TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Identification of Unreported Self-Employment Taxes Can Be Improved

October 11, 2007

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

October 11, 2007

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Identification of Unreported Self-Employment Taxes Can Be Improved (Audit # 200630028)

This report presents the results of our review of the Internal Revenue Service's (IRS) processing of Social Security and Medicare taxes on self-employment income. The overall objective of this review was to determine the effectiveness of the IRS' process for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes. This review was part of our Fiscal Year 2007 audit plan and contributes to our efforts to assess the Fiscal Year 2007 Major Management Challenge of addressing the tax gap.[1]

Impact on the Taxpayer

According to the Government Accountability Office, outlays from the main trust funds of the Social Security and Medicare programs are projected to exceed revenues in the next decade. As the tax collector for the Social Security and Medicare programs, the IRS must help self-employed taxpayers meet their tax responsibilities by assessing and collecting the proper amount of self-employment taxes. We estimate the IRS could assess an additional $19 million in Social Security and Medicare taxes each year by making the changes recommended in this report.

Synopsis

Taxpayers generally pay self-employment taxes on net self-employment earnings of $400 or more in a given tax year, in addition to any income taxes that may be due; they are considered to be self-employed if they conduct a trade or business as a sole proprietor, earn income as an

[1] See Appendix V for a Glossary of Terms.

independent contractor or a member of a partnership, or are in any way in business for themselves. Taxpayers with self-employment income should use a U.S. Individual Income Tax Return (Form 1040) Self-Employment Tax (Schedule SE) to calculate the amount of self-employment taxes and attach the Schedules SE to their Forms 1040.

The IRS Office of Internal Audit and the Treasury Inspector General for Tax Administration issued audit reports in 1998[2] and 2000,[3] respectively, that focused on the identification and collection of self-employment taxes. Both reports found (1) individual returns with unreported self-employment taxes could be identified during initial processing, (2) self-employment taxes should be assessed before any refunds are issued to taxpayers, and (3) the IRS could improve its processes to more accurately identify the taxpayers and income that are subject to self-employment taxes. Most recommendations from our prior reports have been reported as implemented. However, the IRS has not implemented our recommendation that the Correspondence Examination function initiate a program to immediately work significant cases with refunds available to offset against the unreported self-employment taxes.

We reviewed the assignment of Return Processing Code (RPC) "N," which is used by the Submission Processing function to indicate a return with apparent nonemployee compensation on Form 1040 line 21 (Other income) that should be reviewed for self-employment tax liability. When RPC "N" was input, it was generally warranted; however, 29 percent of the cases in our samples with significant entries on line 21 should have had RPC "N" input but did not. We discussed the procedures for assigning RPC "N" with IRS personnel and found inconsistent guidance for the treatment of returns reporting on line 21 income that is potentially subject to the self-employment tax.

To determine the effectiveness of the IRS' current processes for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes, we selected a statistically valid sample of 138 Tax Year (TY) 2003 returns that reported income of $2,000[4] or more on a Form 1040 Profit or Loss From Business (Schedule C), Profit or Loss From Farming (Schedule F), and/or line 21 (Other income) but did not include a Schedule SE. We found 52 (38 percent) of the 138 returns in our sample had been selected for audit by the IRS, and the audits had been completed for 50 returns. Of the 50 returns, 5 had been closed as "no-change" returns (i.e., no changes were made to the tax liabilities) and 12 had been surveyed, meaning the audits were closed with little or no examination[5] of the returns. The remaining 33 of 50 returns had been closed with additional tax liabilities averaging $1,818 per return.

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[2] *Compliance With Self-Employment Tax Requirements* (Reference Number 083502, dated May 19, 1998).
[3] *The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes* (Reference Number 2000-30-151, dated September 2000).
[4] For the purposes of the current and previous audits, our materiality threshold was self-employment income of $2,000 or more for which no self-employment taxes were paid.
[5] As used in this report, the terms "examination" and "audit" are synonymous.

Of the 86 returns in our sample that had not been selected for audit, 28 (33 percent) appeared to have self-employment tax liabilities. A total of $34,089 in self-employment taxes could have been assessed on the 28 returns (average of $1,217 per return); 6 of the 28 returns had potential assessments exceeding $2,000 per return.

We also noted a significant problem with assigning Audit Code "V"[6] to returns. Of the 138 TY 2003 returns in our sample, 33 (24 percent) either had Audit Code "V" improperly assigned when a return had no self-employment tax issue or did not have the Code assigned when a self-employment tax issue was present.

Overall, 35 (25 percent) of all returns in our sample had potential self-employment tax issues but either were not selected for audit or were surveyed although the taxpayers had not properly reported self-employment taxes; 15 (43 percent) of these 35 returns had refunds available to offset all or part of the self-employment tax liabilities.

Recommendations

We recommended the Commissioner, Wage and Investment Division, (1) emphasize the importance of properly assigning RPC "N" to returns with potential self-employment tax liabilities and provide additional training to tax examiners in the Code and Edit function to improve the review of income reported on Form 1040 line 21, especially for returns with missing or unclear descriptions of the income, and (2) strengthen the processes for reviewing returns upon initial receipt for potential unpaid self-employment taxes, especially the processes for including the statutory income indicator in the W-2 database and for assigning Audit Code "V" to appropriate returns. We recommended the Commissioner, Small Business/Self-Employed Division, reconsider the decision to cancel our previous recommendation to immediately work cases with significant unreported self-employment tax, a refund available to be applied to the unreported self-employment tax, and no response or an inadequate response to any letter issued by the IRS during returns processing.

Response

IRS management agreed with the first two recommendations and disagreed with the third recommendation. The Director, Submission Processing, Wage and Investment Division, will coordinate with the Learning and Education function to explore the possibility of expanding existing RPC "N" and Audit Code "V" editing training in course materials to be issued January 1, 2008. However, the Commissioner, Small Business/Self-Employment Division, disagreed with our recommendation to consider immediately working cases with significant

[6] Audit Code "V" is used by the Code and Edit function at IRS campuses during initial processing to identify returns with income that may be subject to the self-employment tax.

unreported self-employment tax, a refund available to be applied to the unreported self-employment tax, and no response or an inadequate response to any letter issued by the IRS during returns processing. IRS management stated the parameters could not be accurately identified to ensure the IRS would not be holding the refunds of taxpayers not subject to self-employment taxes. In addition, management noted that their current process for selecting inventory excludes most of the returns originally assigned RPC “N” and/or Audit Code “V.” Management’s complete response to the draft report is included as Appendix VI.

Office of Audit Comment

While we agree it is important to not delay refunds properly owed to taxpayers, we also believe it is important to not issue large refunds to taxpayers who will ultimately owe additional taxes. Based on the results of this and previous audits, we maintain it is feasible for the IRS to initiate examinations of the returns of taxpayers that appear to owe a significant amount of self-employment tax, have an available refund, and have not responded to initial contact letters from the IRS, and we encourage the IRS to move in that direction. In addition, it has long been noted by the IRS that “upstream” prevention efforts during returns processing are lower in cost and less intrusive to taxpayers than one-on-one enforcement efforts occurring later in the process.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.

Table of Contents

Background....................Page 1

Results of Review....................Page 3

The Internal Revenue Service Has Implemented Most of Our Previous Recommendations for Identifying Taxpayers Who May Be Subject to Self-Employment Tax....................Page 3

Procedures for Assigning Return Processing Code "N" Should Be Improved....................Page 5

Recommendation 1:....................Page 6

Procedures for Selecting Returns With Potential Unpaid Self-Employment Tax for Audit Should Be Strengthened....................Page 7

Recommendation 2:....................Page 12

Priority Should Be Given to Initiating Correspondence Examinations for Returns With Significant Amounts of Potential Unpaid Self-Employment Tax and Refunds Available....................Page 12

Recommendation 3:....................Page 14

Appendices

Appendix I – Detailed Objective, Scope, and Methodology....................Page 15

Appendix II – Major Contributors to This Report....................Page 18

Appendix III – Report Distribution List....................Page 19

Appendix IV – Outcome Measures....................Page 20

Appendix V – Glossary of Terms....................Page 22

Appendix VI – Management's Response to the Draft Report....................Page 24

Abbreviations

IRS	Internal Revenue Service
RPC	Return Processing Code
TY	Tax Year

Background

In general, taxpayers pay self-employment taxes on net self-employment earnings of $400 or more in a given tax year, in addition to any income taxes that may be due;[1] they are considered to be self-employed if they conduct a trade or business as a sole proprietor, earn income as an independent contractor or a member of a partnership, or are in any way in business for themselves. Certain types of income are exempt from self-employment tax,[2] as are members of certain religious organizations that are conscientiously opposed to accepting public insurance benefits.[3]

Underreported self-employment tax is estimated to be the single largest component of the tax gap.

Taxpayers typically report self-employment income on their U.S. Individual Income Tax Returns (Form 1040) using Profit or Loss From Business (Schedule C) and/or Profit or Loss From Farming (Schedule F). Certain types of self-employment income are mistakenly reported on Form 1040 line 21 (Other income), particularly "nonemployee" compensation reported to taxpayers on Miscellaneous Income (Form 1099-MISC).

Taxpayers with self-employment income should calculate the amount of self-employment taxes and the associated income tax deductions[4] using a Form 1040 Self-Employment Tax (Schedule SE) and attach the Schedules SE to their Forms 1040. The maximum self-employment tax rate is currently 15.3 percent and consists of 2 components: 12.4 percent for Social Security (payable on the first $94,200 of combined wages and net earnings in 2006) and 2.9 percent for Medicare (no income limitation).

The Internal Revenue Service (IRS) estimated the gross tax gap[5] for Tax Year (TY) 2001 to be approximately $345 billion. Of this amount, about $54 billion (16 percent) is attributable to underreported employment taxes. Self-employment tax is estimated to make up about $39 billion (72 percent) of underreported employment taxes, or 11 percent of the total gross tax gap, making it one of the largest components of the tax gap. The added burden of the tax gap on

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[1] Internal Revenue Code Sections 1401-1403 (2002).
[2] These include fees earned as a notary public, income from real estate or farm rentals for taxpayers who are not active in these businesses, and payments to retired partners who are not active in the partnership.
[3] Members of these organizations must also file an Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits (Form 4029).
[4] Taxpayers may deduct one-half of the self-employment taxes paid from their total income reported on Form 1040.
[5] See Appendix V for a Glossary of Terms.

taxpayers is substantial—the IRS National Taxpayer Advocate testified that the tax gap added about $2,000 to the average tax bill in 2001.[6]

In addition to increasing the tax gap, failure to identify and collect the correct amount of self-employment taxes also contributes to the deteriorating financial outlook for the Social Security and Medicare programs. The Government Accountability Office has reported that outlays from the Social Security[7] and Medicare[8] trust funds will begin to exceed revenues in the next decade.[9] As the tax collector for the Social Security and Medicare programs, the IRS must help self-employed taxpayers meet their tax responsibilities by assessing and collecting the proper amount of self-employment taxes.

This review was performed at the Small Business/Self-Employed Division National Headquarters in New Carrollton, Maryland; the Submission Processing function of the IRS Fresno Campus in Fresno, California; the Examination Operations function of the IRS Cincinnati Campus in Covington, Kentucky; and the Small Business/Self-Employed Division Planning and Workload Selection function in Florence, Kentucky, during the period August 2006 through March 2007. The audit was conducted in accordance with *Government Auditing Standards*. This review was part of our Fiscal Year 2007 audit plan and contributes to our efforts to assess the Fiscal Year 2007 Major Management Challenge of addressing the tax gap.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[6] Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance on the Tax Gap and Tax Shelters, July 2004.
[7] The Social Security program has two trust funds: the Old Age Survivors Insurance Trust Fund and the Disability Insurance Trust Fund.
[8] The Medicare program has two trust funds: the Hospital Insurance Trust Fund and the Supplemental Medical Insurance Trust Fund.
[9] For Social Security funding, see *Social Security Reform: Greater Transparency Needed about Potential General Revenue Financing* (GAO-07-213, dated March 2007). For Medicare funding, see *Medicare: Financial Challenges and Considerations for Reform* (GAO-03-577T, dated April 10, 2003).

Results of Review

The Internal Revenue Service Has Implemented Most of Our Previous Recommendations for Identifying Taxpayers Who May Be Subject to Self-Employment Tax

The IRS Office of Internal Audit and the Treasury Inspector General for Tax Administration issued audit reports in 1998[10] and 2000,[11] respectively, that focused on the identification and collection of self-employment taxes. Both reports found (1) individual returns with unreported self-employment taxes could be identified during initial processing, (2) self-employment taxes should be assessed before any refunds are issued to taxpayers, and (3) the IRS could improve its processes to more accurately identify the taxpayers and income that are subject to self-employment taxes. The recommendations from the reports are shown in Figures 1 and 2, along with the status of the recommendations from the Joint Audit Management Enterprise System.

Figure 1: Status of Recommendations From Report Reference Number 083502

Recommendations	Status
1. The Office of Internal Audit will monitor the results of our sample of cases in the three service centers and provide these results to the Service Center Examination Section in the National Office. If the results warrant, management should request a computer program similar to ours to identify, during processing, those cases owing self-employment taxes.	*Implemented*
2. Management should solicit a position paper from the IRS Office of Chief Counsel regarding the legality of freezing a taxpayer's refund on a self-employment tax issue.	*Implemented*
3. The Submission Processing function should incorporate into the training of Code and Edit function tax examiners details regarding the specific types of income included on Form 1040 line 21 that should be considered as self-employment income and should emphasize the importance of properly coding this information.	*Implemented*

Source: Report Reference Number 083502 and the Joint Audit Management Enterprise System report for Report 083502.

[10] *Compliance With Self-Employment Tax Requirements* (Reference Number 083502, dated May 19, 1998).
[11] *The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes* (Reference Number 2000-30-151, dated September 2000).

Figure 2: Status of Recommendations From Report Reference Number 2000-30-151

Recommendations	Status
1. The Chief Operations Officer should ensure programming is completed to identify unreported self-employment taxes during processing. Educational letters similar to those sent to taxpayers by the Kansas-Missouri District Office Research and Analysis function should then be sent to these taxpayers.	*Implemented*
2. The Assistant Commissioner (Customer Service) should initiate a program for the Correspondence Examination function to immediately work significant cases with a refund available to offset against the unreported self-employment tax and no response or an inadequate response to any letter issued by the IRS during returns processing.	**Cancelled**
3. The Assistant Commissioner (Forms and Submission Processing) should take steps to ensure information from Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits (Form 4029) and Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners (Form 4361) is accurately entered in IRS computers.	*Implemented*
4. The Assistant Commissioner (Forms and Submission Processing) should develop a means of capturing the identity of taxpayers who are contacted to pay self-employment taxes but indicate they have filed either Form 4029 or Form 4361. This information should be used to perfect the IRS' database of taxpayers who are exempt from self-employment tax.	*Implemented*
5. The Assistant Commissioner (Forms and Submission Processing) should improve instructions for Form 1040 line 21, to make it clearer to taxpayers that they should not include self-employment income on line 21 and to help taxpayers understand what constitutes self-employment income.	*Implemented*
6. The Assistant Commissioner (Forms and Submission Processing) should take steps to ensure data transcribers do not overlook the statutory employee checkbox on Form 1040 Schedule C and Form 1040 Net Profit From Business (Schedule C-EZ).	*Implemented*
7. The Assistant Commissioner (Customer Service) should revise the formula for scoring the self-employment tax inventory so it accurately reflects the potential self-employment tax deficiency on a tax return.	*Implemented*
8. The Assistant Commissioner (Customer Service) should consider certain changes to the educational letter sent to taxpayers with potential self-employment tax deficiencies.	*Implemented*
9. The Assistant Commissioner (Customer Service) should consider the feasibility of sending different letters to taxpayers based on the amount of self-employment income earned by the taxpayer.	**Rejected**

Source: Report Reference Number 2000-30-151 and the Joint Audit Management Enterprise System report for Report 2000-30-151.

As shown in Figures 1 and 2, most recommendations from our prior reports have been reported as implemented. Even though the IRS initially agreed with Recommendation 2 in our 2000 report (see Figure 2), it requested cancellation of the Recommendation in 2004 by stating:

> *Because we do not have a systemic filter to identify returns with high potential for self-employment tax, we cannot justify holding refunds. Also, we do not have a systemic method to hold refunds on returns with potential self-employment tax liabilities.*

The IRS rejected Recommendation 9 in its response to our audit report issued in 2000, stating that sending different letters to taxpayers would result in disparate treatment of taxpayers. Although we did not agree with the IRS' rejection of this Recommendation, we did not elevate the dispute to the Department of the Treasury.

Due to the length of time since our previous reports were issued and changes in the IRS' structure and operations in the intervening years, we initiated a review of the current state of the processes for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes.

Procedures for Assigning Return Processing Code "N" Should Be Improved

The IRS uses Return Processing Codes (RPC) to identify special conditions or computations in returns that otherwise would not post to the IRS Master File. RPC "N" is intended to indicate a return with what appears to be nonemployee compensation on Form 1040 line 21 (Other income) that should be reviewed for self-employment tax liability. This determination is normally made by a tax examiner who initially reviews the return upon its receipt in the Code and Edit function of the Submission Processing function at an IRS campus. The guidance for assigning RPC "N" to returns is found in the Internal Revenue Manual. In summary, RPC "N" should be assigned to returns that report self-employment income of more than a specified amount on line 21 but do not include a Schedule SE to assess the self-employment tax liability.

To determine whether RPC "N" is being properly assigned to returns with potential self-employment tax liabilities, we obtained data from the IRS Master File for 24,989 TY 2005 Forms 1040 that reported more than a certain dollar amount on line 21 and were assigned RPC "N." From this population, we reviewed a statistically valid sample of 138 Forms 1040[12] and determined RPC "N" was correctly assigned for 132 (96 percent) of the returns reviewed.

To determine if there were returns that should have been assigned RPC "N" but were not, we obtained data from the IRS Master File for 5,030,333 TY 2005 Forms 1040 that reported more than a certain dollar amount on line 21 but were not assigned RPC "N." From this population, we reviewed a statistically valid sample of 138 Forms 1040[13] and determined RPC "N" should have been assigned to 40 (29 percent) of the returns reviewed.

While there were a variety of factors involved with the 40 returns that should have been assigned RPC "N," we noted that 18 (45 percent) of the 40 returns were filed electronically and 33 (83 percent) contained little or no description of the income reported on line 21. Without some sort of description of the income on line 21, it is unclear to us how tax examiners determined the amounts reported were not potentially subject to self-employment taxes. Unless

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

the description of the line 21 income makes it clear the amount is not subject to self-employment tax, RPC "N" should be assigned to the return so the taxpayer will be contacted to provide an explanation for the income.

We discussed our review methodology and the results of our review for selected returns with IRS personnel at the Fresno Campus. We noted inconsistencies in assigning RPC "N" to returns with line 21 income reported on a Form 1099-MISC and were informed the practice at that Campus was to assign RPC "N" only when the Form 1099-MISC reports income in box 7 (Nonemployee compensation). We noted Internal Revenue Manual Section 3.11.3 did not specifically require that only returns with income reported in Form 1099-MISC box 7 be assigned RPC "N." We asked IRS officials if the practice used at the Fresno Campus was the standard for all campuses or a matter of local discretion and were advised that:

> *While the practice of deviating from existing IRM [Internal Revenue Manual] instructions is discouraged, it appears that both Fresno and Philadelphia are correct. Consequently, Hot Topic W&I [Wage and Investment]-IA-2002-510 was issued on March 21, 2007[,] to remedy this problem. Tax Examiners are now instructed at 3.11.3.14.2.15 (pg. 164) to edit RPN*[sic] *"N" when Form 1099-MISC is present with an amount in* ***box 7****.* (emphasis added)

Although we agree that amounts reported in Form 1099-MISC box 7 are likely to be subject to self-employment taxes and should be assigned RPC "N," the treatment of other amounts, such as those reported in box 3 (Other income), is less certain. The instructions for Form 1099-MISC list items such as "prizes, awards, taxable damages, Indian gaming profits" as income that should be reported in box 3; however, they also include a catchall of "other taxable income." Many small businesses and sole proprietors provide Forms 1099-MISC to their workers, and some may not understand the distinction between other taxable income to be reported in box 3 and nonemployee compensation to be reported in box 7. Some cases in our sample of TY 2005 returns that were not assigned RPC "N" involved income reported in Form 1099-MISC box 3 that appeared to be from self-employment, based on the fact that the Form 1099-MISC was issued by a business. Because of this, we believe the review of Form 1099-MISC income should not be limited to considering just amounts reported in box 7 but should also include all amounts reported on Form 1099-MISC, especially if the description of the income on Form 1040 line 21 is missing or unclear.

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should emphasize the importance of properly assigning RPC "N" to returns with potential self-employment tax liabilities and provide additional training to tax examiners in the Code and Edit function to improve the review of income reported on Form 1040 line 21, especially for returns with missing or unclear descriptions of the income.

Management's Response: IRS management agreed with this recommendation. The Director, Submission Processing, Wage and Investment Division, will coordinate with the Learning and Education function to explore the possibility of expanding existing RPC "N" editing training in course material to be issued January 1, 2008.

Procedures for Selecting Returns With Potential Unpaid Self-Employment Tax for Audit Should Be Strengthened

Correspondence examinations[14] are the primary method used to audit individual returns with only potential self-employment tax liabilities. These examinations are conducted primarily by mail by tax examiners at various IRS campuses located throughout the country.

Returns with potential self-employment tax issues are selected for correspondence examination by the Workload Selection and Delivery function within the Small Business/Self-Employed Division Planning and Workload Selection function. A planned number of cases to be selected for self-employment tax examination, as well as other areas of emphasis, is developed each year by Workload Selection and Delivery function personnel in coordination with Small Business/ Self-Employed Division management.

Once the planned number of examinations is established, the Workload Selection and Delivery function extracts data from the Midwest Automated Compliance System database to identify returns that may be subject to self-employment tax. Filters are run against the data extracts to exclude taxpayers that are not likely to be subject to self-employment tax.

When the planned number of returns with potential self-employment tax issues is identified, the correspondence examination workload is assigned to Examination Operations function teams in various IRS campuses based on the annual workplan for each campus. The correspondence examination process typically does not begin until several months after the filing of the return. We met with representatives of the Examination Operations function at the Cincinnati Campus in January 2007 and were informed that they were completing work on TY 2004 returns with potential self-employment tax issues, most of which were filed in early 2005 and examined in Fiscal Year 2006.

Based on the following factors, we determined the self-employment tax examination program could be improved:

- The assessments per return for self-employment tax cases were much lower than those for other correspondence examination cases, and the no-change rate was much higher.
- A significant number of potential self-employment tax cases were overlooked during processing and were never included in the potential self-employment tax inventory; many

[14] As used in this report, the terms "examination" and "audit" are synonymous.

had potential unpaid self-employment taxes amounting to more than that on the cases identified and examined.

- Many self-employment tax cases were surveyed (meaning the audit was closed with little or no examination of the return), although the taxpayers had not properly reported self-employment taxes.
- Inaccuracies in some of the data used to select returns for audit may contribute to problems with the identification and selection of returns.

The assessments per return for self-employment tax cases were much lower than those for other correspondence examination cases, and the no-change rate was much higher

Approximately 29,000 examinations of returns with potentially unpaid self-employment taxes were closed in Fiscal Year 2006 for the primary Audit Information Management System project codes established for self-employment tax examinations. More than 21,000 of these examinations resulted in taxpayers owing additional taxes totaling almost $42 million or approximately $2,000 per return. However, more than 27 percent of the examinations were closed without an assessment (i.e., no changes were made to tax liabilities). Figure 3 shows that the assessment per return and the no-change rate for self-employment tax examinations do not compare favorably to the overall results for Fiscal Year 2006 correspondence examinations of individual taxpayers because the assessment per return was lower and the no-change rate was higher. Our analysis of the overall Fiscal Year 2006 results excluded taxpayers with incomes of $100,000 or more who would most likely be subject only to the 2.9 percent Medicare tax and therefore would not be selected for a self-employment tax correspondence examination.

Figure 3: Comparison of Self-Employment Tax Correspondence Examination Results to Overall Correspondence Examination Results (Fiscal Year 2006)

Type of Examination	Assessment per Return	No-change Rate
Self-employment Tax Correspondence	$1,976	27.3%
Individual Correspondence (income < $100K)	$3,748	16.0%

Source: Our analysis of IRS 2006 Data Book data and Fiscal Year 2006 self-employment tax examination data for Audit Information Management System Project Codes 0124 (SE Tax), 0395 (SE Tax Not Reported by Taxpayer), and 0376 (Bogus Schedule C Losses Identified Through Criminal Investigation Referrals) provided by the Small Business/Self-Employed Division. SE = Self-employment.

A significant number of potential self-employment tax cases were overlooked during processing and were never included in the potential self-employment tax inventory

To determine the effectiveness of the IRS' current processes for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes, we selected a statistically valid sample of 138 TY 2003 returns that reported income of $2,000[15] or more on Form 1040 Schedule C, Schedule F, and/or line 21 (Other income) but did not include a Schedule SE. Of the 138 returns selected in our sample, 52 (38 percent) had been selected for audit by the IRS, and the audits had been completed for 50 returns. Of the 50 returns with completed audits, 5 had been closed as no-change returns and 12 had been surveyed. The remaining 33 of 50 returns had been closed with additional tax liabilities averaging $1,818 per return. The results of this review are summarized in Figure 4.

Figure 4: IRS Examination Results for TY 2003 Returns in Our Sample

	Number of Returns	Percentage of Sample (138)	Percentage of Returns Audited (50)	Average Assessment per Return
Returns With Completed Audits	50	36%	N/A	N/A
Returns Owing Additional Taxes	33	24%	66%	$1,818
Returns Closed As No-change	5	4%	10%	N/A
Returns Surveyed	12	9%	24%	N/A

Source: Our review of TY 2003 individual tax returns. N/A = not applicable.

We reviewed the 86 returns that had not been selected for audit and determined 28 (33 percent) appeared to have self-employment tax liabilities. For these returns, the taxpayers did not appear to be exempt from self-employment taxes but had not filed Schedules SE. We determined $34,089 in self-employment taxes could have been assessed on the 28 returns (average of $1,217 per return). Six (21 percent) of the 28 returns had potential assessments exceeding $2,000 per return. Where applicable, our estimated assessments were reduced to allow for the effect that the deduction of one-half of the self-employment taxes from the taxpayers' taxable incomes would have on their income tax liabilities. The results of this review are summarized in Figure 5.

[15] For the purposes of the current and previous audits, our materiality threshold was self-employment income of $2,000 or more for which no self-employment taxes were paid.

Figure 5: Review of TY 2003 Returns With Potential Self-Employment Tax Liabilities Not Selected for Review by the IRS

	Number of Returns	Percentage of Nonselected (86)	Percentage of Sample (138)	Average Potential Assessment per Return
Total Nonselected Returns With Potential Self-Employment Tax	28	33%	20%	$1,217
Nonselected Returns With Potential Self-Employment Tax > $2,000	6	7%	4%	N/A
Nonselected Returns Without Potential Self-Employment Tax	58	67%	42%	N/A

Source: Our review of TY 2003 individual tax returns. N/A = not applicable.

Projecting the percentage of nonselected returns with potential self-employment tax to our sample universe, as adjusted for certain inaccuracies discussed below, we estimate that an additional 15,492 TY 2003 Forms 1040 had self-employment tax liabilities but were not selected for examination. Assuming the examinations would have been closed as no-change at the same rate as in Fiscal Year 2006 (27.3 percent), based on our statistical sample, the IRS could have assessed approximately $13.7 million more in Social Security and Medicare taxes on 11,263 TY 2003 returns not selected for examination.[16]

Many cases were surveyed, although the taxpayers had not properly reported self-employment taxes

We reviewed the 12 returns that had been surveyed and could not determine a sound basis for the decision for 7 returns (58 percent). The taxpayers in these cases appeared to report self-employment income subject to self-employment tax and did not appear to be exempt from self-employment tax, but they had not filed Schedules SE. We determined $13,216 in self-employment taxes could have been assessed on the 7 returns (average of $1,888 per return). The estimated assessments were reduced to allow for the effect of the deduction of one-half of the self-employment taxes on the taxpayers' income tax liabilities. The results of this review are summarized in Figure 6.

[16] See Appendix IV for details on the estimates.

Figure 6: Review of TY 2003 Returns Surveyed by the IRS

	Number of Returns	**Percentage of Surveyed** (12)	**Percentage of Sample** (138)	**Average Potential Assessment per Return**
Returns Surveyed With No Apparent Basis for Decision	7	58%	5%	$1,888
Returns Surveyed With Apparent Basis for Decision	5	42%	4%	N/A

Source: Our review of TY 2003 individual tax returns. N/A = not applicable.

Based on our sample, we estimate an additional 3,873 TY 2003 Forms 1040 had self-employment tax liabilities but were surveyed without justification. Assuming the examinations would have been closed as no-change returns at the same rate as in Fiscal Year 2006, we estimate the IRS could have assessed approximately $5.3 million more in Social Security and Medicare taxes on 2,816 TY 2003 returns surveyed without justification.[17]

Overall, the significant percentage of unexamined (including surveyed) returns with potential self-employment tax liabilities in our review of TY 2003 returns indicates a need for the IRS to improve its review of returns upon initial receipt for potential self-employment tax liabilities and its selection of returns for audit. The comparison of current performance statistics for the self-employment tax examination program to those for correspondence examinations in general (see Figure 3) also supports this conclusion.

Inaccuracies in some of the data used to select returns for audit may contribute to problems with the identification and selection of returns

To obtain a valid sample of 138 TY 2003 returns, we were required to select and review 193 returns because 55 returns that appeared to meet our selection criteria were eliminated from the sample. Of the 193 total returns reviewed, 30 (16 percent) reported statutory income on Schedule C, but the taxpayers' records in the W-2 database did not include the code indicating the presence of statutory income. The failure to properly include this code in the W-2 database could cause returns to be improperly selected for audit and result in increases in the number of examinations closed by survey or as no-change returns.

We also noted a significant problem with assigning Audit Code "V" to returns, which is used by the Code and Edit function at IRS campuses during initial processing to identify returns with income that may be subject to self-employment tax. Of the 138 returns in our sample of

[17] See Appendix IV for details on the estimates.

TY 2003 returns, 33 (24 percent) either had Audit Code "V" improperly assigned when a return had no self-employment tax issue or did not have the Code assigned when a self-employment tax issue was present. The returns that were improperly assigned the Code could have been selected for audit without self-employment tax issues being present, resulting in surveyed or no-change examinations. Returns that were not assigned the Code may not have been selected for audit, and the proper self-employment taxes would not have been assessed.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should strengthen the processes for reviewing returns upon initial receipt for potential unpaid self-employment taxes, especially the processes for including the statutory income indicator in the W-2 database and assigning Audit Code "V" to appropriate returns.

> ***Management's Response:*** IRS management agreed with this recommendation. The Director, Submission Processing, Wage and Investment Division, will coordinate with the Learning and Education function to explore the possibility of expanding existing Audit Code "V" editing training in course material to be issued January 1, 2008.

Priority Should Be Given to Initiating Correspondence Examinations for Returns With Significant Amounts of Potential Unpaid Self-Employment Tax and Refunds Available

We reviewed a statistically valid sample of 138 TY 2003 returns that reported income of $2,000 or more on Form 1040 Schedule C, Schedule F, and/or line 21 (Other income) without a Form 1040 Schedule SE associated with the return. Of these 138 returns, 35 (25 percent) had potential self-employment tax issues but either were not selected for audit or were surveyed, although the taxpayers had not properly reported self-employment taxes. As shown in Figure 7, 15 (43 percent) of the 35 returns with potential self-employment tax issues had refunds available to offset all or part of the self-employment tax liabilities.

Figure 7: Nonexamined TY 2003 Returns With Refunds Available to Offset All or Part of the Potential Self-Employment Tax Liabilities

	Number of Returns	Total Potential Self-Employment Tax Liability	Returns With Refunds to Offset Self-Employment Tax	Refunds to Offset Self-Employment Tax[18]	Percentage of Self-Employment Tax Liability Offset by Refunds
Returns Surveyed With No Apparent Basis for Decision	7	$13,216	2	$1,087	8%
Nonselected Returns With Potential Self-Employment Tax	28	$34,089	13	$7,082	21%

Source: Our review of TY 2003 individual tax returns.

In Figure 7, the 2 surveyed returns had an average potential self-employment tax liability of $1,249 and an average refund of $544 (44 percent) available to offset the unpaid self-employment tax liability. The 13 nonselected returns had an average potential self-employment tax liability of $1,193 and an average refund of $545 (46 percent) available to offset all or part of the unpaid self-employment tax liabilities. Our calculation of available refunds did not include the portions of any refunds that exceeded the potential tax liabilities for the returns reviewed (10 returns in the calculation that either were nonselected or had been surveyed had refunds exceeding the potential self-employment tax liabilities).

For the 33 returns in our sample that owed additional self-employment taxes (see Figure 4), 13 (39 percent) had refunds available to offset all (8) or part (5) of the self-employment tax liabilities. The average refund amount available for these returns was $1,714.

At the time it requested cancellation of Recommendation 2 from our audit report issued in 2000, the IRS stated it could not justify holding refunds because it did "not have a systemic filter to identify returns with high potential for self-employment tax." As discussed previously, our interviews with IRS personnel indicated that a systematic method is now used to select returns for review. The IRS also stated in its request for cancellation that it did "not have a systemic

[18] For returns with refunds exceeding the amount of potential self-employment tax liability, only the portion of the refund equaling the amount of self-employment tax liability was included in the computation.

method to hold refunds on returns with potential self-employment tax liabilities." However, a freeze code could be used to hold refunds for returns with potential self-employment tax liabilities, as is currently done to hold refunds for various other conditions such as a duplicate return, an amended return, or a potential manual interest or penalty adjustment.

Recommendation

Recommendation 3: The Commissioner, Small Business/Self-Employed Division, should reconsider the decision to cancel our previous recommendation to immediately work cases with significant[19] unreported self-employment tax, a refund available to be applied to the unreported self-employment tax, and no response or an inadequate response to any letter issued by the IRS during returns processing.

Management's Response: The Commissioner, Small Business/Self-Employed Division, disagreed with our recommendation, stating that the parameters could not be accurately identified to ensure the IRS would not be holding the refunds of taxpayers not subject to self-employment tax. In addition, management noted that their current process for selecting inventory excludes most of the returns originally assigned RPC "N" and/or Audit Code "V."

Office of Audit Comment: While we agree it is important to not delay refunds properly owed to taxpayers, we also believe it is important to not issue large refunds to taxpayers who will ultimately owe additional taxes. Based on the results of this and previous audits, we maintain it is feasible for the IRS to initiate examinations of the returns of taxpayers that appear to owe a significant amount of self-employment tax, have an available refund, and have not responded to initial contact letters from the IRS, and we encourage the IRS to move in that direction. In addition, it has long been noted by the IRS that "upstream" prevention efforts during returns processing are lower in cost and less intrusive to taxpayers than one-on-one enforcement efforts occurring later in the process. The 1998 report of the IRS Customer Service Task Force, *Reinventing Service at the IRS*,[20] recommended the IRS move additional workload upstream in the compliance process to reduce costs and resolve customer account problems sooner. Some of the steps discussed in the 1998 report to accomplish this (and to which the IRS committed) included identifying issues early and adjusting refunds.

[19] For the purposes of the current and previous audits, we defined significant as $2,000 or more of self-employment income for which no self-employment taxes were paid.
[20] IRS Publication 2197 (3-98).

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the effectiveness of the IRS' process for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes. To accomplish our objective, we:

I. Reviewed the Internal Revenue Code, the Internal Revenue Manual, and other reference materials to determine the current requirements for the payment of self-employment tax.

   A. Determined the procedures for the review of income tax returns for individuals that appear to be subject to self-employment tax.

   B. Determined the current "no-change" rate for self-employment tax examinations and the current percentage of self-employment tax examinations that resulted in assessment of additional tax and full payment of that tax.

II. Interviewed knowledgeable IRS officials to determine the actual procedures for identifying returns that appear to be subject to self-employment tax.

   A. Determined whether notices are still being sent to taxpayers potentially owing self-employment tax.

   B. Determined the status of the recommendation in our previous report[1] for the Correspondence Examination function to immediately work significant cases with refunds available to offset against the unreported self-employment taxes.

   C. Determined whether there are any active programs or initiatives to promote self-employment tax compliance.

III. Reviewed previous IRS Office of Internal Audit and Treasury Inspector General for Tax Administration audit reports pertaining to self-employment tax.

   A. Determined the status of previous recommendations, including changes to forms and improvements in employee training.

   B. Determined the status of any Requests for Information Services noted as incomplete in our prior report(s).

[1] *The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes* (Reference Number 2000-30-151, dated September 2000).

IV. Coordinated with a Treasury Inspector General for Tax Administration information technology specialist to develop a computer program to select from the Individual Master File[2] TY 2003 U.S. Individual Income Tax Returns (Form 1040) that appear to be subject to a significant amount of self-employment tax but for which no Form 1040 Self-Employment Tax (Schedule SE) was filed. The criteria for selecting returns included:

A. Wages less than $85,000 ($2,000 less than the Social Security tax threshold for 2003).

B. RPC "S"[3] not assigned to the return.

C. Total net profit on Form 1040 Profit or Loss From Business (Schedule C), Profit or Loss From Farming (Schedule F), and/or line 21 (Other income) (RPC "N")[4] of $2,000[5] or more.

D. No self-employment tax reported.

E. Statutory Employee code "1" not present.

F. Schedule C Principal Business or Professional Activity Codes of 113000 (Forestry and Logging), 454390 (Other Direct Selling), 524210 (Insurance Agencies and Brokerages), or 813000 (Religious, Grantmaking, Civic, Professional, and Similar Organizations) not used.

V. From the universe of 90,406 returns identified by the computer program in Step IV., selected a statistically valid sample of 138 Forms 1040 for review. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 10 percent, and a precision level of ±5 percent. We established the reliability of the data obtained by performing various database analyses to confirm whether the data received were what had been requested and by tracing selected taxpayer accounts to the data posted in the IRS Integrated Data Retrieval System to confirm whether the data were accurate. We reviewed each return in the sample for the following criteria:

A. Determined whether RPC "N" was properly assigned to those returns with "Other income" on Form 1040 line 21.

B. Determined whether Audit Code "V"[6] was properly assigned during returns processing.

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[2] See Appendix V for a Glossary of Terms.
[3] RPC "S" indicates the taxpayer is not subject to self-employment tax.
[4] RPC "N" indicates nonemployee compensation is present on Form 1040 or U.S. Individual Income Tax Return (Form 1040A) for the Examination Operations function to assess potential self-employment tax liability.
[5] For the purposes of the current and previous audits, our materiality threshold was self-employment income of $2,000 or more for which no self-employment taxes were paid.
[6] Audit Code "V" indicates the presence of income that may be subject to self-employment tax.

C. Reviewed the self-employment income reported on the return and determined whether the income should have been coded as exempt from self-employment tax.

D. Determined the status and outcome of any examinations of those returns selected for audit.

VI. Reviewed TY 2005 Forms 1040 to determine whether line 21 (Other income) is properly coded as potential self-employment income.

A. Reviewed IRS guidance and procedures on the use of RPC "N" for amounts reported on line 21.

B. Selected a statistically valid sample of 138 returns from a universe of 24,989 TY 2005 Forms 1040 selected from the Individual Master File that reported more than a certain dollar amount on line 21 and were assigned RPC "N" and determined whether the "N" code was properly used. We established the reliability of the data obtained by tracing selected taxpayer accounts to the data posted in the Integrated Data Retrieval System to confirm whether the data were accurate. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 10 percent, and a precision level of ±5 percent.

C. Selected a statistically valid sample of 138 returns from a universe of 5,030,333 TY 2005 Forms 1040 selected from the Individual Master File that reported more than a certain dollar amount on line 21 and were not assigned RPC "N" and determined whether the "N" code should have been used. We established the reliability of the data obtained by tracing selected taxpayer accounts to the data posted in the Integrated Data Retrieval System to confirm whether the data were accurate. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 10 percent, and a precision level of ±5 percent.

Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle R. Andersen, Director
L. Jeff Anderson, Audit Manager
Robert M. Jenness, Lead Auditor
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Dorothy E. Richter, Information Technology Specialist

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Assistant Deputy Commissioner for Services and Enforcement SE
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Commissioner, Wage and Investment Division SE:W
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Deputy Commissioner, Wage and Investment Division SE:W
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Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CLD
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Examination, Small Business/Self-Employed Division SE:S:E
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Audit Liaisons:

- Commissioner, Small Business/Self-Employed Division SE:S
- Commissioner, Wage and Investment Division SE:W

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $68,535,355 (over 5 years) in additional Social Security and Medicare taxes on 11,263 taxpayer accounts (see page 7).

Methodology Used to Measure the Reported Benefit:

We obtained from the Individual Master File[1] a nationwide computer extract of 90,406 TY 2003 U.S. Individual Income Tax Returns (Form 1040) that reported total net profit of $2,000[2] or more on Form 1040 Profit or Loss From Business (Schedule C), Profit or Loss From Farming (Schedule F), and/or line 21 (Other income) but did not include a Form 1040 Self-Employment Tax (Schedule SE) assessing self-employment tax liability. From this population, we reviewed a statistical sample of 138 Forms 1040. In our sample review, we noted that 30 (15.544 percent) of 193 returns selected to obtain our sample size of 138 were not valid selections because the returns had reported statutory income on Schedule C, but the taxpayers' records in the W-2 database did not include the audit code indicating the presence of statutory income. By multiplying the total sample universe size of 90,406 by .15544, we reduced the sample universe by 14,053 returns and the sample universe of valid Forms 1040 to 76,353, which did not affect the sample size of 138.

We determined 28 (20.2899 percent) of the 138 valid Forms 1040 in our sample appeared to have self-employment tax liabilities but were not selected for audit. By multiplying .202899 x 76,353, we project that 15,492[3] TY 2003 Forms 1040 would have had self-employment tax liabilities but were not selected for audit. Assuming the 15,492 returns would have been closed as no-change returns at the same rate as in Fiscal Year 2006 (27.3 percent), we project that 4,229 returns would have been closed as no-change returns and 11,263 would have owed additional taxes. We determined an average potential assessment of

[1] See Appendix V for a Glossary of Terms.
[2] For the purposes of the current and previous audits, our materiality threshold was self-employment income of $2,000 or more for which no self-employment taxes were paid.
[3] Our projection is based on a 95 percent confidence level and a precision (range) of ±5,119 (20,611 – 10,373 Forms 1040).

$1,217 for each return not selected for audit. By multiplying $1,217 by 11,263 returns, we project a total of $13,707,071 in self-employment tax liabilities could be assessed per year. Multiplying this amount by 5 years, we estimate the potential assessment of $68,535,355 in additional Social Security and Medicare taxes for these returns.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $26,583,040 (over 5 years) in additional Social Security and Medicare taxes on 2,816 taxpayer accounts (see page 7).

Methodology Used to Measure the Reported Benefit:

We used the population and sample described in the first Outcome Measure and determined 7 (5.0725 percent) of the 138 valid Forms 1040 in our sample were initially selected for audit but were later surveyed (meaning the audit was closed with little or no examination of the return) for no reason that was apparent on the returns. By multiplying .050725 x 76,353, we project that 3,873[4] TY 2003 Forms 1040 would have had self-employment tax liabilities but would have been surveyed without apparent justification. Assuming the 3,873 returns would have been closed as no-change returns at the same rate as in Fiscal Year 2006 (27.3 percent), we project that 1,057 returns would have been closed as no-change returns and 2,816 would owe additional taxes. We determined an average potential assessment of $1,888 for each return surveyed without apparent justification. By multiplying $1,888 by 2,816 returns, we project a total of $5,316,608 in self-employment tax liabilities could be assessed per year. Multiplying this amount by 5 years, we estimated the potential assessment of $26,583,040 in additional Social Security and Medicare taxes for these returns.

[4] Our projection is based on a 95 percent confidence level and a precision (range) of ±2,793 (6,666 – 1,080 Forms 1040).

Appendix V

Glossary of Terms

Audit Code	Audit codes are used to alert the Examination Operations function about a particular condition on the return.
Audit Information Management System	The Audit Information Management System is a computer system used by the Small Business/ Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.
Campus	Campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Code and Edit Function	The Code and Edit function ensures tax forms are complete and include the proper codes to allow computation of tax liabilities.
Data Book	The Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.
Freeze Code	Freeze codes are alpha codes that identify specific conditions in the Master File that can be generated systemically during processing operations or input manually.
Individual Master File	The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.
Integrated Data Retrieval System	The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

Joint Audit Management Enterprise System	The Joint Audit Management Enterprise System is the Department of the Treasury's automated audit tracking and management control system.
Master File	The Master File is the IRS database that stores various types of taxpayer account information and contains data on individuals, businesses, and employee plans and exempt organizations.
Midwest Automated Compliance System	The Midwest Automated Compliance System is a standalone, automated database that allows immediate access to 3 years' of tax return information and is used primarily for classifying and selecting returns for audit.
Project Code	Project codes are 4-digit codes used on the Audit Information Management System to identify a special program to which an examination belongs.
Service Center	Service Center is the former term for Campus.
Statutory Income	Statutory income involves earnings reported to taxpayers on a Wage and Tax Statement (Form W-2), with employment taxes withheld by the employer but reported as self-employment income on U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Business (Schedule C) or Form 1040 Net Profit From Business (Schedule C-EZ) rather than as wages. Because employment taxes are withheld by the employer, statutory income is not subject to self-employment tax.
Tax Examiner	Among other duties, a tax examiner processes tax returns, establishes and edits tax account records, and determines proper tax liabilities.
Tax Gap	The gross tax gap is the difference between the total taxes that taxpayers should have paid and the total taxes that were actually paid timely.
W-2 Database	The W-2 database is created by the Treasury Inspector General for Tax Administration using IRS information reported on Forms W-2 for each tax year.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

September 4, 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak Kathy K. Petronchak
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Identification of Unreported Self-Employment Taxes Can Be Improved (Audit # 200630028)

We have reviewed the draft report titled, "Identification of Unreported Self-Employment Taxes Can Be Improved." This report contains three recommendations to strengthen current processes for identifying and assessing potential unpaid self-employment taxes. We agree with two of the recommendations and are working to implement them.

As in the previous audit, we are unable to support the recommendation to work these cases before issuing a refund. Until we can significantly improve the identification of taxpayers with a true self-employment tax liability, we should not risk delaying a potentially high number of valid refund requests.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me or call Cheryl Sherwood, Director, Campus Compliance Services, Small Business/Self-Employed Division, at (202) 283-2518.

Attachment

Attachment

RECOMMENDATION 1:
The Commissioner, Wage and Investment (W&I) Division, should emphasize the importance of properly editing RPC "N" to returns with potential self-employment tax liability and provide additional training to Tax Examiners in the Code and Edit function to improve the review of income reported on Form 1040, Line 21, especially for returns with missing or unclear descriptions of the income.

CORRECTIVE ACTION:
We will coordinate with Learning and Education to explore the possibility of expanding existing RPC "N" editing training in course material issued January 1, 2008.

IMPLEMENTATION DATE:
January 15, 2008

RESONSIBLE OFFICIAL:
Director, Submission Processing, W&I Division

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

RECOMMENDATION 2:
The Commissioner, W&I Division, should strengthen the processes for reviewing incoming returns for potential unpaid self-employment tax, especially the processes for including the statutory income indicator in the W-2 file and assigning Audit Code "V" to returns.

CORRECTIVE ACTION:
We will coordinate with Learning and Education to explore the possibility of expanding existing Audit Code "V" editing training in course material issued January 1, 2008.

IMPLEMENTATION DATE:
January, 15, 2008

RESONSIBLE OFFICIAL:
Director, Submission Processing, W&I Division

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

RECOMMENDATION 3:
The Commissioner, Small Business/Self-Employed Division, should revisit the decision to cancel our previous recommendation to immediately work cases with significant unreported self-employment taxes, a refund available to be applied to the unreported self-employment tax, and no response or an inadequate response to any letter issued by the IRS during returns processing.

CORRECTIVE ACTION:
We disagree with this recommendation. We do not believe the parameters can be accurately identified to ensure that we will not be holding refunds on taxpayers not subject to self-employment tax. Our current return selection process excludes most of the returns originally identified as Return Processing Code (RPC) "N"[1] and Audit Code "V"[2]. This is due to our establishing a floor for selecting inventory.

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1 2 2(c) [redacted]