The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes

September 2000

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Redaction Legend:

2a = Law Enforcement Criteria

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 22, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) had taken effective corrective actions to improve the identification and collection of unreported self-employment taxes.

In summary, significant amounts of self-employment taxes remain unassessed and uncollected each year. Although the IRS has taken some actions to address unreported self-employment taxes, it needs to take steps to further improve the identification and collection of these taxes.

We recommended that the IRS identify unreported self-employment taxes during returns processing and assess these taxes before refunds are issued to taxpayers. We also recommended that the IRS take actions to improve the accuracy of the information used to determine if taxpayers are liable for self-employment taxes.

IRS management agreed with all but one of our recommendations and is planning adequate corrective actions for these recommendations. Management did not agree with recommendation number nine in the report. We recommended that the IRS consider the feasibility of sending different letters to taxpayers based on the amount of self-employment income earned by the taxpayer. Management disagreed because they believe this would result in disparate treatment of taxpayers. While we agree that sending different letters to taxpayers based on the amount of self-employment tax they owed would result in different treatment of taxpayers, in our opinion, the differing treatment is consistent with the way the IRS currently administers taxes. The IRS takes different actions when processing tax returns or when taking enforced collection actions based on the amount of tax involved.

We believe this is still a worthwhile recommendation; however, we do not intend to elevate it as a significant management decision to which we disagree. Consequently, no further action on your part is required.

While management agreed that implementing our recommendations would increase the amount of revenue the IRS collects, management questioned our estimate that $21 million each year could be assessed for those taxpayers with self-employment income of $2,000 or more. The basis for their concern was that we did not audit the tax returns of taxpayers who did not respond to the IRS' educational letter. In our opinion, the $21 million estimate is reasonable. We performed in-depth analyses of all the returns included in our samples, for both those taxpayers who responded to the IRS' letter and those who did not respond. Many of the taxpayers who did not respond to the IRS' educational letter reported the same types of income as those shown on the returns of taxpayers who amended their returns in response to the IRS' letter. Other taxpayers appeared to owe self-employment taxes based on the descriptions of income entered on their returns or based on regulations governing self-employment taxes. A tax auditor from one of the IRS' Correspondence Examination functions confirmed our determinations on cases where it was more difficult to determine whether taxpayers owed self-employment taxes.

Management's comments have been incorporated into the text of this report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Executive Summary

The Internal Revenue Service (IRS) could assess and collect significant amounts of unreported self-employment taxes each year before tax refunds are issued to taxpayers. We estimate that over a 2-year period, taxpayers did not report $156 million in self-employment taxes; over 61 percent of these taxpayers received $51 million in tax refunds that could have been offset against the unreported self-employment taxes.

The self-employment tax is a Social Security and Medicare tax on the income of individuals who work for themselves. Funding of Social Security and its long-term viability have received considerable political attention in recent years.

The General Accounting Office recently reported that non-wage income has grown significantly since 1970 as a portion of total individual income. The number of tax returns that included self-employment income increased 138 percent from 1970 to 1990. Self-employment income was the largest portion of non-wage income included in the IRS' inventory of tax debts at the end of Fiscal Year 1993.

In a 1998 report, *Compliance with Self-Employment Tax Requirements* (Reference Number 083502, dated May 19, 1998), the Treasury Inspector General for Tax Administration (formerly IRS Internal Audit) recommended that the IRS take steps to improve its process of administering self-employment tax requirements. The objective of this audit was to determine whether the IRS had taken effective corrective actions in response to that report to improve the identification and collection of unreported self-employment taxes.

Results

The IRS has taken some actions to address unreported self-employment taxes. Changes were implemented to the computer screening criteria used to identify tax returns with unreported self-employment taxes. The IRS also developed an educational letter which was sent to taxpayers filing these tax returns, requesting the taxpayers to review their tax returns and amend the returns by submitting Self-Employment Tax (Schedule SE) if they deemed it necessary. This letter was sent well after the tax returns had been processed.

Despite these efforts, significant amounts of self-employment taxes remain unassessed and uncollected each year. The IRS needs to take steps to further improve the identification and collection of these taxes. The ongoing "stand up" of the IRS' new Small Business/Self-Employed (SB/SE) Division presents an excellent opportunity to address these issues.

The Internal Revenue Service Could More Timely Identify and Collect Unreported Self-Employment Taxes

In our prior report, we recommended that the IRS identify taxpayers owing self-employment taxes when returns are processed and work those cases immediately in Correspondence Examination. The IRS has not implemented those recommendations.

Identifying unreported self-employment taxes as tax returns are processed and assessing self-employment taxes on those cases with available tax refunds would help the IRS:

- Comply with the desires of the United States (U.S.) Congress for the IRS to promptly inform taxpayers of their obligations with respect to tax deficiencies.
- Minimize the burden to some taxpayers of paying self-employment taxes.
- Minimize the cost of collecting the taxes.

By assessing unreported self-employment taxes before refunds are issued, the IRS could immediately collect self-employment taxes of $21 million each year owed by 78,000[1] taxpayers with self-employment income of $2,000 or more.

The Internal Revenue Service Needs to Reduce Certain Processing Errors to Further Improve the Computerized Identification of Unreported Self-Employment Taxes

The IRS made processing errors on tax returns and related documents, which caused its computers to erroneously identify some taxpayers as owing self-employment taxes. An estimated 30,000[2] taxpayers were erroneously identified in this way and sent self-employment tax education letters. These taxpayers had either: (1) claimed religious exemptions from self-employment tax requirements, (2) reported "Other Income" on the U.S. Individual Income Tax Return (Form 1040) line 21, or (3) indicated they were

[1] The amount that could be collected and the number of taxpayers are estimates based on a statistically valid sample of cases identified by the IRS as potentially owing self-employment taxes. While IRS management agreed that implementing our recommendations would increase the amount of revenue the IRS collects, they questioned our estimate that $21 million each year could be assessed for those taxpayers with self-employment income of $2,000 or more. The basis for their concern was that we did not audit tax returns of taxpayers who did not respond to the IRS' educational letter. In our opinion, the $21 million estimate is reasonable. We performed in-depth analyses of all the returns included in our samples, for both those taxpayers who responded to the IRS' letter and those who did not respond. Many of the taxpayers who did not respond to the IRS' educational letter reported the same types of income as those shown on the returns of taxpayers who amended their returns in response to the IRS' letter. Other taxpayers appeared to owe self-employment taxes based on the descriptions of income entered on their returns or based on regulations governing self-employment taxes. A tax auditor from one of the IRS' Correspondence Examination functions confirmed our determinations on cases where it was more difficult to determine whether taxpayers owed self-employment taxes.

[2] Estimate based on the same sample referred to above.

statutory employees by checking the appropriate box on Profit or Loss From Business (Schedule C).

Criteria for Prioritizing Self-Employment Tax Cases Need to Be Revised to Accurately Reflect Potential Unreported Self-Employment Taxes

The logic of the IRS' computer program to identify and prioritize tax returns with unreported self-employment taxes is flawed. As a result, tax returns with significantly varying amounts of unreported self-employment taxes can receive the same priority in the IRS' compliance program. This can lead to the ineffective use of scarce Examination function resources.

Educational Letters to Taxpayers Potentially Owing Self-Employment Taxes Could Be Improved

The educational letters sent to taxpayers appearing to owe self-employment taxes should be more specific and assertive, provide an explanation of the importance of the self-employment tax, and explain to taxpayers what will happen if they do not respond. If taxpayers are not convinced of the importance of taking action in response to an IRS letter, many will not respond.

Future plans are to send letters to all taxpayers with self-employment income of $2,000 or more that did not report self-employment taxes. During the implementation of the Self-Employment Tax National Strategy, letters were sent to all taxpayers with self-employment income of $1,000 or more. Letters to taxpayers with less than $2,000 resulted in gross self-employment tax revenue of approximately $3.3 million. Although these cases individually may not warrant follow-up by the IRS, they do warrant letters informing taxpayers of their self-employment tax obligation.

Summary of Recommendations

The IRS should identify unreported self-employment taxes during returns processing and assess these taxes before refunds are issued to taxpayers. To make this process more effective, the IRS should improve the accuracy of the information used to determine if taxpayers are liable for self-employment taxes. This information relates to applications for exemptions from self-employment taxes, income reported on line 21 of Form 1040, and the statutory employee indicator on Schedule C. In addition, the IRS should revise the formula for prioritizing self-employment tax cases and should improve the educational letters sent to taxpayers potentially owing self-employment taxes.

Management's Response: In January 2001, the IRS will begin identifying, via computer, taxpayers with potential unreported self-employment taxes as the returns are processed.

A project to hold refunds of a limited number of taxpayers who owe self-employment taxes will be tested. If the project is successful and if resources are available, the project will be expanded to all SB/SE Correspondence Examination sites by 2003. The IRS will forward copies of forms indicating taxpayers are exempt from self-employment taxes to the area responsible for processing that information to ensure that the applicable records are updated. The IRS will revise instructions for Form 1040, line 21 and will revise returns processing instructions to improve the accuracy of data indicating that taxpayers are statutory employees and not liable for self-employment taxes. The IRS will also revise the scoring formula used to identify and prioritize tax returns with potential unpaid self-employment taxes and will make changes to letters sent to taxpayers potentially owing self-employment taxes.

Office of Audit Comment: While we agree that sending different letters to taxpayers based on the amount of self-employment tax they owed would result in different treatment of taxpayers, in our opinion, the differing treatment is consistent with the way the IRS currently administers taxes. The IRS takes different actions when processing tax returns or when taking enforced collection actions based on the amount of tax involved.

Objective and Scope

The objective of this audit was to determine whether the IRS had taken effective corrective actions to improve the identification and collection of unreported self-employment taxes.

The overall objective of this audit was to determine whether the Internal Revenue Service (IRS) had taken effective corrective actions to improve the identification and collection of unreported self-employment taxes.

We conducted this audit from September 1999 to May 2000. The audit was conducted in accordance with *Government Auditing Standards*.

To accomplish our objective, we analyzed tax return information, interviewed IRS personnel, and reviewed documentation from the IRS' Self-Employment Tax (SET) National Strategy.[1] Our audit work was performed at the Ogden IRS Center. However, our analysis included data taken nationwide from tax returns posted to the IRS' Individual Masterfile.[2] Due to the large volume of tax return information, we selected samples using statistically valid sampling techniques.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The self-employment tax is a Social Security and Medicare tax for individuals who work for themselves.

Generally, taxpayers who have income from self-employment are liable not only for income taxes but also for self-employment taxes. The self-employment tax is a Social Security and Medicare tax on the income of individuals who work for themselves. Payments of self-employment taxes contribute to taxpayers' coverage under the Social Security system. Social Security

[1] The IRS' SET National Strategy is an attempt by the IRS to implement an educational letter as an alternative to audits of taxpayers who may owe self-employment taxes.
[2] The Individual Masterfile is the IRS database that maintains transactions or records of individual tax accounts.

coverage provides taxpayers with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits. The self-employment tax is similar to the Social Security and Medicare taxes withheld from the pay of wage earners.

Self-employment income/loss is usually reported on Profit or Loss From Business (Schedule C) and Profit or Loss From Farming (Schedule F). Also, taxpayers often report self-employment income on the United States (U.S.) Individual Income Tax Return (Form 1040) line 21, “Other Income.” Taxpayers with self-employment income should file Self-Employment Tax (Schedule SE) with their Form 1040. The Schedule SE is used to calculate the amount of self-employment tax and the associated income tax deduction.

There are a few exceptions to the requirements to pay self-employment taxes. Among these are certain exempted occupations and members of certain religious organizations.

Funding of Social Security and its long-term viability have received considerable political attention in recent years.

Funding of Social Security and its long-term viability have received considerable political attention in recent years. Both the White House and members of the Congress have expressed concern for the program.

Self-employment has grown since 1970. The General Accounting Office recently reported that non-wage income has grown significantly since 1970 as a portion of total individual income. The number of tax returns that included self-employment income increased 138 percent from 1970 to 1990. Self-employment income was the largest portion of non-wage income included in the IRS’ inventory of tax debts at the end of Fiscal Year 1993. Finally, in a 1998 report, *Compliance with Self-Employment Tax Requirements* (Reference Number 083502, dated May 19, 1998), the Treasury Inspector General for Tax Administration (formerly IRS Internal Audit) recommended that the IRS take steps to improve the identification of taxpayers who did not report their self-employment taxes and to use taxpayer refunds to pay these taxes when possible.

The IRS maintains an inventory of Forms 1040 that contain potentially unreported self-employment taxes. The IRS refers to this inventory as the SET inventory. Historically, this SET inventory has been a source of discretionary workload for Service Center Correspondence Examination units, which have worked only a small percentage of it.

The returns in this inventory are identified and worked by the Examination units well after they are filed and processed by the IRS. As a result, the resources required to work these cases increase and any refunds that might be used to pay the additional self-employment taxes have already been issued.

Results

The IRS has taken some actions to address unreported self-employment taxes.

The IRS has taken some actions to address unreported self-employment taxes. Specifically, the Kansas-Missouri District Office Research and Analysis (KSMO DORA) group implemented changes to the computer screening criteria used to identify cases for the SET inventory. The KSMO DORA also developed an educational letter requesting taxpayers to review their tax returns and amend the returns by submitting Schedule SE if they deemed it applicable. As part of the implementation of the IRS' SET National Strategy, the IRS mailed over 328,000 of these letters to taxpayers filing individual income tax returns for Tax Years 1996 and/or 1997. These taxpayers reported potential self-employment income of $1,000 or more but did not file Schedule SE. In future years, the KSMO DORA recommends these letters be sent to taxpayers with self-employment income of $2,000 or more.

Despite the IRS' efforts, significant amounts of self-employment taxes remain unassessed and uncollected each year.

Despite these efforts, significant amounts of self-employment taxes remain unassessed and uncollected each year. The KSMO DORA's results from the SET National Strategy for Tax Years 1996 and 1997, and our review of statistical samples of the tax returns and responses from taxpayers receiving educational letters, showed that:

- Only 15 percent of the taxpayers receiving educational letters amended their tax returns and reported self-employment taxes.
- Almost 69 percent of the taxpayers owed self-employment taxes but did not amend their returns.
- Taxpayers who did not amend their tax returns owed approximately $156 million in self-employment taxes for these 2 years.
- The average amount of self-employment taxes owed by those taxpayers not amending their returns was $688. This amount increased to $911 for taxpayers with self-employment income of $2,000 or more.[3]

The IRS needs to take further steps to improve the identification and collection of unreported self-employment taxes.

The Internal Revenue Service Could More Timely Identify and Collect Unreported Self-Employment Taxes

In our prior report, we recommended that the IRS identify taxpayers owing self-employment taxes during processing.

In our prior report, we recommended that the IRS identify taxpayers owing self-employment taxes during processing and work those cases immediately in Correspondence Examination. In response to our report, the IRS' National Strategy Implementation Team for Self-Employment Tax Compliance agreed to take action to facilitate identifying unreported self-employment taxes during processing. The team prepared a Request for Information Services (RIS) to arrange for necessary computer programs to accomplish this. Because this RIS was given a low priority by the IRS' Submission Processing function, it has yet to be completed. The RIS is tentatively scheduled for implementation in 2001.

[3] The amount of self-employment tax owed by taxpayers with self-employment income of $2,000 or more totaled approximately $142 million.

In its report on the implementation of the SET National Strategy, the KSMO DORA plans to recommend that returns with unreported self-employment taxes be identified by the Error Resolution System within the IRS' Submission Processing function.

Because the RISs prepared by the IRS did not address the need for unreported self-employment tax cases to be worked before refunds were issued, unreported self-employment tax cases continue to be worked after available taxpayer refunds are issued.

Neither the RIS prepared in response to our recommendation nor the recommendation planned by the KSMO DORA addresses the need for Correspondence Examination to work these cases before refunds are sent to taxpayers. Both discussed educational letters being sent to taxpayers and non-response cases being included in the SET inventory and worked by Correspondence Examination as usual. In the past, these cases have been worked after processing of the returns has been completed and any available refunds have been issued.

The Congress recently confirmed its desires for the IRS to promptly inform taxpayers of their tax obligations.

The Congress recently confirmed its desires for the IRS to promptly inform taxpayers of their obligations with respect to tax deficiencies. It did so by passing a legislative provision[4] suspending interest and certain penalties after 1 year if taxpayers are not contacted within 1 year of the due date or filing date of their return (whichever is later).

Identifying unreported self-employment taxes as returns are processed, and immediately assessing self-employment taxes on those cases with available refunds, allows the IRS to apply taxpayers' refunds toward those self-employment taxes. The IRS' Office of the Chief Counsel has ruled that the IRS could freeze refunds and offset them against self-employment taxes owed by taxpayers.

As discussed earlier, we estimate that those taxpayers who did not amend their tax returns in response to letters sent by the IRS owed approximately $156 million for Tax Years 1996 and 1997. Over 61 percent of the taxpayers involved had refunds available to pay all or part of the self-employment tax.

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[4] IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685, Section 3305.

Using available tax refunds to pay additional taxes reduces the amounts taxpayers pay by minimizing interest and can reduce the cost to the government of collecting unpaid taxes. In fact, we estimate that available refunds could have been used to collect a total of $51 million of the $156 million in unreported self-employment taxes.

By assessing unreported self-employment taxes before refunds were issued, the IRS could have immediately collected self-employment taxes of $21 million each year owed by 78,000 taxpayers with self-employment income of $2,000 or more.[5]

Recommendations

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 KSMO DORA should then be sent to these taxpayers.

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[5] The amount that could be collected and the number of taxpayers are estimates based on a statistically valid sample of cases identified by the IRS as potentially owing self-employment taxes. While IRS management agreed that implementing our recommendations would increase the amount of revenue the IRS collects, they questioned our estimate that $21 million each year could be assessed for those taxpayers with self-employment income of $2,000 or more. The basis for their concern was that we did not audit tax returns of taxpayers who did not respond to the IRS' educational letter. In our opinion, the $21 million estimate is reasonable. We performed in-depth analyses of all the returns included in our samples, for both those taxpayers who responded to the IRS' letter and those who did not respond. Many of the taxpayers who did not respond to the IRS' educational letter reported the same types of income as those shown on the returns of taxpayers who amended their returns in response to the IRS' letter. Other taxpayers appeared to owe self-employment taxes based on the descriptions of income entered on their returns or based on regulations governing self-employment taxes. A tax auditor from one of the IRS' Correspondence Examination functions confirmed our determinations on cases where it was more difficult to determine whether taxpayers owed self-employment taxes.

The IRS' Correspondence Examination function should immediately work some self-employment tax cases.

2. The Assistant Commissioner (Customer Service) should initiate a program for the Correspondence Examination function to immediately work cases meeting the following criteria:

    - Significant unreported self-employment taxes (for purposes of this audit, we defined significant as $2,000 or more of self-employment income for which no self-employment taxes were paid).
    - A refund available to be applied to the unreported self-employment taxes.
    - No response or an inadequate response to the letter issued by the IRS during returns processing.

    Other cases should be prioritized based on the SET score (discussed later in this report) and worked by the Correspondence Examination function when possible.

Management's Response: In January 2001, the IRS will begin identifying, via computer, taxpayers with potential unreported self-employment tax as the returns are processed. Upon review, if return information is present showing the taxpayer is not subject to the tax, the account will be corrected. If not, the IRS will correspond with the taxpayer to obtain additional information. Depending upon the response, the IRS will assess self-employment tax, correct the account data, or direct the return to the Examination function for further review.

Starting with this fiscal year and for Fiscal Year 2001, the IRS Correspondence Examination function will devote resources to examine the returns of taxpayers who did not respond to the educational letter. A Project Prospectus will be prepared to study the feasibility of holding refunds on a limited number of tax returns. This project will be limited to one site initially, but could be expanded to all Small Business/Self-Employed (SB/SE) Correspondence Examination sites by 2003 if successful.

The Internal Revenue Service Needs to Reduce Certain Processing Errors to Further Improve the Computerized Identification of Unreported Self-Employment Taxes

Certain processing errors resulted in an estimated 30,000 taxpayers receiving erroneous letters indicating that they were liable for self-employment taxes.

IRS errors in processing tax returns and related documents caused taxpayers to receive erroneous educational letters regarding self-employment taxes. Three types of IRS processing errors resulted in an estimated 30,000 taxpayers erroneously receiving letters indicating that they were liable for self-employment taxes.[6]

Religious exemptions

Approximately 15,000 of the 30,000 taxpayers receiving erroneous letters indicated they had filed religious exemption forms with the IRS. When information from these forms is properly entered into the IRS' computer system, an indicator is established on the Individual Masterfile. This indicator can be used to identify taxpayers who are exempt from self-employment tax requirements, to prevent them from being included in the SET inventory.

We reviewed a sample of 50 approved Applications for Exemption from Social Security and Medicare Taxes and Waiver of Benefits (Form 4029) on file at the IRS and found that 24 percent were not entered on the IRS computers. We also reviewed a sample of 60 Applications for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners (Form 4361) and found that 7 percent were not accurately reflected on the IRS' computers.

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[6] This estimate is based on a statistically valid sample of 325 letters sent to taxpayers. Of the taxpayers in this sample, 15 indicated they had filed exemptions, 10 reported income on line 21 of their Form 1040 which was improperly identified as self-employment income by the IRS, and 5 indicated they were statutory employees.

Controls at the IRS' processing centers included in our review were inconsistent and were not adequate to ensure that these forms were correctly entered on the IRS' computers.

Other income

IRS employees improperly identified some income reported on line 21 of Form 1040 as self-employment income.

Approximately 10,000 of the 30,000 taxpayers receiving erroneous letters reported "Other Income" amounts on their Forms 1040, line 21. IRS employees had improperly identified this income as self-employment income.

Although instructions for Form 1040, line 21 tell taxpayers not to include income from self-employment on this line, many taxpayers do so. When taxpayers enter an amount on line 21 of Form 1040, they are asked to enter a description of the income. For paper returns, IRS tax examiners review this description to determine if the income is subject to self-employment taxes.

We reviewed a sample of 322 Forms 1040 with income reported on line 21 that the IRS identified as self-employment income. Over 10 percent had been incorrectly identified.

Tax return instructions telling taxpayers not to report self-employment income on line 21 do not define or give an example of what constitutes self-employment income. These instructions are not readily identifiable as being applicable to line 21.

In our view, it is difficult for IRS employees to accurately identify self-employment income reported on line 21. Instructions for IRS employees to determine whether amounts on line 21 are subject to self-employment taxes cover 14 pages in the Internal Revenue Manual and include a list of 185 examples of self-employment income. Line 21 is one of many lines on a tax return that must be reviewed by these employees. Finally, these employees generally must process from 40 to 50 returns per hour.

Statutory employees

Approximately 5,000 of the 30,000 taxpayers receiving erroneous letters indicated they were statutory employees. However, the IRS had not entered the data into its computers as required.

Taxpayers indicate that they are statutory employees by checking a box on Schedule C. If the box is checked, IRS employees should enter that information into IRS computers during processing of the tax return. However, if the box is not checked, no entry is required. Since the vast majority of Schedules C do not have the statutory employee box checked, it is easy for IRS employees to overlook the box.

The box on Schedule C identifying taxpayers as statutory employees is being overlooked by IRS data entry employees.

In a separate sample of 322 tax returns with Schedule C attached and no self-employment tax reported, 48 had a check in the statutory employee box. IRS data entry employees had overlooked the statutory employee check box in half of these instances.

We reported this same condition in our previous audit. In an attempt to correct the problem, the IRS enlarged and bolded the statutory employee box. However, the box is still being overlooked by IRS data entry employees.

Recommendations

The Assistant Commissioner (Forms and Submission Processing) should:

3. Take steps to ensure that information from Forms 4029 and Forms 4361 is accurately entered in IRS computers.
4. Develop a means of capturing the identity of taxpayers who are contacted to pay self-employment taxes but indicate they have filed one of these two forms. This information should be used to perfect the IRS' database of taxpayers who are exempt from self-employment taxes.

5. 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.

6. Take steps to ensure that data transcribers do not overlook the statutory employee check box on Schedules C and C-EZ. One option discussed with IRS managers from the Submission Processing function was to have tax examiners from the Code and Edit function circle the statutory employee box if it has been checked by the taxpayer.

Management's Response: The Assistant Commissioner (Forms and Submission Processing) will ensure that copies of approved Forms 4029 and 4361 which indicate that taxpayers are exempt from self-employment taxes are forwarded to the area responsible for processing these forms. The SB/SE Compliance functions will forward these forms to the unit responsible for processing them so the Individual Masterfile can be updated.

The Assistant Commissioner (Forms and Submission Processing) will revise instructions for Form 1040, line 21, to provide a caution advising that self-employment income must not be reported on this line. He has revised instructions for IRS employees in the Code and Edit function to add a check mark above the statutory employee box when it has been checked by the taxpayer. The indicator's importance will be emphasized during year-end training.

Criteria for Prioritizing Self-Employment Tax Cases Need to Be Revised to Accurately Reflect Potential Unreported Self-Employment Taxes

The IRS has developed a computer program to identify and prioritize cases in the SET inventory. This program was modified based on recommendations in our prior report and recommendations made by the National Strategy Implementation Team for Self-Employment Tax Compliance. The computer program calculates a score for each tax return in the SET inventory. The score should help identify those tax returns with the greatest potential for unreported self-employment taxes. However, the score was not always a reliable measure of potential unreported self-employment tax.

When developing the formula to calculate the score, IRS employees attempted to account for both the Medicare and Federal Insurance Contribution Act portion of the self-employment tax and to give both portions a relative weight. However, the logic used in developing their weighting factor was flawed.

Using the IRS' current formula for calculating a priority score for self-employment tax cases, tax returns with significantly varying potential for unreported self-employment taxes can receive the same score.

As a result, tax returns with significantly varying amounts of unreported self-employment taxes can receive the same SET score. For example, a hypothetical taxpayer earning 2a-----------------------
2a---
2a--
2a--

2a---
2a--

Assigning the same priority to tax returns with significantly different amounts of unreported self-employment taxes results in the ineffective use of scarce Examination function resources.

Recommendation

7. The Assistant Commissioner (Customer Service) should revise the formula for scoring the SET inventory so it accurately reflects the potential self-employment tax deficiency on a tax return.

Management's Response: The National Director, Compliance and Accounts Division, will work on developing a revised SET scoring formula.

Educational Letters to Taxpayers Potentially Owing Self-Employment Taxes Could Be Improved

The KSMO DORA designed an educational letter intended for taxpayers who appeared to be liable for self-employment taxes but did not report them. The letter was sent to taxpayers with $1,000 or more of self-employment income and did not require a response from taxpayers. Future plans are to send letters to taxpayers with $2,000 or more of self-employment income. These letters will require responses from taxpayers.

The text of the educational letter should be improved

Wording of the letter to be sent to taxpayers is not assertive, provides no explanation of the importance of the self-employment tax, and does not explain to taxpayers what will happen if they do not respond.

The educational letter to be sent to taxpayers in the future states that after looking at the taxpayers' return information, the IRS has determined the taxpayers reported income that "could" be subject to self-employment taxes. This letter should be more assertive, provide an explanation of the importance of the self-employment tax, and explain to taxpayers what will happen if they do not respond.

One objective of this letter is to prompt taxpayers to voluntarily report self-employment taxes on their self-employment income. The initial letter was developed as a test, and all necessary refinements to the letter have not been made. If taxpayers are not convinced of the importance of taking action in response to an IRS letter, many will not respond.

Different letters may be appropriate, based on the amount of self-employment income earned by taxpayers

In a statistical sample of taxpayers included in the implementation of the SET National Strategy, over 19 percent of the taxpayers reporting potential self-employment income of less than $2,000 amended their tax returns after receiving their educational letter. This compares to 14 percent of taxpayers with potential self-employment income of $2,000 or more.

The average amount of self-employment taxes owed by taxpayers reporting self-employment income of $2,000 or more but who did not amend their tax returns in response to the IRS' educational letter was $911. This amount may warrant requiring a taxpayer response and possible follow-up by Correspondence Examination if an inadequate response or no response is received. The letter sent to taxpayers with significant amounts of unreported self-employment taxes should explain that a response is required.

Taxpayers reporting self-employment income of less than $2,000 who did not amend their tax return in response to the educational letter owed an average of $196. This amount most likely would not justify the cost of requiring a taxpayer response and follow-up by Correspondence Examination. Because of this, the KSMO DORA decided not to issue a letter to these taxpayers in the future.

Letters sent to taxpayers reporting self-employment income of less than $2,000 generated approximately $3.3 million in self-employment taxes over 2 years.

Although follow-up by Correspondence Examination may not be warranted, a letter similar to the one used previously by the KSMO DORA would be appropriate for these taxpayers. The letter stated that no action was necessary if the taxpayers determined they were not liable for self-employment taxes. During the implementation of the SET National Strategy, the amount of revenue generated by letters sent to taxpayers with self-employment income of less than $2,000 far exceeded the cost of issuing the letters and working any related taxpayer responses. The gross amount generated from these letters projects to approximately $3.3 million. Based on the KSMO DORA's data, the estimated costs of sending and responding to the letters attributable to this $3.3 million are just under $400,000.

Recommendations

The Assistant Commissioner (Customer Service) should:

8. Consider the following changes to the educational letter sent to taxpayers with potential self-employment tax deficiencies:

   - State that the IRS has determined that the taxpayer most likely owes self-employment taxes.

   - Educate the taxpayer about the importance of the self-employment tax by explaining what it is and why the taxpayer owes it. For example, "*The self-employment tax is a Social Security and Medicare tax on the income of individuals who work for themselves. Your payments of self-employment taxes contribute to your coverage under the Social Security system. Social Security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance benefits. The self-employment tax is similar to the Social Security and Medicare taxes withheld from the pay of wage earners. You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do in addition to your regular job, may also be self-employment.*"

   - For taxpayers with significant self-employment income, explain that if the taxpayer takes no action, the IRS will hold any refund available from their tax return and will forward their return to the Examination function for follow-up.

9. Consider the feasibility of sending different letters to taxpayers based on the amount of self-employment income earned by the taxpayer. Letters to taxpayers with significant self-employment income would require a response, while letters to taxpayers with lesser amounts of self-employment income would not require a response.

Management's Response: The National Director, Compliance and Accounts Division, has made all of the recommended changes to the letter except for the holding of taxpayer refunds. Letters will be modified later, depending on the results of the Examination project discussed earlier.

The IRS disagreed with the recommendation to send different letters to taxpayers based on the amount of self-employment income at issue and stated that it would result in disparate treatment of taxpayers. The same letter will be sent to all taxpayers regardless of the amount of potential self-employment income earned.

Office of Audit Comment: While we agree that sending different letters to taxpayers based on the amount of self-employment tax they owed would result in different treatment of taxpayers, in our opinion, the differing treatment is consistent with the way the IRS currently administers taxes. The IRS takes different actions when processing tax returns or when taking enforced collection actions based on the amount of tax involved.

Conclusion

Social Security coverage provides taxpayers with retirement benefits, disability benefits, survivor benefits, and hospital insurance benefits. Funding of Social Security has received considerable political attention in recent years. By improving the identification of taxpayers who do not report self-employment taxes, and by offsetting taxpayer refunds to pay these taxes when possible, the IRS can improve taxpayer compliance with the requirement to pay into Social Security with minimal burden to the taxpayers.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this audit was to determine whether the Internal Revenue Service (IRS) had taken effective corrective actions to improve the identification and collection of unreported self-employment taxes.

To accomplish our objective, we analyzed tax return information, interviewed IRS personnel, and reviewed documentation from the IRS' Self-Employment Tax (SET) National Strategy.[1] Our audit work was performed at the Ogden IRS Center. However, our analysis included data taken nationwide from tax returns posted to the IRS' Individual Masterfile.[2] Due to the large volume of tax return information, we selected samples from nationwide data using statistically valid sampling techniques. Where information was obtained through computer extracts, we validated the data to verify its accuracy and completeness. Specifically, we performed the following audit tests:

I. Management corrective actions

   A. Reviewed proposed management corrective actions from our prior report *Compliance with Self-Employment Tax Requirements* (Reference Number 083502, dated May 19, 1998) and evaluated whether these actions corrected the findings in the report.

   B. Reviewed the Department of the Treasury's Inventory Tracking and Control System and related documentation to determine if corrective actions were taken for each finding in the report.

II. Effectiveness of current procedures for working potential underpaid self-employment tax returns.

   A. Evaluated whether "Other Income" shown on line 21 of the United States Individual Income Tax Return (Form 1040) was properly coded as potential self-employment income.

      1. From the IRS' Individual Masterfile, selected a random sample of 322 Tax Year 1998 Forms 1040 with income on line 21 and

[1] The IRS' SET National Strategy is an attempt by the IRS to implement an educational letter as an alternative to audits of taxpayers who may owe self-employment taxes.
[2] The Individual Masterfile is the IRS database that maintains transactions or records of individual tax accounts.

evaluated whether the tax returns should have received a return processing code "N."[3]

2. From the IRS' Individual Masterfile, selected a random sample of 330 Tax Year 1998 Forms 1040 with income on line 21 which had received a return processing code "N" and evaluated whether the "N" codes were properly used.

3. From the IRS' Individual Masterfile, selected a random sample of 322 Tax Year 1998 Forms 1040 with a Profit or Loss From Business (Schedule C) attached and no self-employment taxes paid and evaluated whether the "Statutory Employee" box was checked. For those tax returns with the box checked, we verified that the tax returns were marked as "Statutory Employees" on the IRS' Individual Masterfile.

4. Selected a judgmental sample at 2 IRS Centers of 110 exemption forms on file where taxpayers applied for an exemption from paying self-employment taxes and evaluated whether the IRS properly processed these forms. We reviewed 60 Applications for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners (Form 4361) and 50 Applications for Exemption from Social Security and Medicare Taxes and Waiver of Benefits (Form 4029).

5. Reviewed Schedule C to determine whether the IRS had made the box for statutory employee larger and more noticeable than in previous years, as agreed to in our prior report.

B. Evaluated the effectiveness of the educational letters being sent to taxpayers potentially owing self-employment tax.

1. Obtained a copy of the letter being sent to taxpayers potentially owing self-employment tax and reviewed the letter for clarity and content.

2. Determined the percentage of tax returns amended and the amount of additional revenue collected as a result of the letters.

a) Selected a statistical sample of 325 tax returns where a notice was sent to the taxpayer. (Population=328,823,

[3] A return processing code "N" is entered on tax returns by IRS employees if they determine income included on line 21 should be subject to the self-employment tax. This "N" code is used to identify cases with unreported self-employment taxes.

Confidence=95 percent, Precision +/- 5 percent, Expected Error Rate=30 percent)

b) Researched the IRS' Individual Masterfile to determine the number of sampled returns that were amended and the amount of additional revenue collected.

3. Determined the extent of taxpayers receiving the letter who did not amend their returns and who appeared to owe self-employment tax.

a) Based on the non-amended returns from II.B.2.b), reviewed the returns to determine the amount of self-employment tax appearing to be owed on the returns.

b) On those returns determined to owe self-employment tax, determined if a refund was present on the return.

c) Summarized the number, the amount of self-employment tax, and the amount of refunds on the returns.

III. Proposed future changes to the SET National Strategy.

A. Evaluated whether established Requests for Information Services (RIS) were adequate and effective to implement future computer programming.

1. Evaluated the RIS prepared for the IRS' Submission Processing function to determine whether it agreed with the suggested changes in our prior report.

2. Evaluated the RIS prepared for the IRS' Correspondence Examination function to determine whether it agreed with the suggested changes in our prior report. We determined whether the returns that should have been excluded from the SET inventory were properly excluded.

B. Determined the amount of revenue lost by not timely implementing the RISs.

1. Reviewed responses to the RISs and determined when the RISs would be implemented and whether the implementation dates were reasonable.

2. Interviewed the team leader of the SET National Strategy Team to determine what steps have been taken to get the RISs implemented.

3. Using the results obtained from audit step II.B.3., determined the number of returns with refunds, the average amount of the refunds,

and the average amount of self-employment tax appearing to be owed on each return.

4. Based on results from audit step III.B.3., determined the amount of self-employment tax revenue that could have been generated by freezing the refunds rather than sending to taxpayers letters which required no response.

Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)
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Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Chief Operations Officer OP
Commissioner, Small Business/Self-Employed Division S
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Forms and Submission Processing) OP:FS
Office of Management Controls CFO:A:M
Office of the Chief Counsel CC
National Taxpayer Advocate C:TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis M:O
National Director, Customer Service Compliance, Accounts and Quality OP:C:A
National Director, Submission Processing OP:FS:S
National Director, Tax Forms and Publications Division OP:FS:FP
Audit Liaisons:
- Chief Operations Officer OP
- Assistant Commissioner (Customer Service) OP:C
- Assistant Commissioner (Forms and Submission Processing) OP:FS
- National Director, Submission Processing OP:FS:S:X
- National Director, Tax Forms and Publications OP:FS:FP

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 the Congress.

Finding and recommendation:
The Internal Revenue Service (IRS) could more timely identify and collect unreported self-employment taxes. Requests for Information Services (RIS) have been prepared to facilitate educational letters being sent to taxpayers during returns processing, but the RISs have not been programmed. Further, the RISs do not address self-employment taxes being assessed immediately while tax refunds are still available (see page 4).

The Chief Operations Officer should ensure programming is completed to identify unreported self-employment taxes during processing. The Assistant Commissioner (Customer Service) should initiate a program for the Correspondence Examination function to immediately work significant cases with refunds available to offset against the unreported self-employment taxes.

Type of Outcome Measure:

- Increased Revenue/Revenue Protected (Potential)
- Taxpayer Burden (Potential)

Value of the Benefit:
Based on our statistical samples, we estimate that approximately $71 million in self-employment taxes remain unassessed each year for taxpayers earning self-employment income of $2,000 or more. By working these cases in Correspondence Examination before refunds are issued to taxpayers, the IRS could immediately collect self-employment taxes of $21 million each year. Over 5 years, this totals $105 million.

Based on our statistical sample, we estimate that 78,000 taxpayers each year have self-employment income of $2,000 or more but do not report self-employment taxes. By using available refunds to pay self-employment tax assessments, the IRS could reduce burden on over 42,000 taxpayers each year by eliminating or reducing interest and penalties these taxpayers would be required to pay.

Methodology Used to Measure the Reported Benefit:
From our statistical sample of 325 tax returns referred to above, we identified 84 taxpayers who: (1) reported self-employment income of $2,000 or more but reported no self-employment taxes, (2) did not amend their tax returns after the IRS sent them a letter, and (3) received tax refunds from the tax returns in question. We used the data from this sample to estimate the number of taxpayers affected and the refunds available to be applied to unreported self-employment taxes. We recognize that, as with any new compliance program, there will be opportunity costs as resources are diverted from one program to another. We have no data regarding these costs. However, the ongoing "stand up" of the IRS' new Small Business/Self-Employed Division presents an excellent opportunity to address this issue.

Finding and recommendation:
The IRS made processing errors which caused some taxpayers to be erroneously identified by IRS computers as owing self-employment taxes (see page 8).

The IRS should improve the accuracy of the information used to determine if taxpayers are liable for self-employment taxes.

Type of Outcome Measure:
- Taxpayer Burden (Potential)
- Cost Savings (Potential)

Value of the Benefit:
The three types of processing errors discussed in this report (religious exemptions, other income, and statutory employees) resulted in an estimated 30,000 taxpayers receiving erroneous letters from the IRS for Tax Years 1996 and/or 1997 indicating they may be liable for self-employment taxes. Since these letters were sent over a period of 2 years, eliminating these errors would result in reduction of burden to 15,000 taxpayers each year.

The costs associated with issuing and working these 15,000 letters totals approximately $60,000. Over 5 years, this totals $300,000 in cost savings.

Methodology Used to Measure the Reported Benefit:
Implementation of the IRS' Self-Employment Tax (SET) National Strategy[1] resulted in the IRS sending 328,823 educational letters to taxpayers informing them that they may be liable for self-employment taxes for income reported on their 1996 and/or 1997 tax returns. We took a statistical sample of 325 of the tax returns involved (based on a 95 percent confidence level and a precision level of +/- 5 percent) and found that

[1] The IRS' SET National Strategy is an attempt by the IRS to implement an educational letter as an alternative to audits of taxpayers who may owe self-employment taxes.

9 percent of the taxpayers were sent a letter because the IRS had made certain processing errors. These errors affected: (1) taxpayers claiming religious exemptions from self-employment tax requirements, (2) taxpayers reporting income on United States Individual Income Tax Returns (Form 1040) line 21, "Other Income," and (3) taxpayers indicating they were statutory employees by checking the appropriate box on Profit or Loss From Business (Schedule C).

To calculate the cost of sending these letters, we used the total costs of sending and responding to all letters calculated by the Kansas-Missouri District Office Research and Analysis function (KSMO DORA).

Finding and recommendation:
The educational letter designed by the KSMO DORA was sent to taxpayers with $1,000 or more of self-employment income during the initial implementation of the SET National Strategy, but future plans are to send letters only to taxpayers with $2,000 or more of self-employment income. Results from the initial implementation of the SET National Strategy indicate that letters sent to taxpayers with self-employment income of less than $2,000 will generate approximately $3.3 million (see page 13).

The Assistant Commissioner (Customer Service) should consider sending to these taxpayers an educational letter which requires no response .

Type of Outcome Measure:
- Increased Revenue (Potential)

Value of the Benefit:
Letters sent to taxpayers with self-employment income between $1,000 and $1,999 would result in a net increase in self-employment tax revenues of over $1.4 million per year. Over 5 years, this increase totals $7 million.

Methodology Used to Measure the Reported Benefit:
We used the data from our statistical sample of 325 tax returns referred to above to estimate the self-employment taxes generated by letters sent to taxpayers with self-employment income of less than $2,000 and the number of taxpayers involved.

To determine the cost of sending these letters, we used the cost data calculated by the KSMO DORA (approximately $4 per letter).

Appendix V

Management's Response to the Draft Report

COMMISSIONER

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

RECEIVED
SEP 1 2 2000
8:45AM

September 11, 2000

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Charles O. Rossotti Bob Wenzel for
Commissioner of Internal Revenue

SUBJECT: Draft Audit Report – The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes (Audit #199930110)

Thank you for the opportunity to respond to your draft report entitled "The Internal Revenue Service Needs to Improve the Identification and Collection of Unreported Self-Employment Taxes." We appreciate your recognition of the actions taken by the Kansas-Missouri District Office Research and Analysis group (KSMO DORA) and the Kansas City Service Center to address unreported self-employment taxes (SET).

We agree with most of your recommendations to improve the processing, collection, and examination of unreported SET. However, we feel a further analysis of the resource impact on operations is required before we can commit to holding refunds (to be applied to SET deficiencies) of taxpayers who do not report and pay SET. We are proposing a small-scale test to hold refunds of non-compliant SET taxpayers, and if it is successful, we will implement the project nationwide. We do not agree with your recommendation to send different types of educational letters to taxpayers based on their income level because this would result in disparate treatment.

We agree that implementing your recommendations would increase the amount of revenue we collect. However, we question the accuracy of your $21 million dollar measurement since you did not conduct any audits to determine the SET liability of taxpayers who did not respond to the educational letters. You only considered taxpayers who filed an amended tax return to be respondents. Your review of the non-respondents consisted of looking at the taxpayer's original tax return "to determine the amount of self-employment tax appearing to be owed on the returns." However, the educational letter specifically stated "If you determine that you don't owe self-employment tax . . . you don't need to take any further action." Therefore, the $21 million dollar measurement may assume taxpayers who didn't respond to the educational letter are liable for SET when, in fact, they are not. This results in an inflated measurement.

2

Our comments on your specific recommendations in this report follow:

IDENTITY OF RECOMMENDATION/FINDING 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 KSMO DORA should then be sent to these taxpayers.

ASSESSMENT OF CAUSE:
The IRS uses manual procedures to identify unreported self-employment tax. In addition, we do not contact taxpayers who may owe unreported self-employment tax until after we have processed the return and sent any applicable refund.

CORRECTIVE ACTIONS:
Beginning in January 2001, we will begin systemically identifying taxpayers with potential unreported self-employment tax during processing. Returns for taxpayers with income that could be subject to self-employment tax will be routed to the error resolution function for review. They will correct the account information if there is documentation showing the taxpayer is not subject to self-employment tax (e.g., the taxpayer has a ministerial exemption or is a statutory employee). If, upon review, we do not find information indicating the taxpayer is not subject to self-employment tax, we will correspond with the taxpayer to obtain additional information. Depending upon the response, we will assess self-employment tax, correct other account data, or direct the return to examination for further review. These actions will eliminate the need for the educational letters developed by the KSMO DORA.

IMPLEMENTATION DATE:
PROPOSED: January 2, 2001

RESPONSIBLE OFFICIAL(S)
Assistant Commissioner (Forms and Submission Processing)

FUTURE BUSINESS OWNER(S)
Director, Wage and Investment Customer Account Services
Director, Small Business/Self-Employed Customer Account Services

CORRECTIVE ACTION(S) MONITORING PLAN
Submission Processing management will oversee the implementation of the new programming and procedures to ensure they are effectively implemented.

3

IDENTITY OF RECOMMENDATION/FINDING 2
The Assistant Commissioner (Customer Service) should initiate a program for the Correspondence Examination function to immediately work cases meeting the following criteria:

- Significant unreported self-employment taxes for purposes of this audit, we defined significant as $2,000 or more of self-employment income for which no self-employment taxes were paid.
- A refund available to be applied to the unreported self-employment taxes.
- No response or an inadequate response to the letter issued by the IRS during returns processing.

Other cases should be prioritized based on the SET score (discussed later in this report) and worked by the Correspondence Examination function when possible.

ASSESSMENT OF CAUSE
Legislative mandates and Treasury Department directives required examinations of returns claiming questionable Earned Income Tax Credits as part of the Revenue Protection Strategy. This has prevented Correspondence Examination from working self-employment tax cases.

CORRECTIVE ACTIONS
Starting this fiscal year (FY) and for FY 2001, the Correspondence Examination function will devote resources to examine taxpayers who have failed to respond to the educational letter notifying them to amend their tax returns and report and pay self-employment tax. With the pending "stand-up" of the IRS's Small Business/Self-Employed (SB/SE) Division, greater emphasis will be placed on serving the self-employed taxpayer.

We will prepare a Project Prospectus to study the feasibility of holding refunds on a limited number of tax returns identified as non-compliant in reporting self-employment tax. This project will be limited to one site. If successful, and resources are available, the project could be expanded to all SB/SE Correspondence Examination sites by 2003.

IMPLEMENTATION DATE
PROPOSED: January 1, 2003

RESPONSIBLE OFFICIAL(S)
National Director, Compliance and Accounts Division

4

FUTURE BUSINESS OWNER
Director, Small Business/Self-Employed Compliance

CORRECTIVE ACTION(S) MONITORING PLAN
SB/SE Compliance management will oversee the deployment of resources to examine SET and ensure the project is piloted at one site.

IDENTITY OF RECOMMENDATION/FINDING 3
The Assistant Commissioner (Forms and Submission Processing) should take steps to ensure that information from Forms 4029 and 4361 is accurately entered in IRS computers.

ASSESSMENT OF CAUSE
Not all Forms 4029 and 4361 have been entered into IRS computer systems.

CORRECTIVE ACTIONS
In addition to correcting the taxpayer's current year account as discussed under Recommendations 1 and 4, we will forward copies of approved Forms 4029 and 4361 which indicate the taxpayer is exempt from SET to the area responsible for processing the forms. IRM procedures are sufficient to ensure the system is updated to indicate a Form 4029 or Form 4361 exemption.

IMPLEMENTATION DATE
PROPOSED: January 2, 2001

RESPONSIBLE OFFICIAL(S)
Assistant Commissioner (Forms and Submission Processing)
Assistant Commissioner (Customer Service)

FUTURE BUSINESS OWNER(S)
Director, Small Business/Self-Employed Customer Account Services
Director, Wage and Investment Customer Account Services

CORRECTIVE ACTION(S) MONITORING PLAN
Submission Processing management will oversee forwarding copies of approved Forms 4029 and 4361 to the area responsible for processing these forms.

IDENTITY OF RECOMMENDATION/FINDING 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 one of these two forms. This information should be used to perfect the IRS' database of taxpayers that are exempt from self-employment taxes.

ASSESSMENT OF CAUSE
Processing errors resulted in taxpayers receiving letters indicating they owed self-employment tax for which they were not liable.

CORRECTIVE ACTIONS
SB/SE Compliance functions will forward Forms 4361 and 4029 to the unit responsible for processing them, to ensure the Masterfile is updated. SB/SE Compliance IRMs will be updated to make sure these procedures are clearly referenced.

IMPLEMENTATION DATE
PROPOSED: September 30, 2001

RESPONSIBLE OFFICIAL(S)
Assistant Commissioner (Customer Service)

FUTURE BUSINESS OWNER
Director, Small Business/Self-Employed Compliance
Director, Small Business/Self-Employed Customer Account Services
Director, Wage and Investment Customer Account Services

CORRECTIVE ACTION(S) MONITORING PLAN
SB/SE Compliance Quality Review functions will review work completed under these IRM procedures to ensure that quality standards are maintained.

IDENTITY OF RECOMMENDATION/FINDING 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.

ASSESSMENT OF CAUSE
Although the tax form instructions for line 21 advise taxpayers not to report self-employment income there, TIGTA found that taxpayers do so anyway. IRS employees are instructed to review the explanation of income on Form 1040, line 21 to determine if it is self-employment income. In some cases, the employees, working with detailed instructions and at high speed, incorrectly identify some income as self-employment income. This causes erroneous notices to taxpayers.

CORRECTIVE ACTIONS
During the course of this audit, Forms and Submission Processing staff and TIGTA discussed possible changes to the Form 1040 instructions. We suggested, and TIGTA agreed, that we revise Form 1040, line 21 instructions to provide a caution advising that self-employment income must not be reported on this line.

IMPLEMENTATION DATE
PROPOSED: November 1, 2000

RESPONSIBLE OFFICIAL(S)
Assistant Commissioner (Forms and Submission Processing)

FUTURE BUSINESS OWNER
Director, Wage and Investment Communications, Assistance, Research and Education

CORRECTIVE ACTION(S) MONITORING PLAN
Tax Forms and Publications management will ensure Form 1040 instructions are revised.

IDENTITY OF RECOMMENDATION/FINDING 6
The Assistant Commissioner (Forms and Submission Processing) should take steps to ensure that data transcribers do not overlook the statutory employee check box on Schedules C and C-EZ. One option discussed with IRS managers from the Submission Processing function was to have tax examiners from the Code and Edit function circle the statutory employee box if it has been checked by the taxpayer.

ASSESSMENT OF CAUSE
In some cases, the data transcriber overlooked the statutory employee checkbox when entering data on Schedule C and C-EZ. Statutory employees are not subject to SET and should not receive correspondence from the IRS concerning it. By failing to enter the statutory employee indicator, we caused erroneous correspondence and unnecessary burden to some taxpayers.

CORRECTIVE ACTIONS
To highlight an entry in the statutory employee checkbox, we revised Code and Edit instructions to add a check mark above the statutory box when it has been checked by the taxpayer. We will also emphasize the indicator's importance during year-end training. We cannot circle the statutory employee box, as recommended, because when an entry is circled, it means the data transcriber should not enter that information.

IMPLEMENTATION DATE
PROPOSED: January 2, 2001

RESPONSIBLE OFFICIAL(S)
Assistant Commissioner (Forms and Submission Processing)

FUTURE BUSINESS OWNER
Director, Wage and Investment Submission Processing

CORRECTIVE ACTION(S) MONITORING PLAN
To ensure instructions are being followed, we will evaluate and monitor the process with the Computer Assisted Pipeline Review system.

IDENTITY OF RECOMMENDATION/FINDING 7
The Assistant Commissioner (Customer Service) should revise the formula for scoring the SET inventory so it accurately reflects the potential self-employment tax deficiency on a tax return.

ASSESSMENT OF CAUSE
The IRS' current formula can give the same SET score to tax returns with varying self-employment tax potential.

CORRECTIVE ACTIONS
SB/SE Compliance will work on developing a revised SET scoring formula.

IMPLEMENTATION DATE
PROPOSED: January 1, 2002

RESPONSIBLE OFFICIAL(S)
National Director, Compliance and Accounts Division

FUTURE BUSINESS OWNER
Director, Small Business/Self Employed Compliance

CORRECTIVE ACTION(S) MONITORING PLAN
SB/SE Compliance will test the revised SET scoring formula for the highest examination potential.

IDENTITY OF RECOMMENDATION/FINDING 8
The Assistant Commissioner (Customer Service) should consider the following changes to the educational letter sent to taxpayers with potential self-employment tax deficiencies:

- State that the IRS has determined that the taxpayer most likely owes self-employment taxes.

- Educate the taxpayer of the importance of the self-employment tax by explaining what it is and why the taxpayer owes it. For example, "The self-employment tax is a Social Security and Medicare tax on the income of individuals who work for themselves. Your payments of self-employment taxes contribute to your coverage under the Social Security system. Social Security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance benefits. The self-employment tax is similar to the Social Security and Medicare taxes withheld from the pay of wage earners. You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do in addition to your regular job, may also be self-employment."

- For taxpayers with significant self-employment income, explain that if the taxpayer takes no action, the IRS will hold any refund available from their tax return, and will forward their return to the Examination function for follow-up.

ASSESSMENT OF CAUSE
Prior versions of the letters did not explain to the taxpayer the importance of contributing to the Social Security system.

CORRECTIVE ACTIONS
We made the suggested changes, except for the holding of taxpayer refunds, and the National Director, Education, Walk-In and Correspondence Improvement has approved use of the modified letter (3077). Letters will be modified for holding refunds pending the results of the study discussed earlier.

IMPLEMENTATION DATE:
COMPLETED: July 27, 2000

RESPONSIBLE OFFICIAL(S)
National Director, Compliance and Accounts Division

CORRECTIVE ACTION(S) MONITORING PLAN
N/A

IDENTITY OF RECOMMENDATION/FINDING 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. Letters to taxpayers with significant self-employment income would require a response, while letters to taxpayers with lesser amounts of self-employment income would not require a response.

ASSESSMENT OF CAUSE(S)
The IRS does not send different letters to taxpayers based on their income level.

CORRECTIVE ACTIONS
We do not agree with this recommendation. The IRS will provide the same letter to all taxpayers regardless of income since it is important for all self-employed taxpayers to contribute toward the Social Security system by paying self-employment taxes, thereby earning credits to qualify for benefits.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL(S)
N/A

CORRECTIVE ACTION(S) MONITORING PLAN
N/A

If you have any questions about this response, please contact me at (202)622-9511 or a member of your staff may contact Robert C. Wilkerson, Director, Business Systems Planning at (202)927-1947.