



*All Individual Tax Returns Filed
Electronically in the 2013 Filing Season
Were Processed Using the
Modernized e-File System*

September 27, 2013

Reference Number: 2013-40-131

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

2 = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

ALL INDIVIDUAL TAX RETURNS FILED ELECTRONICALLY IN THE 2013 FILING SEASON WERE PROCESSED USING THE MODERNIZED E-FILE SYSTEM

Highlights

**Final Report issued on
September 27, 2013**

Highlights of Reference Number: 2013-40-131 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The Modernized e-File (MeF) system replaced the Legacy e-File system as the primary electronic filing (e-filing) platform for individual tax returns during the 2013 Filing Season. The MeF system provides real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite tax return acknowledgments to taxpayers. The IRS successfully transferred the processing of all e-filed tax returns to the MeF system during the 2013 Filing Season.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS successfully transitioned e-filing of individual tax returns to the MeF system for the 2013 Filing Season. The objective of this review was to determine whether the MeF system received, processed, and posted individual tax return information timely, accurately, and effectively.

WHAT TIGTA FOUND

The IRS successfully transitioned the processing of all e-filed individual income tax returns through the MeF system for the 2013 Filing Season. As of May 4, 2013, the IRS received approximately 129 million e-filed Tax Year 2012 Forms 1040, *U.S. Individual Income Tax Return*. The IRS accepted approximately 114 million (88 percent) of the 129 million tax returns and rejected more than 15 million (12 percent) tax returns.

The MeF system processed most tax returns correctly. Our review of a statistically valid

sample of 560 Forms 1040 tax returns received by the IRS from January 30, 2013, through May 4, 2013, found that 558 tax returns (99.6 percent) were processed correctly. TIGTA found that the MeF system did not identify the remaining two tax returns for taxpayers who appeared to have a requirement to pay self-employment tax but did not pay it.

Further review of the tax returns with qualifying self-employment income on Schedule C, *Profit or Loss From Business*, filed from January 27 through June 29, 2013, for which the taxpayer did not pay self-employment tax, identified 11,700 taxpayers with more than \$12 million in self-employment income for whom IRS records showed that they were not exempt from paying self-employment tax. TIGTA estimates that the self-employment tax that should have been paid by these individuals totaled more than \$1.4 million.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division, revise the Error Resolution Program to identify and correspond with all taxpayers who claim qualifying self-employment income but no corresponding self-employment tax is paid, and there is no indication that the taxpayer has an exemption from paying the tax to obtain a Schedule SE, *Self-Employment Income*. The Commissioner, Wage and Investment Division, should also initiate a program to correspond with the 11,700 taxpayers TIGTA identified to obtain a Schedule SE and ensure that the proper amount of self-employment tax is assessed.

In their response to the report, IRS management agreed with our first recommendation and stated that it plans to review existing processes and consider reducing the tolerances to address more taxpayers who claim qualifying self-employment tax with no tax paid and no indication of an exemption. The IRS did not agree with our second recommendation to correspond with the 11,700 taxpayers TIGTA identified. However, the IRS plans to consider cost-effective alternatives to provide for optimal coverage at the time tax returns are processed.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 27, 2013

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System (Audit # 201340011)

This report presents the results of our review to determine whether the Internal Revenue Service's (IRS) Modernized e-File system received, processed, and posted individual tax return information timely, accurately, and effectively. This is the seventh in a series of audits that we have performed since 2009 tracking the growth and maturity of this processing system. This review is included in our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Modernization.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me if you have questions or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

e-file(d), e-filing	Electronically file(d); electronic filing
IRS	Internal Revenue Service
MeF	Modernized e-File
TIGTA	Treasury Inspector General for Tax Administration
TRDB	Tax Return Database



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Background

The Modernized e-File (MeF) system is an Internet-based electronic filing (e-filing) platform that replaced the Internal Revenue Service's (IRS) prior e-filing system, referred to as the Legacy e-File system. The MeF system provides a single method for filing business and individual tax returns, forms, and schedules via the Internet. The system provides real-time processing of tax returns, improves error detection, standardizes business rules, and expedites tax return acknowledgements to taxpayers. The MeF system also allows taxpayers to submit supporting documents in a Portable Document Format¹ with their tax return.

Individual tax returns processed through the MeF system must pass validation rules to be accepted for processing

The MeF system uses three levels of validation for processing acceptance. Once a tax return has passed all three levels of validation, it will enter the IRS's tax return processing stream. The three levels of validation include:

- **Level 1 – Schema Validation** – A MeF system tax return is divided into a series of different data structures. Schemas provide the basic definitions for the data elements within each data structure and the interrelationships among the data elements (e.g., what is required, field length, data type, and allowable field values). The MeF system verifies the accuracy of the data format in the tax return by validating each tax return against the individual schemas. If an error is found during the schema validation, the tax return is rejected.
- **Level 2 – National Account Profile² Checks** – The taxpayer, spouse, and dependent name controls and Social Security Numbers contained on the tax return must match the information on the National Account Profile before the IRS will accept the tax return for processing. The MeF system conducts the same basic verification as the Legacy e-File system. As with schema validations, a tax return is rejected if it fails one or more of the National Account Profile validations.
- **Level 3 – Business Rule Check** – The IRS establishes criteria or business rules that each tax return must pass before it can be processed electronically. The business rules are designed to validate basic requirements on a tax return, such as income limits for tax

¹ A file format for representing documents in a manner that is independent of the original application software, hardware, and operating system used to create those documents.

² A compilation of selected entity data from the IRS Master Files, which are the databases that store various taxpayer information. The National Account Profile includes all valid and invalid taxpayer entity information.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

credits and deductions and the need to attach a specific schedule if certain conditions are present on the tax return. A tax return will be rejected if one or more of the business rules are not met.

Implementation of individual tax return processing using the MeF system occurred over a three-year period

Prior to the 2013 Filing Season,³ the IRS accepted e-filed tax returns using both the Legacy e-File and MeF systems. The IRS implemented the MeF system for the processing of e-filed individual tax returns in three phases beginning with the 2010 Filing Season.

- **Phase I** – Included accepting Form 1040, *U.S. Individual Income Tax Return*; Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*; and 21 forms and schedules related to the Form 1040 for Tax Year⁴ 2009 for MeF processing. The IRS first began accepting individual tax returns through the MeF system in February 2010.
- **Phase II** – Implemented during the 2011 Filing Season, it did not provide for the filing of any additional tax forms or schedules other than those that could be filed in the first phase. The primary difference between the first and second phase was that, in the second phase, prior year returns of individual taxpayers could be filed using the MeF system. For example, for the 2011 Filing Season, individual taxpayers were able to file both their Tax Year 2009 and Tax Year 2010 tax returns using the MeF system.
- **Phase III** – Implemented during the 2012 Filing Season. This phase included 129 individual tax forms for Tax Year 2011 and prior year processing support for the original forms deployed in the first and second phases.

The Treasury Inspector General for Tax Administration (TIGTA) performed annual reviews to assess each phase of IRS's implementation of the MeF system

TIGTA conducted reviews to evaluate each phase of the IRS's continued implementation of the MeF system. These reviews assessed whether individual income tax returns were processed accurately and timely and whether sufficient progress was made to replace the Legacy e-File system for the 2013 Filing Season. Figure 1 details issues reported and recommendations made.

³ The period from January through mid-April when most individual income tax returns are filed.

⁴ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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Figure 1: TIGTA Reviews of the IRS's Implementation of the MeF System

Audit Report Number	Audit Findings	Recommendations
2010-40-111 ⁵	<ul style="list-style-type: none"> ○ The MeF system was rejecting tax returns in error or not providing an accurate explanation as to why the tax return was rejected. ○ The IRS was unable to assess the system's capability to handle large volumes of tax returns as a result of the low volume of tax returns received through the MeF system. 	<ul style="list-style-type: none"> ○ Establish processes to analyze data to identify trends that may indicate errors in tax return processing and ensure that the explanation provided for rejecting a tax return is accurate. ○ Work with transmitters and States to address participation concerns.
2011-40-131 ⁶	<ul style="list-style-type: none"> ○ Processes used to test and monitor the MeF system did not ensure that MeF system business rules were working as intended. ○ Lower than expected tax return volumes raised concerns regarding the IRS's ability to replace the Legacy e-File system for the 2013 Filing Season. ○ The IRS had not pursued the use of the MeF system as an option to scan and attach supplemental information to tax returns. 	<ul style="list-style-type: none"> ○ Test a variety of tax return types and volumes to simulate the production volume expected during the 2012 Filing Season. ○ Continue to work with transmitters and States to identify and address participation concerns. ○ Promote the benefits of the MeF system Portable Document Format feature to include attachments.
2012-40-116 ⁷	<ul style="list-style-type: none"> ○ The MeF system had not shown that it could consistently process large volumes of tax returns for an extended period. ○ Issues identified during testing were not always addressed prior to processing. ○ Processes to validate and monitor the MeF system did not ensure accuracy. 	<ul style="list-style-type: none"> ○ Ensure that the MeF system can timely and accurately process the anticipated number of individual tax returns it expects to receive in a single filing season before discontinuing the use of the Legacy e-File system. ○ Enhance test procedures based on lessons learned.

Source: TIGTA Internet website at www.treasury.gov/tigta.

⁵ TIGTA, Ref. No. 2010-40-111, *System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized e-File System for Individual Tax Return Processing* (Sept. 2010).

⁶ TIGTA, Ref. No. 2011-40-131, *Low Participation and Tax Return Volumes Continue to Hinder the Transition of Individual Income Tax Returns to the Modernized e-File System* (Sept. 2011).

⁷ TIGTA, Ref. No. 2012-40-116, *While Use of the Modernized e-File System for Individual Tax Returns Has Increased, the Legacy e-File System Is Still Needed As a Backup* (Sept. 2012).



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

This review was performed at the Wage and Investment Division's Office of Submission Processing in Atlanta, Georgia, and the Information Technology Office of Applications Development in New Carrollton, Maryland, during the period October 2012 through July 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Results of Review

Individual Tax Returns Were Processed Using the Modernized e-File System

The IRS successfully transitioned the processing of all e-filed individual income tax returns to the MeF system for the 2013 Filing Season. As of May 4, 2013, the IRS received approximately 129 million e-filed Tax Year 2012 Forms 1040. The IRS accepted approximately 114 million (88 percent) and rejected more than 15 million (12 percent) tax returns. Figure 2 shows the number of Forms 1040 the IRS received through the MeF system in Processing Years⁸ 2010 through 2013 as of May 4 for each year.

Figure 2: Forms 1040 Processed via the MeF System Processing Years 2010 Through 2013⁹ (as of May 4)

Forms 1040	2010	2011	2012	2013
Transmitted	825,602	9,215,187	76,113,569	128,953,215
Accepted	672,898	7,994,819	66,674,569	113,626,952
Rejected	152,704	1,220,368	9,439,000	15,326,263

Source: IRS tax return processing reports for e-filed tax returns.

In addition to receiving Tax Year 2012 Forms 1040, the IRS received (as of May 4, 2013):

- 7.8 million Forms 4868.
- 74.6 million State income tax returns. The IRS partners with States to allow taxpayers to e-file both their Federal and State income tax returns at the same time. The IRS receives the State income tax returns and forwards them on to the specific States for processing.
- 91,272 prior year tax returns.

⁸ The calendar year in which the tax return or document is processed by the IRS.

⁹ During the 2010 and 2011 Filing Seasons, MeF system processing of individual tax returns only supported the Form 1040, Form 4868, and 21 forms and schedules related to Form 1040.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

The performance of the MeF system improved—no tax returns were processed using the Legacy e-File system during the 2013 Filing Season

In our September 2012 report,¹⁰ we concluded that the MeF system had not shown that it could consistently process large volumes of tax returns for an extended period of time. Although the IRS significantly increased the volume of tax returns processed through the MeF system during the 2012 Filing Season, the volume of tax returns received was less than anticipated as a result of performance issues and programming errors. For example, on at least two different occasions in the 2012 Filing Season, the IRS had to suspend MeF system processing to correct system performance and programming issues, which resulted in delays in the processing of individual tax returns. In February 2012, due to programming issues, the IRS announced that transmitters were allowed to use either the MeF or Legacy e-File systems.

The Legacy e-File system was maintained as a contingency for the 2013 Filing Season

In response to our September 2012 report, the IRS agreed to maintain the Legacy e-File system as a contingency should the MeF system experience significant delays in processing tax returns during the 2013 Filing Season. The IRS indicated that the Legacy e-File system would be used during the 2013 Filing Season if the MeF system experienced outages exceeding 48 hours. Although the IRS experienced intermittent delays in the MeF system's processing of tax returns during the 2013 Filing Season, none of these delays exceeded the 48-hour criteria requiring the processing of e-filed tax returns using the Legacy e-File system.

The delays in MeF system processing during the 2013 Filing Season were minimal. For example, apart from the scheduled downtime for system maintenance, the IRS took the MeF system offline¹¹ eight times from February 12, 2013, through April 15, 2013, to address performance issues. Figure 3 shows the dates the MeF system was taken offline and the duration of time the system was unavailable.

¹⁰ TIGTA, Ref. No. 2012-40-116, *While Use of the Modernized e-File System for Individual Tax Returns Has Increased, the Legacy e-File System Is Still Needed As a Backup* (Sept. 2012).

¹¹ The MeF system was not available for tax return transmitters to send tax returns to the IRS or retrieve tax return acknowledgements.



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Figure 3: Date and Duration of MeF System Intermittent Delays February 12, 2013, Through April 15, 2013

Date	Duration Offline (in hours)
February 12, 2013	3.5
February 13, 2013	4
February 21, 2013	4
February 24, 2013	1
February 26, 2013	2
March 7, 2013	4
March 15, 2013	5
April 7, 2013	12

Source: TIGTA analysis of IRS Quick Alerts and Knowledge, Incident/Problem, Service and Asset Management production tickets.¹²

The longest intermittent delay occurred on April 7, 2013. The IRS took the MeF system offline for scheduled maintenance but was unable to restart the system when planned. IRS management informed us that the inability to restart the system resulted from errors in the way the MeF system was shut down prior to performing the maintenance. However, the IRS successfully moved MeF processing to its disaster recovery platform and was able to resume processing of tax returns using the MeF system within about 12 hours of the system being taken offline.

In April 2013, TIGTA reported¹³ that MeF system infrastructure changes were on track to deliver improvements in performance and reliability for the 2013 Filing Season because the IRS had taken steps to address MeF system performance issues identified during the 2012 Filing Season. We also reported that the IRS was implementing expanded monitoring tools to improve its ability to monitor and measure MeF system availability. According to the IRS, these new monitoring tools allowed it to identify performance issues that had the potential to result in significant system delays earlier than in prior years and address those issues before they significantly affected the MeF system's ability to receive and accept tax returns.

¹² Knowledge, Incident/Problem, Service and Asset Management production tickets are used to help troubleshoot computer system problems and report problem resolution status.

¹³ TIGTA, Ref. No. 2013-20-039, *Enhancements Made to the Modernized e-File System in Release 8 Should Improve System Performance for the 2013 Filing Season* (Apr. 2013).



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Improvements are needed to ensure timely acknowledgement of tax returns and to ensure the accuracy of prior year tax return information included in the Tax Return Database¹⁴

While the IRS successfully transitioned the processing of all individual tax returns to the MeF system, it should continue its efforts to improve MeF system performance. Our analysis of MeF system performance during the 2013 Filing Season identified two areas where improvements are needed:

- **Tax return acknowledgements are still slower than expected.** Taxpayers who e-file their tax return receive an acknowledgement from the IRS when their tax return has been accepted for processing. The IRS strives to issue tax return acknowledgements to taxpayers within five minutes of receipt of the tax return during nonpeak processing periods and within two hours during peak processing periods.¹⁵ Although the MeF system processed the majority of e-filed tax returns within the IRS's established processing time periods, the system has not yet achieved the IRS's expectations for issuing tax return acknowledgements. The IRS issued alerts to tax return transmitters several times throughout the filing season indicating that MeF acknowledgements were slow. In addition, it took the IRS several days to issue all of the acknowledgements for the tax returns transmitted to the IRS during the period when the MeF system was down on April 7, 2013.
- **Rejected prior year tax returns are incorrectly shown as Tax Year 2012 tax returns in the Tax Return Database (TRDB).** The TRDB contains limited information on tax returns that are rejected by the MeF system. This information can be used by IRS employees to assist taxpayers who contact the IRS with questions about their tax return. Our analysis of a statistically valid sample of 100 of the 23,108 prior year tax returns rejected by the MeF system between the period January 30, 2013, through May 4, 2013, showed that all 100 returns were incorrectly recorded in the TRDB as Tax Year 2012 tax returns—93 were Tax Year 2011 and seven were Tax Year 2010 tax returns. It should be noted that the tax period for all of the rejected tax returns is correctly recorded in the MeF database. We notified the IRS of our concerns on May 16, 2013. According to the IRS, a programming error caused the tax year for all tax returns input to the TRDB to be Tax Year 2012. As a result, prior year tax returns were incorrectly shown as Tax Year 2012 tax returns. IRS management informed us that the TRDB programming was corrected on August 1, 2013, to capture the actual tax year for a tax return. In addition, IRS management indicated that the IRS has corrected the tax year in the TRDB for tax returns filed prior to August 1, 2013, to reflect the correct tax year.

¹⁴ The TRDB contains tax return source information for all electronically filed tax returns.

¹⁵ The term "peak" refers to the period of time in which the return volume increases for a specific form family. For Form 1040, there is a spike (or mini peak) in volume in January and early February. The major peak periods center on the April 15 deadline and October 15 extension deadline.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Most Electronically Filed Tax Returns Were Processed Correctly; However, Errors in Taxpayers' Reporting of Self-Employment Tax Were Not Always Identified

We obtained an extract of approximately 118 million Forms 1040 from the MeF system (including both accepted and rejected returns) that were received by the IRS from January 30 through May 4, 2013.¹⁶ Our review of a statistically valid sample of 560 of the almost 118 million tax returns showed that 558 (99.6 percent) tax returns were processed correctly. For the remaining two tax returns, we found that the individuals appear to have a requirement to pay self-employment tax, yet no self-employment tax was paid. MeF system business rules do not identify for further review tax returns that appear to have a self-employment tax liability but no tax is paid.

We identified 179,362 taxpayers who filed a tax return through the MeF system from January 27, 2013, through June 29, 2013, with an attached Schedule C, *Profit or Loss From Business*, and qualifying self-employment income,¹⁷ yet no self-employment tax was paid. Our analysis identified that 11,700 of the taxpayers were not identified as part of the Error Resolution Program. These taxpayers claimed more than \$12 million in qualifying self-employment income, but no self-employment tax was paid and there was no indication that the taxpayer was exempt from the tax. We estimate that these 11,700 taxpayers potentially owe more than \$1.4 million in self-employment tax. The following is a hypothetical example of the tax returns we identified.

Taxpayer A files a tax return showing net self-employment income on Schedule C totaling \$1,000. Taxpayer A is subject to self-employment tax on the \$1,000 in net income because the income exceeds the minimum net self-employment income that is subject to the tax. However, Taxpayer A did not file a Schedule SE, Self-Employment Tax, showing self-employment tax. In addition, Taxpayer A did not indicate on the Schedule C that he or she was exempt from paying self-employment tax and IRS records do not indicate that Taxpayer A has an approved exemption from paying self-employment tax.

Most taxpayers who report qualifying self-employment income from a business on Schedule C are required to pay self-employment tax and should include Schedule SE with their tax return. However, some taxpayers are exempt from the self-employment tax requirement. For example, taxpayers who are considered a statutory employee are exempt from self-employment tax on

¹⁶ Our analysis is based on tax returns contained in a data subset within the MeF system. As a result of timing delays in updating this subset, we were unable to obtain information for all of the approximately 129 million Forms 1040 that the IRS received during this same period.

¹⁷ Individuals must earn \$434 or more in net self-employment income before being required to pay self-employment tax.



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their wages because their employer withholds Social Security and Medicare taxes. Statutory employees are individuals who work for an employer but the employer does not withhold Federal income tax from their wages.¹⁸ Statutory employees generally report their Form W-2, *Wage and Tax Statement*, wages on Schedule C along with their business expenses. Statutory employees should have the “statutory employee” box checked on the employer-provided Form W-2. In addition, statutory employees should check the “statutory employee” box on Schedule C when they file their tax return. Other taxpayers who may be exempt from self-employment tax include:

- Ordained, commissioned, or licensed ministers of a church.
- Members of religious orders who have not taken a vow of poverty.
- Christian Science practitioners.
- Members of recognized religious groups.

The taxpayers previously described must apply to the IRS for exemption by filing a Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, or Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*. Once approved, the IRS notates the taxpayer’s tax account to show the self-employment tax exemption. None of the 11,700 taxpayers we identified notated their tax return as being exempt from paying the self-employment tax.

IRS Error Resolution Program procedures identify tax returns that claim net self-employment income above an established dollar amount when no self-employment tax is paid. The IRS corresponds with the taxpayer to obtain the missing Schedule SE. If the taxpayer does not provide the missing schedule, the tax return is referred to the Examination function for a potential audit. The IRS does not identify tax returns with net self-employment income below the established dollar amount. Using these criteria, we determined that the IRS would not have identified 11,700 (12 percent) taxpayers who do not appear to be exempt from paying self-employment tax but did not pay the tax. These taxpayers claimed more than \$12 million in qualifying self-employment income and potentially owe more than \$1.4 million in self-employment tax.

¹⁸ Statutory employees include agent drivers and commission drivers, full-time life insurance sales agents, individuals who work at home, and traveling or city salespersons.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Revise the Error Resolution Program to identify and correspond with all taxpayers who claim qualifying self-employment income where no tax is paid and there is no indication that the taxpayer has an exemption from paying the tax to obtain a Schedule SE.

Management's Response: The IRS agreed with this recommendation. IRS management will review existing processes within the Error Resolution Program and consider alternative treatments that may permit the IRS to reduce the tolerances established for the existing procedures. If the tolerance level can be decreased, the result will be a net increase in the coverage for addressing this issue with taxpayers who appear to have an unreported self-employment tax liability.

Recommendation 2: Initiate a program to correspond with the 11,700 taxpayers we identified who filed a Tax Year 2012 return with qualifying self-employment income where no tax was paid and who appear to not be exempt from paying self-employment tax to obtain a Schedule SE and ensure that the proper amount of self-employment tax is assessed.

Management's Response: The IRS did not agree with this recommendation. IRS management stated that initiating correspondence with the identified group of taxpayers will result in costs that exceed the potential tax to be recovered. This would not be a prudent use of limited resources. However, the IRS responded that it will consider cost-effective alternatives to provide for optimal coverage at the time the returns are processed.

Office of Audit Comment: Although the IRS did not agree with our recommendation, its proposed alternative corrective action is responsive to the recommendation.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS's MeF system received, processed, and posted individual tax return information timely, accurately, and effectively. To accomplish our objective, we:

- I. Determined if the MeF system was able to process all tax returns received into the system during the 2013 Filing Season.
 - A. Obtained and analyzed IRS MeF processing and performance statistics on the number of tax returns accepted and rejected.
 - A. Analyzed MeF system statistics obtained by TIGTA's Strategic Data Services¹ for accepted and rejected tax returns.
- II. Determined if the MeF system accurately processed tax returns and timely provided information to IRS downstream tax return processing systems.
 - A. Obtained weekly extracts of tax returns processed through the MeF system from the TIGTA Strategic Data Services.
 - B. Obtained National Account Profile² data from TIGTA's Data Center Warehouse³ to verify taxpayer and dependent names and dates of birth.
 - C. Reviewed a statistically valid sample of 560 of the 117,995,527 tax returns received by the MeF system (including both accepted and rejected returns) between January 30, 2013, and May 4, 2013.⁴ We used stratified sampling to select 40 tax returns each week. We evaluated the 560 tax returns to ensure that the tax returns were rejected or accepted correctly and the tax return accurately and timely posted to the IRS Individual Master File.⁵ We used our contract statistician to develop a proper sampling plan and sample size.
 1. Determined if tax return acknowledgements were accurate and timely.

¹ TIGTA's Strategic Data Services is responsible for managing and retrieving IRS data, detecting unauthorized accesses to IRS computer systems, and detecting other computer crimes within the IRS.

² A compilation of selected entity data from the IRS Master Files, which are the databases that store various taxpayer information. The National Account Profile includes all valid and invalid taxpayer entity information.

³ A collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits.

⁴ Our sample included all Forms 1040 received by the IRS, including prior year tax returns.

⁵ The IRS database that maintains transactions or records of individual tax accounts.



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2. Tracked tax returns through the IRS's tax return processing system using the IRS's Integrated Data Retrieval System⁶ to determine if tax returns were posting correctly to the Individual Master File.
 3. Based on the results of our statistical sample, we expanded our analysis to review all 94,947 taxpayers who claimed qualifying self-employment income but did not pay self-employment tax and for whom there was no indication that they were exempt from paying the tax.
- D. Reviewed a statistically valid sample of 100 of the 23,108 prior year tax returns rejected by the MeF system between January 30, 2013, and May 4, 2013, to ensure that the tax returns were correctly recorded in the IRS's data systems.

Data Reliability

We reviewed MeF system documentation obtained from the IRS's Information Technology operation. We compared the data received from the TIGTA Strategic Data Services to the documentation to ensure that the data were in the expected format and fields contained expected data. We also reviewed the data received for logical errors such as inappropriate dates. In addition, we used the IRS's Integrated Data Retrieval System to validate the accuracy of the information contained in our extracts of tax returns accepted and rejected by the MeF system. We compared the information contained in the extract to information contained on the tax return as part of our analysis of the accuracy of MeF system processing. The data are considered sufficiently reliable for our audit purposes.

Sampling Techniques

Statistical sample of tax returns received between January 30, 2013, and May 4, 2013 – We selected a statistically valid stratified sample of 560 tax returns from the 117,995,527 tax returns received by the MeF system (including both accepted and rejected returns) between January 30, 2013, and May 4, 2013. Our sample included all Forms 1040, *U.S. Individual Income Tax Return*, received by the IRS, including prior year tax returns. We used our contract statistician to develop a proper sampling plan and sample size. Our sample size was based on a confidence level of 95 percent, an expected error rate of 50 percent, and a precision factor of ± 5 percent. We selected our sample by randomly selecting 40 tax returns from the tax returns received each week for 14 weeks. Our sample included Form 1040, Form 1040A (*U.S. Individual Income Tax Return*), and Form 1040EZ (*Income Tax Return for Single and Joint Filers With No Dependents*).

⁶ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Statistical Sample of 100 prior year tax returns rejected by the MeF system – We selected a statistically valid random sample of 100 of the 23,108 prior year tax returns that appeared to have incorrect information recorded in the IRS’s TRDB. Our sample size was based on a confidence level of 95 percent, an expected error rate of 50 percent, and a precision factor of ± 10 percent.

Internal controls methodology

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the controls in place to ensure that 1) tax returns were properly accepted or rejected by the MeF system, 2) tax returns were properly accounted for in the MeF system, and 3) tax returns were properly recorded in downstream processing systems and the Individual Master File. We tested these controls by reviewing and analyzing relevant documents and data.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Appendix II

Major Contributors to This Report

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All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Appendix III

Report Distribution List

Acting Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Office of the Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Operations, Wage and Investment Division SE:W
Deputy Commissioner, Support, Wage and Investment Division SE:W
Director, Business Modernization Office, Wage and Investment Division SE:W:BMO
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Director, E-File Service, Wage and Investment Division SE:W:CAS:SP:ES
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division
SE:W:S:PEI



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

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; \$1,441,457 in self-employment tax that was not paid by 11,700 taxpayers (see page 9).

Methodology Used to Measure the Reported Benefit:

Using the IRS's Individual Return Transaction File,¹ we identified 179,362 Tax Year 2012 taxpayers who filed tax returns through the MeF system from January 27, 2013, through June 29, 2013, and claimed Schedule C income totaling \$434 or more but did not pay self-employment tax.² Using this same data, we identified 52,395 taxpayers who indicated on their Schedule C that they were statutory employees and were exempt from paying self-employment tax.

Using the Individual Master File,³ we identified 32,020 taxpayers who had an approved Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, or Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*, self-employment tax exemption. We determined that the remaining 94,947 taxpayers with Schedule C income and no tax exemption claimed Schedule C income totaling \$1,129,282,797.

We used the Form 1040 Schedule SE, *Self-Employment Tax*, to compute the self-employment tax due for each of the 94,947 taxpayers we identified. Using this calculation, we estimate that the 94,947 taxpayers should have paid \$116,852,979 in self-employment tax.

To identify those taxpayers who would not be identified by the IRS Error Resolution Program, we identified taxpayers with self-employment income below the established dollar tolerance. We determined that 33,436 of the 94,947 taxpayers claimed qualifying self-employment income

¹ The Individual Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040, *U.S. Individual Income Tax Return*, series and related forms and schedules for the current processing year and two prior years.

² Individuals who earn less than \$434 in net self-employment income are not required to pay self-employment tax.

³ The IRS database that maintains transactions or records of individual tax accounts.



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under the dollar tolerance. The 33,436 taxpayers claimed a total of \$35,311,099 in qualifying self-employment income and potentially owe \$4,101,847.

We also used the Individual Tax Return Transaction file located on the TIGTA Data Center Warehouse⁴ to determine how many of the 94,947 taxpayers also filed a Schedule F, *Profit or Loss From Farming*, or Schedule E, *Supplemental Income and Loss*. Our analysis identified 21,736 of the 33,436 taxpayers who filed a Schedule F or Schedule E in addition to claiming Schedule C income. These taxpayers claimed \$23,305,359 in self-employment income. Because the IRS Error Resolution Program reviews tax returns for Schedules F and E income when computing net self-employment tax, we removed these 21,736 taxpayers from our analysis.

The remaining 11,700 taxpayers would not have been identified for additional review by the IRS Error Resolution Program because the self-employment income claimed was below the dollar tolerance and there was no Schedule F or Schedule E filed. These taxpayers claimed qualifying self-employment income totaling \$12,005,740 and potentially owe a total of \$1,441,457 in self-employment tax.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 23,108 prior year tax returns with an incorrect tax period recorded in the TRDB⁵ (see page 5).

Methodology Used to Measure the Reported Benefit:

We analyzed a statistically valid sample of 100 of the 23,108 prior year tax returns rejected by the MeF system between January 30, 2013, and May 4, 2013. Our analysis showed that all 100 tax returns were incorrectly recorded in the TRDB as Tax Year 2012 tax returns—93 were Tax Year 2011 and seven were for Tax Year 2010 tax returns. Based on the results of our review, we estimate that all 23,108 prior year tax returns rejected by the MeF system were incorrectly recorded in the TRDB.

⁴ A collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits.

⁵ The TRDB contains tax return source information for all electronically filed tax returns.



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Appendix V

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

SEP 23 2013

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – All Individual Tax Returns Filed
Electronically in the 2013 Filing Season Were Processed
Using the Modernized e-File System
(Audit # 201340011)

We appreciate the opportunity to review the subject draft report. The transition to receiving all electronically filed individual income tax returns through the Modernized e-File (MeF) system represents a significant accomplishment in our efforts to improve tax administration. With the full implementation of MeF for individual returns, taxpayers receive improved levels of service when filing their returns and the taxpaying public benefits from savings realized by a more cost-effective process. As of August 23, 2013, the IRS has received and accepted more than 117 million individual tax returns through the MeF system, which is in excess of 84 percent of all individual income tax returns filed for the 2012 Tax Year. Based on the success of the MeF system during this filing season, the Legacy processing system for individual income tax returns will be retired this year. This will achieve a substantial cost savings goal for the IRS and the tax return preparation software industry by not having to maintain two systems for processing individual returns

As the report notes, a review of a statistically valid sample of 558 MeF receipts found that 99.6 percent of the returns were processed correctly. Two returns were counted as errors because the taxpayers reported net income on Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, yet did not submit Schedule SE, *Self-Employment Tax*, or otherwise report a self-employment tax liability on the return. This condition is indicative of an error on the return; however, its detection and treatment occurs at a later step in return processing. Both electronic and paper returns are submitted to analysis where the failure to report a self-employment tax liability would be detected by business rules and the return flagged for follow-up correspondence by a Tax Examiner.



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

The 11,700 taxpayers estimated by the Treasury Inspector General for Tax Administration (TIGTA) as being affected by the self-employment tax issue have an average tax understatement of approximately ****2*** per taxpayer¹. With limited resources, it is necessary to establish threshold tolerances for issues that require review and action by employees to ensure their time is used productively. The cases identified by the TIGTA fell below the established tolerance. We will explore alternative treatment streams that may permit us to reduce the costs associated with correspondence to taxpayers on this issue.

In response to questions posed on another audit, the average cost of a correspondence examination was calculated to be ***2***. We do not agree with the TIGTA's recommendation to implement a correspondence program with the taxpayers who appear not to be exempt from self-employment tax and did not report a self-employment tax liability. This issue is already addressed when the amount of tax at stake exceeds the established tolerance; pursuing the issue when the potential recovery by the government is less than the cost of taking action is not a prudent use of limited resources.

Attached are our comments on your recommendations. If you have any questions, please contact me, or a member of your staff may contact Paul Mama, Director, Submission Processing, Wage and Investment Division, at (859) 669-5554.

Attachment

1. *****2*****

² TIGTA, Audit 201240016, Effectiveness of the IRS's Verification of Alimony Paid and Alimony Received



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1

Revise the Error Resolution Program to identify and correspond with all taxpayers who claim qualifying self-employment income where no tax is paid and there is no indication that the taxpayer has an exemption from paying the tax to obtain a Schedule SE.

Corrective Action

We will review existing processes within the Error Resolution Program and consider alternative treatments that may permit the IRS to reduce the tolerances established for our existing procedures. If the tolerance level can be decreased, the result will be a net increase in the coverage for addressing this issue with taxpayers who appear to have an unreported self-employment tax liability.

Implementation Date

February 15, 2015

Responsible Official

Director, Submission Processing, Customer Account Services, Wage and Investment Division

Corrective Action Monitoring Plan

We will monitor this corrective action as part of our internal management control system.

Recommendation 2

Initiate a program to correspond with the 11,700 taxpayers we identified who filed a Tax Year 2012 return with qualifying self-employment income where no tax was paid and who appear to not be exempt from paying self-employment tax to obtain a Schedule SE and ensure that the proper amount of self-employment tax is assessed.

Corrective Action

We do not agree with this recommendation. Initiating correspondence with the identified group of taxpayers will result in costs that exceed the potential tax to be recovered. This would not be a prudent use of limited resources. We will consider cost effective alternatives to provide for optimal coverage at the time the returns are processed.

Implementation Date

N/A

Responsible Officials

N/A



All Individual Tax Returns Filed Electronically in the 2013 Filing Season Were Processed Using the Modernized e-File System

2

Corrective Action Monitoring Plan

N/A