable income amounts that were incorrectly reported as a QBI Deduction. Internal guidelines require tax examiners to edit obviously misplaced entries and move them to the correct lines prior to data transcription. Some of these incorrect entries could have been due to data entry errors. According to the IRS, these 710 processing errors were corrected in Error Resolution where the QBI Deduction was removed.
- Tax examiners erroneously denied the QBI Deduction before corresponding with the taxpayer in 47 (5 percent) of the cases reviewed. Internal guidelines require tax examiners to correspond with taxpayers when a Form 8995 or Form 8995-A is not included with their paper-filed tax return to request the missing forms. According to the IRS, math error notices were issued explaining that the QBI Deduction was not allowed because the Form 8995 or Form 8995-A was not attached.

On June 11, 2020, IRS management issued an e-mail to its campus managers requesting that they provide training to tax examiners.

The Deputy Commissioner for Services and Enforcement should:

Recommendation 4: Develop processes to ensure that tax examiners are sending correspondence to taxpayers prior to disallowing the QBI Deduction and moving misplaced entries to correct lines, as required.

> **Management's Response:** The IRS disagreed with this recommendation. The IRS already has procedures in place to correspond with taxpayers for missing documentation prior to disallowing the QBI Deduction. IRS management also provided training to tax examiners responsible for resolving errors involving returns claiming the QBI Deduction as part of the annual 2020 Error Resolution System training. In June 2020, management notified campus managers to remind employees to follow the established procedures for corresponding for missing documentation. Additionally, IRS management does not believe it should correspond for supporting documentation when correcting an obvious taxpayer error and moving misplaced entries to correct lines.
>
> > **Office of Audit Comment:** The IRS did not provide the steps that it would take to ensure that correspondence was sent as required and that obvious errors were corrected by its tax examiners prior to data transcription.

Recommendation 5: Ensure that the remaining 4,234 tax returns identified for which the QBI Deduction may have been erroneously disallowed are reviewed, and when applicable, correspond with taxpayers to request Form 8995 or 8995-A to support their deduction.

> **Management's Response:** The IRS disagreed with this recommendation. IRS management believes the recommended manual review and correspondence would be too costly and duplicative. Management indicated that the majority of these returns were corrections to misplaced QBI Deductions during return perfection activities. For the remaining returns, a math error notice was issued to notify taxpayers of changes made to their return. Math error notices advise taxpayers of their appeal rights and provide the toll-free number or address in which to respond with additional information.
>
> > **Office of Audit Comment:** If the IRS's processes were developed and working at the onset as stated in recommendation 4, this recommendation would not be needed. However, as our report notes, employees in the Code and Edit function did not correctly move misplaced entries or correspond when the Form 8995 or 8995-A was not attached to the paper-filed tax returns. This was confirmed by the IRS's own review of 959 of the 5,193 tax returns that we identified. Therefore, the remaining 4,234 tax returns will likely fall into one of these deficiencies and should be addressed accordingly.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS is ensuring that taxpayers claim the correct QBI Deduction. To accomplish our objective, we:

- Evaluated the accuracy of the Modernized e-File business rules and programming and error resolution codes and programming to ensure that they are working as intended.
- Evaluated the actions taken by the IRS in response to our prior recommendation to [redacted].
- Assessed the IRS's outreach efforts to notify potentially eligible taxpayers about the QBI Deduction.
- Evaluated the IRS's post-processing controls to identify individuals who do not meet eligibility requirements and erroneously claim the QBI Deduction.

Performance of This Review

This review was performed with information obtained from the Small Business/Self-Employed Division Examination Operations, Office of Legislative Implementation function in Washington, D.C., and the Wage and Investment Division Submission Processing function in Ogden, Utah, during the period February through June 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 Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); Diana M. Tengesdal, Director; Linna K. Hung, Audit Manager; Kenneth Carlson, Lead Auditor; and Lorenzo Moss, Auditor.

Validity and Reliability of Data From Computer-Based Systems

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

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: the accuracy and programming of the Modernized e-File business rules, the accuracy and programming of the Error Resolution error codes, the post-processing compliance activities and plans to identify individuals erroneously claiming the deduction, and the accuracy of procedures and rules for paper return processing. We reviewed, analyzed, and evaluated procedures and data related to these controls to assess their reliability.

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; $48.7 million in erroneous QBI Deductions from tax returns that [redacted] (see Recommendations 1 and 2).

Methodology Used to Measure the Reported Benefit:

Using the Individual Return Transaction File, we identified 9,434,925 TY 2019 tax returns claiming a QBI Deduction. We reviewed the 9,434,925 tax returns to determine if the taxpayer [redacted]. Specifically, we determined whether the taxpayer [redacted]:

- [redacted].
- [redacted].
- [redacted].
- [redacted].
- [redacted].
- [redacted].

We identified 12,980 tax returns with $57,094,724 in QBI Deductions from the 9,434,925 TY 2019 tax returns [redacted]. To further refine the potential amount of revenue protected for TY 2019, we used the IRS's examination results because the key characteristics of the cases selected for examination, *i.e.*, [redacted], and in which the taxpayer agreed that the QBI Deduction should be disallowed, were the same characteristics as the cases we identified. As such, we multiplied the percentage of disallowed claims from the IRS's TY 2018 examination results (85.3 percent) to the amount of QBI Deductions claimed for TY 2019 that [redacted] ($57,094,724) to determine that the IRS could protect $48,701,800 in disallowed QBI Deductions for TY 2019 ($57,094,724 x 85.3 percent = $48,701,800).

Management's Response: The IRS disagreed with this outcome measure, stating it assumes the results of a small sample of 68 examined returns can be extrapolated to the population of returns identified by TIGTA as being similar, an assumption that is not statistically supported.

Office of Audit Comment: The purpose of an outcome measure is to quantify the extent of an issue or concern. We continue to use the best data available to ensure that our outcome measures provide a reasonable and reliable estimate.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; 583 tax returns that would require a post-processing compliance examination (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

Using the Individual Return Transaction File, we identified 9,434,925 TY 2019 tax returns claiming a QBI Deduction. We reviewed the 9,434,925 tax returns to determine if the taxpayer [redacted]. Specifically, we determined whether the [redacted]:

- [redacted].
- [redacted].
- [redacted].
- [redacted].
- [redacted].
- [redacted].

We determined that 12,980 of the 9,434,925 tax returns [redacted]. Of those 12,980 tax returns, 12,480 were flagged to be potentially addressed via a post-processing examination. Further analysis identified that 583 had QBI Deductions of [redacted] met the threshold for a post-processing compliance examination.

Management's Response: The IRS disagreed with this outcome measure, stating the information needed to address concerns identified with the 583 tax returns required post-processing compliance efforts. Given that these returns could not have been appropriately addressed during processing, the work was an efficient use of post-processing compliance efforts.

Office of Audit Comment: The IRS's unwillingness to address potentially erroneous claims during processing continues to effect its ability to redirect these already limited resources to focus on the most significant compliance work.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 212 taxpayers claiming QBI Deductions that were incorrectly denied (see Recommendations 4 and 5).

Methodology Used to Measure the Reported Benefit:

Our analysis of the Individual Return Transaction File identified 5,377 taxpayers who filed a paper tax return claiming a QBI Deduction greater than [redacted] without including a Form 8995. We matched the 5,377 tax returns to the Individual Master File for TY 2019 to determine whether the IRS sent a Letter 12C, *Individual Return Incomplete for Processing: Forms 1040, 1040-SR, 1040-A & 1040EZ*, to the taxpayer to request the Form 8995 from the taxpayer. We determined that tax examiners did not send Letters 12C to 5,193 (96.5 percent) of the 5,377 taxpayers. The IRS reviewed 959 out of the 5,193 taxpayers' accounts and found that 47 (5 percent) of the 959 taxpayers had their QBI Deduction denied prior to the tax examiner corresponding with the taxpayer to obtain the additional supporting documentation (either Form 8995 or Form 8995-A). We determined that for the remaining 4,234 taxpayers (5,193 less 959), approximately 212 (5 percent) could have had their QBI Deduction incorrectly denied.

Appendix III

Tax Year 2019 Modernized E-File Business Rules for the Qualified Business Income Deduction

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]

Appendix IV

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 30, 2020

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton Digitally signed by Darren J. Guillot Date: 2020.11.30 15:31:17 -05'00'
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Millions of Dollars in Potentially Erroneous Qualified Business Income Deductions Are Not Being Verified (Audit #202040008)

Thank you for the opportunity to review and comment on the subject draft audit report. The Tax Cuts and Jobs Act (TCJA) added §199A to the Internal Revenue Code (IRC), which provides individuals with a tax deduction for business income called the Qualified Business Income (QBI) deduction. This new code section is complex and presents challenges for both taxpayers and the Internal Revenue Service.

Your report focused on our processes to identify and prevent erroneous qualified business income deduction claims. As acknowledged in your report, we have taken several significant actions since the enactment of IRC §199A, including educating taxpayers and the tax professional community, as well as implementing processing and post processing business rules. The 12,980 returns you identified in the report account for less than 0.14% of the population claiming a QBI deduction (9,434,925 returns). Additionally, more than 95% of those returns were properly screened out due to our post processing compliance thresholds leaving only 1,083 returns (0.01%) available for compliance actions.

Your report includes three outcome measures and we agree that 212 taxpayers claiming QBI deductions may have been denied their deduction without having received a request for missing information first. However, we disagree that $48.7 million of increased revenue potential would be derived from potential erroneous QBI deductions. This measure assumes the results of a small sample of 68 examined returns can be extrapolated to the population of returns identified by TIGTA as being similar, an assumption that is not statistically supported. Additionally, the IRS has determined that taking the actions suggested during processing activities could harm taxpayers and increase risks. Conversely, to pursue post-processing compliance activities would create an opportunity cost that would reduce overall revenue potential by diverting resources from other productive workstreams.

2

Similarly, we disagree that post-processing compliance efforts used resources inefficiently to examine the qualified business income deduction reported on 583 tax returns. The information needed to address the concerns identified with these returns required post-processing compliance efforts. Given that these returns could not have been appropriately addressed during processing, the work was an efficient use of post-processing compliance efforts.

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

Attachment

Attachment

RECOMMENDATION 1:
The Deputy Commissioner for Services and Enforcement should update internal guidelines to require tax examiners to review [redacted] tax returns identified [redacted], and for those claims that involve [redacted], develop and send a soft notice to these taxpayers.

CORRECTIVE ACTION:
Determining the correct qualified business income deduction can be extraordinarily complex. Because a taxpayer who [redacted]. Many of the taxpayers that TIGTA identified with its criteria could be eligible for the deduction claimed. The IRS already has post-processing procedures in place to review returns that claim a QBI deduction where [redacted]. Pursuing soft notices for this issue would not be a good use of resources due to the complexity of the issue and would likely create unnecessary confusion and taxpayer burden.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 2:
The Deputy Commissioner for Services and Enforcement should revise Forms 8995 and 8995-A to include a cautionary statement reminding taxpayers of the [redacted] to claim the QBI Deduction.

CORRECTIVE ACTION:
The IRS will update the Forms 8995 and 8995-A to include a statement which provides the [redacted] to claim the QBI Deduction.

IMPLEMENTATION DATE:
October 15, 2021

2

RESPONSIBLE OFFICIAL:
Director, Office of Legislative Program Coordination, Small Business/Self-Employed Division.

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

RECOMMENDATION 3:
The Deputy Commissioner for Services and Enforcement should identify the [redacted] that [redacted] and revise the Form 1040 filing instructions to [redacted] in support of qualified business income deduction claims.

CORRECTIVE ACTION:
A taxpayer can claim the QBI deduction and [redacted]. Taxpayers are [redacted] required to support any qualified business income deduction claims on existing Forms 8995 and 8995-A by identifying [redacted]. However, we will evaluate tax year 2020 returns that claimed a QBID [redacted] to determine if there is an increasing compliance risk that warrants additional compliance actions.

IMPLEMENTATION DATE:
February 15, 2022

RESPONSIBLE OFFICIAL:
Director, Legislative Program Coordination

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

RECOMMENDATION 4:
The Deputy Commissioner for Services and Enforcement should develop processes to ensure tax examiners are sending correspondence to taxpayers prior to disallowing the QBI Deduction and moving misplaced entries to correct lines, as required.

CORRECTIVE ACTION:
Procedures to correspond with taxpayers for missing documentation prior to disallowing the QBI deduction are already in place. We provided training for tax examiners

responsible for resolving errors involving returns claiming the QBI deduction as part of the annual 2020 Error Resolution System training. In June 2020, we notified campus managers to remind employees to follow the established procedures for corresponding for missing documentation.

The IRS should not correspond for supporting documentation when correcting an obvious taxpayer error and moving an amount from Form 1040, line 10, Qualified business income deduction, to line 9, Standard deduction or itemized deductions.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 5:
The Deputy Commissioner for Services and Enforcement should ensure the remaining 4,234 tax returns identified for which the QBI Deduction may have been erroneously disallowed are reviewed, and when applicable, correspond with taxpayers to request Form 8995 or 8995-A to support their deduction.

CORRECTIVE ACTION:
The majority of these returns were corrections to misplaced QBI deductions during return perfection activities. For the remaining returns, a math error notice was issued to notify taxpayers of changes made to their return. Math error notices advise taxpayers of their appeal rights and provide the toll-free number or address in which to respond with additional information.

The recommended manual review and correspondence is too costly and duplicative.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

Appendix V

Abbreviations

IRS	Internal Revenue Service
QBI	Qualified Business Income
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year

To report fraud, waste, or abuse, call our toll-free hotline at:

(800) 366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

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