



Treasury Inspector General for Tax Administration

IDENTIFICATION OF UNREPORTED SELF-EMPLOYMENT TAXES CAN BE IMPROVED

Issued on October 11, 2007

Highlights

Highlights of Report Number: 2008-30-001 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

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 these programs, the Internal Revenue Service (IRS) must help self-employed taxpayers meet their tax responsibilities by assessing and collecting the proper amount of self-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. 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.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine the effectiveness of the IRS' process for identifying and auditing taxpayers who are subject to but do not pay self-employment taxes. The IRS Office of Internal Audit and TIGTA issued audit reports in 1998 and 2000, respectively, that focused on the identification and collection of self-employment taxes. Most recommendations from our prior reports have been reported as implemented. However, the IRS has not implemented the TIGTA 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.

WHAT TIGTA FOUND

IRS procedures are inconsistent for identifying U.S. Individual Income Tax Returns (Form 1040) reporting income on line 21 that is potentially subject to the self-employment tax. Also, there was a

significant problem with assigning an audit code to returns with potentially unreported self-employment taxes. The code was either improperly assigned when a return had no self-employment tax issue or was not assigned when a self-employment tax issue was present. Overall, 25 percent of the returns sampled had potential self-employment tax issues but either were not selected for audit or were surveyed (i.e., the audits were closed with little or no examination of the returns by the IRS Examination function), although the taxpayers had not properly reported self-employment tax; 43 percent of these returns had refunds available to offset all or part of the self-employment tax liabilities.

WHAT TIGTA RECOMMENDED

TIGTA recommended the Commissioner, Wage and Investment Division, 1) emphasize the importance of assigning the correct processing code 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, and 2) strengthen the processes for reviewing returns upon receipt for potential unpaid self-employment taxes, especially the processes for including the statutory income indicator in the Wage and Tax Statement (Form W-2) W-2 database and for assigning an audit code when a self-employment tax issue is present. Finally, the Commissioner, Small Business/Self-Employed Division, should 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.

In their response to the report, IRS officials agreed with the first two recommendations and disagreed with the third. The IRS plans to explore the possibility of expanding existing returns processing training material to be issued in January 2008. However, 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. Based on the findings of this and previous audits, TIGTA maintains 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 contact letters from the IRS. TIGTA encourages the IRS to move in that direction.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2008reports/200830001fr.pdf>

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