A Service-wide Strategy Is Needed to Address Growing Noncompliance With Individual Retirement Account Contribution and Distribution Requirements

March 29, 2010

Reference Number: 2010-40-043

Phone Number | 202-622-6500
Email Address | inquiries@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 29, 2010

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – A Service-wide Strategy Is Needed to Address Growing Noncompliance With Individual Retirement Account Contribution and Distribution Requirements (Audit #200940016)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) actions to identify and correct individual excess contributions to Individual Retirement Accounts (IRA) and nondisbursements of required minimum distributions from IRAs. This review was included in the Treasury Inspector General for Tax Administration Fiscal Year 2009 Annual Audit Plan and addresses the major management challenge of Processing Returns and Implementing Tax Law Changes.

Impact on the Taxpayer

IRAs are a key tax-preferred way for individuals to save for retirement and are an increasingly important way for individuals to roll over savings from pension plans. The Investment Company Institute[1] estimated that assets held in IRAs were $3.6 trillion in 2008 and that IRAs represented more than 26 percent of total United States retirement assets.[2] Individual noncompliance with IRA excess contribution and minimum distribution requirements continues to grow, resulting in significant revenue loss to the Federal Government.

[1] The Investment Company Institute is the national association of United States mutual funds and other investment companies. Its history as an organization dates from 1940. Members manage total assets of $11.33 trillion and serve nearly 90 million shareholders.
[2] Retirement asset growth has normally correlated with stock and bond market returns and in 2008 nearly all assets experienced negative returns.

Synopsis

There are two main types of IRAs, a traditional IRA and a Roth IRA. Both types allow individuals to contribute up to $4,000 per year ($5,000 if age 50 or older) and provide tax-preferred ways to save for retirement.[3] Any amount contributed to a traditional or Roth IRA for the year that exceeds the contribution limit, or any amount contributed to a traditional IRA by an individual who has reached age 70½, is an excess contribution. Generally, if the excess contribution for the year is not withdrawn by the due date of the tax return (including extensions), there is a 6 percent excise tax on the amount of excess contribution.

Individual noncompliance with IRA excess contribution and minimum distribution requirements continues to grow since our previous review.[4] Our review of Tax Year (TY) 2006 and TY 2007 IRA Contribution Information (Form 5498) and Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R) identified potential revenue losses associated with:

- 295,141 individuals improperly making excess contributions totaling $812,339,722 for TY 2006 and $756,792,044 for TY 2007. We estimate tax revenue losses of $94,150,444 in excise tax and $17,574,276 in income tax for these 2 tax years.
- 255,498 individuals not taking required minimum distributions totaling $348,480,200 for TYs 2006 and 2007. We estimate tax revenue loss of $174,249,074 in excise tax for these 2 tax years.

Our prior review concluded that the IRS' processing procedures for IRAs do not ensure that individuals are complying with IRA rules. In our current review, we again found that IRS procedures are inadequate to identify individuals who make IRA contributions in excess of what the law allows or individuals who are not taking required minimum distributions. In response to concerns we raised in our prior audit report, the IRS initiated four studies.[5] To date, results are available for only one of the IRS' studies, and these results confirm what we had previously reported to the IRS in

The IRS needs to develop a Service-wide strategy to address growing noncompliance with IRA excess contribution and minimum distribution requirements.

[3] These were the contribution limits in effect for Tax Years 2006 and 2007, which are the periods we evaluated. The maximum contribution limit increased $1,000 for Tax Year 2008 to $5,000, ($6,000 if age 50 or older).
[4] *Individual Retirement Account Contributions and Distributions Are Not Adequately Monitored to Ensure Tax Compliance* (Reference Number 2008-40-087, dated March 28, 2008).
[5] The IRS completed and provided results for the study of excess IRA contributions for TY 2006. We have not received results for the two studies on excess IRA contributions for TY 2007 and required minimum distributions for TY 2007. Data from the IRS National Research Program study of TY 2007 individual returns will not be available until late 2010. This study will include data on noncompliance with traditional and Roth IRA contribution rules.

March 2008—individuals are making excess contributions. Based on our analyses, we believe the remaining three studies will confirm what we previously reported—individuals are making excess contributions and individuals are not taking required minimum distributions.

Apart from the initiation of the four studies, the IRS has not taken sufficient action to address the significant revenue losses associated with IRA noncompliance. The IRS should develop a Service-wide strategy to address growing IRA noncompliance. Of particular concern is the lack of functional ownership within the IRS for addressing IRA noncompliance. Based on our analyses of IRA contributions and required minimum distributions, noncompliance will likely continue to grow and continue to result in significant revenue loss. By 2030, the number of people aged 65 and over is expected to double to about 20 percent of the population, or more than 71 million people. The number of people aged 85 and older will be the fastest growing segment of the United States population.[6] Incomes increasingly transition from wages to investment and retirement benefits as individuals reach retirement age.

Recommendation

The Deputy Commissioner for Services and Enforcement should ensure a Service-wide strategy is developed to address retirement provision noncompliance.

Response

IRS management agreed that a Service-wide strategy is warranted. Executives from the Wage and Investment and Tax Exempt and Government Entities Divisions met and agreed to share responsibility for development of this long-term strategy. The strategy will not only address compliance, but will also include plans for outreach and guidance for individual tax payers and employee plan organizations.

IRS management agreed with the outcome measures outlined in Appendix IV, but added that full realization of the potential revenue cited may not be realistic. IRS management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

---

[6] United States Census Bureau, Population Division, Population Projections Branch from *The Wage and Investment Division Strategy and Program Plan FY 2007–FY 2008.*

Table of Contents

Abbreviations

AUR	Automated Underreporter
IRA	Individual Retirement Account (also known as Individual Retirement Arrangement)
IRS	Internal Revenue Service
NRP	National Research Program
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TY	Tax Year
U.S.	United States

Background

Individual Retirement Accounts (IRA) are a key tax-preferred way for individuals to save for retirement and are an increasingly important way for individuals to roll over savings from pension plans. In addition, funds put into IRAs can grow faster than a typical investment account since they are tax deferred. The Investment Company Institute[1] estimated that assets held in IRAs were $3.6 trillion in 2008 and that IRAs represented more than 26 percent of total United States (U.S.) retirement assets.[2] Approximately 47.3 million households, or 4 in 10, owned IRAs in mid-2008. Figure 1 provides a breakdown of these 47.3 million U.S. households.

Figure 1: Millions of Households That Own Individual Retirement Accounts

Type of IRA	Year Created	Number of U.S. Households With Type of IRA, 2008	Percentage of U.S. Households With Type of IRA, 2008
Traditional IRA	1974 (Employee Retirement Income Security Act)	37.5 million	**32.1%**
Simplified Employee Pension (SEP) IRA	1978 (Revenue Act)		
Salary Reduction Simplified Employee Pension (SARSEP) IRA	1986 (Tax Reform Act)	10.0 million	**8.6%**
Savings Incentive Match Plan for Employees (SIMPLE) IRA	1996 (Small Business Job Protection Act)		
Roth IRA	1997 (Taxpayer Relief Act)	18.6 million	**15.9%**
Any IRA[3]		**47.3 million**	**40.5%**

Source: Investment Company Institute, Research Fundamentals, The U.S. Retirement Market, 2008.

[1] The Investment Company Institute is the national association of United States mutual funds and other investment companies. Its history as an organization dates from 1940. Members manage total assets of $11.33 trillion and serve nearly 90 million shareholders.
[2] Retirement asset growth has normally correlated with stock and bond market returns, and in 2008 nearly all assets experienced negative returns.
[3] Adding the number of households owning each type of IRA will not equal the total number of households owning IRAs since households may own more than one type of IRA.

Two Main Types of IRAs – Traditional and Roth

There are two main types of IRAs, a traditional IRA and a Roth IRA. Both types allow individuals to contribute up to $4,000 per year ($5,000 if age 50 or older) and provide tax-preferred ways of saving for retirement.[4] Any amount contributed to a traditional or Roth IRA for the year that exceeds the contribution limit, or any amount contributed to a traditional IRA by an individual who has reached age 70½, is an excess contribution. Generally, if the excess contributions for the year are not withdrawn by the due date of the tax return (including extensions), there is a 6 percent excise tax on the excess contributions. Specific characteristics of traditional and Roth IRAs are shown below.

- **Traditional IRA:** The traditional IRA, within certain income limits and other eligibility factors,[5] allows individuals to deduct the amount of their IRA contribution from their taxable income, thus adding to their tax deferral benefits. When an individual reaches age 70½, the individual can no longer contribute to a traditional IRA and must begin taking required minimum distributions from a traditional IRA.[6] The required minimum distribution must be taken by April 1 following the calendar year in which the individual reaches age 70½ and by December 31 for all subsequent years. The amount that is required to be distributed depends on the traditional IRA balance at the end of the preceding year and the individual's life expectancy. These distributions are generally taxed as ordinary income. Any portion of the required minimum distribution not taken by the individual by the end of the year may be subject to a 50 percent excise tax.[7]
- **Roth IRA:** There is no age limit for making contributions to Roth IRAs[8] (i.e., contributions can be made after reaching age 70½). Roth IRA contributions are not tax deductible, but qualified distributions[9] from Roth IRAs are tax free. In addition, there is no age limit as to when distributions must take place, so individuals can accumulate investment earnings tax free for as long as they choose. For example:

[4] These were the contribution limits in effect for Tax Years 2006 and 2007, which are the periods we evaluated. The maximum contribution limit increased $1,000 for Tax Year 2008 to $5,000, ($6,000 if age 50 or older).
[5] Eligibility takes into account whether the individual has taxable compensation, age at the end of the year, and the income limits and filing status if the individual or spouse had an employer-sponsored retirement account.
[6] Congress passed the Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. No. 110-458), which provides for a 1-year waiver of the required minimum distribution rules for certain retirement plans and accounts. Under Section 201, no minimum distribution is required for Calendar Year 2009 from individual retirement plans and certain employer-provided qualified retirement plans. The next required minimum distribution would be for Calendar Year 2010.
[7] Individuals may request the IRS excuse the penalty if failure to take the required minimum distribution was due to reasonable error.
[8] Eligibility for making a Roth IRA contribution depends on the individual's taxable compensation, modified Adjusted Gross Income, filing status, and whether the individual made traditional IRA contributions. Age and coverage by an employer retirement plan does not affect eligibility for making Roth IRA contributions.
[9] An example of a qualified distribution is a payment from a Roth IRA made at least 5 years after the contribution was placed in the IRA account and the individual is at least 59½ years old.

An unmarried individual age 71 with a traditional IRA balance of $26,500 would be required to take a minimum distribution of $1,000.[10] *If distributions are less than the minimum distribution for the year, the individual is subject to a 50 percent excise tax on the amount not distributed as required. In contrast, if this individual owned a Roth IRA, they would not be required to take a minimum distribution. However, beneficiaries of either traditional or Roth IRAs are required to take minimum distributions, and the rules depend on whether the beneficiary is a surviving spouse, other individual, or an entity, such as a trust or estate.*

While these IRA provisions provide meaningful benefits to individuals, these same provisions can pose a significant risk for tax revenue loss to the Federal Government if the information reported to the Internal Revenue Service (IRS) by IRA account custodians[11] is not used to identify noncompliance with IRA requirements. For example, if an individual contributed the annual maximum to one Roth IRA and then improperly contributes the same amount to a second Roth IRA, the potential amount of tax-free proceeds to beneficiaries could be $505,365 over 30 years due to the annual compounding of interest, as shown in Figure 2.

Figure 2: Potential Impact to Federal Government Revenues

Individual With One Unallowable Roth IRA	$5,000/Yr @ 7% for 10 Years	$5,000/Yr @ 7% for 20 Years	$5,000/Yr @ 7% for 30 Years	Tax-Free Proceeds to Beneficiaries
Principal Plus Interest	$73,918	$219,326	$505,365	$505,365
(Less) Total Contributions[12]	-$50,000	-$100,000	-$150,000	
Total Unreported Interest	$23,918	$119,326	$355,365	

Source: Treasury Inspector General for Tax Administration (TIGTA) computations of compound interest.

In addition, if an individual had sufficient funds to establish more than one unallowable Roth IRA, the risk of significant unreported income could be substantially more than the amounts shown in Figure 2.

[10] The $1,000 is computed by dividing the IRA balance (i.e., fair market value) of $26,500 by 26.5, which is the uniform lifetime distribution period for an unmarried individual age 71.
[11] An agent, bank, trust company, or other organization which holds and safeguards assets belonging to individuals or companies.
[12] We assumed the $5,000 maximum annual IRA contribution limit remains the same over the contribution periods.

Custodial Reporting Requirements

To protect against the risk shown in Figure 2, IRA custodians are required to report IRA contributions to the IRS on IRA Contribution Information (Form 5498)[13] and provide copies to IRA owners (individuals). A separate Form 5498 should be filed for each IRA an individual holds.

Custodians are required to report distributions from IRA accounts on Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R).[14] Custodians must also provide the appropriate distribution codes. For example, code 7 for normal distribution, code 4 for death, etc. In addition, IRA custodians are required to submit Forms 5498 and 1099-R to the IRS Information Returns Branch.[15] This branch collects and processes the information returns so they can be used by other IRS functions or programs. Once the information returns are processed, they are posted to the IRS Information Returns Master File.[16] Data on this system may not be available for months because some information returns for the tax year are not due until the middle of the following year.

A Prior TIGTA Audit Identified Individual Noncompliance With IRA Requirements

This audit is a followup to a prior TIGTA report.[17] In our prior review, we reported that individuals were making contributions in excess of the maximum allowable limit and individuals were not taking required minimum distributions. The focus was on the following issues for traditional or Roth IRAs: (1) contributions in excess of the maximum allowable limit of $4,500 for Tax Year (TY) 2005 and (2) required minimum distributions from traditional IRAs. This audit included a review of contributions made in excess of the maximum allowable limit of $5,000 for TY 2006 and $5,000 for TY 2007 and required minimum distributions not taken by individuals for TY 2006 and TY 2007.

This review was performed at the IRS Wage and Investment Division office in Atlanta, Georgia, during the period May 2009 through December 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

---

[13] Appendix VI provides an example of a Form 5498.
[14] Appendix VII provides an example of a Form 1099-R.
[15] A branch in the IRS Wage and Investment Division, Customer Account Services function.
[16] The Information Returns Master File contains tax information reported from third parties for the current and prior 5 tax years.
[17] *Individual Retirement Account Contributions and Distributions Are Not Adequately Monitored to Ensure Tax Compliance* (Reference Number 2008-40-087, dated March 28, 2008).

Results of Review

Noncompliance With Excess Contribution and Minimum Distribution Requirements Continues to Grow, Resulting in Significant Revenue Loss

Individual noncompliance with IRA excess contribution and minimum distribution requirements continues to grow since our previous review. Our review of TY 2006 and TY 2007 Forms 5498 and Forms 1099-R identified potential revenue losses associated with:

- 295,141 individuals improperly making excess contributions totaling $812,339,722 for TY 2006 and $756,792,044 for TY 2007. We estimate tax revenue losses of $94,150,444 in excise tax and $17,574,276 in income tax for these 2 tax years.
- 255,498 individuals not taking required minimum distributions totaling $348,480,200 for TY 2006 and TY 2007. We estimate tax revenue loss of $174,249,074 for these 2 tax years.

Our prior review concluded that the IRS' processing procedures for IRAs do not ensure that individuals are complying with IRA rules. In response to concerns we raised in our prior audit report, the IRS initiated four studies.[18] To date, results are available for only one of the IRS' studies and these results confirm what we had previously reported to the IRS in March 2008—individuals are making excess contributions. Based on our analyses, we believe the remaining three studies will confirm what we previously reported—individuals are making excess contributions and individuals are not taking required minimum distributions.

The IRS has initiated studies to confirm what the TIGTA previously reported, but has not taken actions to address significant revenue losses associated with IRA noncompliance.

Apart from the initiation of these studies, the IRS has not taken sufficient action to address the significant revenue losses associated with IRA noncompliance.

[18] The IRS completed and provided results for the study of excess IRA contributions for TY 2006. We have not received results for the two studies on excess IRA contributions for TY 2007 and required minimum distributions for TY 2007. Data from the IRS National Research Program study of TY 2007 individual returns will not be available until late 2010. This study will include data on noncompliance with traditional and Roth IRA contribution rules.

Individuals continue to make contributions in excess of maximum limits

In our prior review, we identified 107,129 individuals who appeared to have exceeded the $4,500 maximum allowable IRA contribution limit for TY 2005 and did not report excise tax on the excess contributions.[19] We estimated the potential revenue loss resulting from the excess contributions of more than $6.6 million in unreported excise tax. We estimated that over 5 years, the potential amount of lost excise tax revenue would be approximately $33 million. This estimate was based on the probability that these individuals would continue to make the same excess contributions over the next 5 years.

For this review, to identify the potential underreported excise tax resulting from excess contributions, we performed an analysis similar to the concept of the IRS Automated Underreporter (AUR) Program, which uses third-party reporting documents (Forms 5498 and Forms 1099-R) to identify potentially noncompliant individuals. Appendix V details the specific methodology we used which could be used by the IRS in developing an IRA compliance initiative.

Excess contributions by 295,141 individuals in TYs 2006 and 2007 resulted in $235 million in unreported excise tax over 5 years.

Our review of TY 2006 and TY 2007 IRA contributions showed that noncompliance with the excess contribution limit has grown significantly. We identified 295,141 individuals who exceeded the maximum annual limit of $5,000.[20] The excess contributions for these individuals totaled more than $1.5 billion. We estimate potential revenue loss of more than $94.1 million in unreported excise tax resulting from the excess contributions for TY 2006 and TY 2007. Figure 3 shows that over 5 years, the potential amount of lost excise tax revenue totals more than $235 million. Our estimate is based on the individuals continuing to make the same excess contributions over the next 5 years.

[19] To avoid erroneously identifying individuals age 50 and older as having exceeded their IRA contribution limit, the maximum allowable amount of $4,500 for TY 2005 was used.
[20] To avoid erroneously identifying individuals age 50 and older as having exceeded their IRA contribution limit, the maximum allowable amount of $5,000 for TYs 2006 and 2007 was used.

Figure 3: Potential Revenue Loss From Unreported Excise Tax

Tax Year	Number of Individuals With Excess IRA Contributions	Total Excess IRA Contributions	6% Excise Tax on Excess IRA Contributions
TY 2006	151,165	$812,339,722	$48,741,723
TY 2007	143,976	$756,792,044	$45,408,721
Totals of TYs 2006 and 2007	**295,141**	**$1,569,131,766**	**$94,150,444**[21]
Average for TYs 2006 and 2007	147,571	$784,565,883	$47,075,222
Potential Unreported Excise Tax Over 5 Years	**737,853**	**$3,922,829,415**	**$235,376,110**

Source: TIGTA analysis of TYs 2006 and 2007 Forms 5498.

For TY 2006 and TY 2007, IRA contribution limits were generally the smaller of $4,000 ($5,000 if age 50 or older by the end of the year) or taxable compensation. Individuals could contribute to both traditional and Roth IRAs for the same year; however, the total contributions could not exceed the maximum limit. For example, an individual age 50 or older could contribute $3,000 to a Roth IRA and $2,000 to a traditional IRA, or any other combination provided that the total contribution did not exceed $5,000. Contributions that are in excess of the limits and not properly withdrawn are subject to a 6 percent excise tax.

In addition, we estimate potential revenue loss of more than $17.5 million in income tax on unreported interest on the more than $1.5 billion of excess contributions for TY 2006 and TY 2007. Figure 4 shows the potential revenue loss of income tax on unreported interest over the next 5 years using a 4 percent interest rate and a 28 percent tax rate.[22]

[21] For TY 2006 and TY 2007, the 6 percent excise tax was calculated for each individual, rounded, and totaled. Because of rounding for each individual, the results will not match the total excess IRA contributions multiplied by 6 percent.

[22] Our estimates use the average of the tax rates that the IRS used in its study of excess IRA contributions for TY 2006. However, our estimate included both traditional IRA and Roth IRA excess contributions; whereas, the IRS study included only Roth IRA excess contributions. Our results were based on analyses of IRA contributions reported on all Forms 5498 submitted to the IRS; whereas, the IRS study only considered IRA contribution data for taxpayers that were included in the AUR Program.

Figure 4: Potential Revenue Loss From Unreported Interest

Tax Year	4% Interest Income on Excess IRA Contributions	Revenue Loss Due to Income Tax Avoidance
TY 2006	$32,493,589	$9,098,205
TY 2007	$30,271,682	$8,476,071
Total for TY 2006 and TY 2007	**$62,765,271**	**$17,574,276**
Average for TY 2006 and TY 2007	$31,382,635	$8,787,138
Potential Revenue Loss for TYs 2008 to 2012	**$169,978,476**[23]	**$47,593,973**[24]

Source: TIGTA computation of unreported interest and income tax avoidance.

IRS Actions to Date Have Not Reduced Excess Contribution Noncompliance

In our prior review, we recommended that the Commissioner, Wage and Investment Division, develop and implement strategies to bring noncompliant individuals back into compliance. To date, no strategies have been developed or implemented to reduce noncompliance. Instead, to address our recommendations, the IRS initiated studies to identify cases with IRA contributions in excess of the limits for TY 2006 and TY 2007. The IRS study for TY 2006 found the same problem that we previously reported; i.e., individuals are making excess contributions resulting in significant revenue loss. The results of the TY 2007 study of excess IRA contributions are not yet available. However, the IRS advised us that the TY 2007 results are consistent with the TY 2006 results.

The IRS limited the cases it reviewed as part of its TY 2006 study to the total population of cases in AUR Program inventory that, along with other issues, also included an IRA issue. There were 38,761 of these cases. The IRS calculated lost excise tax revenue of approximately $15.4 million ($397 average per case) in excise tax on the excess contributions. Excess contributions for these 38,761 noncompliant cases totaled $256,619,933. The IRS informed us that the $397 average excise tax per case is below the AUR Program case average. The study also estimated that at least $29.5 million ($764 average per case) to as much as $109.5 million ($2,836 average per

[23] Unreported interest if compounded annually over 5 years only on the average excess contributions of $784.5 million for TYs 2006 and 2007.
[24] This is the revenue loss calculated at a 28 percent effective tax rate. Appendix V provides more information on how TYs 2008 to 2012 amounts were computed.

case)[25] of income tax revenue was lost due to unreported interest income on the excess Roth IRA contributions for one tax year.[26]

We determined that the IRS incorrectly calculated the average income tax avoidance per case. The IRS used the total number of traditional and Roth IRA over-contribution cases to compute the average. Instead, the IRS should have only used the number of Roth IRA over-contribution cases to compute the average. This is because withdrawals from Roth IRAs are tax free; whereas, withdrawals from traditional IRAs are subject to income tax. The IRS agreed an error had been made. Figure 5 provides the recalculated average income tax avoidance per case.

Figure 5: Recalculated Average Income Tax Avoidance Estimate

	Minimum (2%)	Maximum (6%)
Total Income Tax Avoidance	$ 29,519,294	$ 109,526,109
Average Income Tax Avoidance per Case	$ 1,413	$ 5,241

Source: TIGTA analysis of the IRS AUR Program IRA Over-Contribution study.

Individuals continue to not take required minimum distributions

In our prior review, we identified 471,383 individuals who were required to take minimum distributions in TY 2005 who did not report any distributions. We reviewed a judgmental sample of 30 individual accounts and determined that 5 individuals (17 percent) did not take any or all of their TY 2005 required minimum distributions. We determined that $188,852 (72 percent) of the $261,447 total estimated required minimum distributions for the 5 individuals was not taken and excise tax of $94,426 were not reported on this income. We did not project our results because our sample was judgmental.

For our analysis of TY 2006 and TY 2007, we identified 598,239 individuals who did not appear to have taken their required minimum distributions. We reviewed a statistically valid sample of 96 individuals and estimated that the population contained 255,498 noncompliant individuals who did not take required minimum distributions totaling more than $348 million.[27] We estimate the potential excess tax revenue loss of more than $174.2 million for TY 2006 and TY 2007.

[25] The study did not provide the number of cases that was used to compute this average.
[26] The minimum estimate is based on a 2 percent gain on investment and the maximum estimate is based on a 6 percent gain on investment. Both estimates used a 28 percent income tax rate.
[27] See Appendix I for the sampling methodology.

The results of our statistically valid sample of 96 individuals are as follows:

- 41 individuals (43 percent) did not take required minimum distributions. The estimated amount of required minimum distributions not taken by these 41 individuals totaled $55,921 and the 50 percent excise tax was $27,962.
- 28 individuals (29 percent) were compliant. For example, we determined that some individuals took their required minimum distributions in the calendar year following the year in which they reached age 70½. We also determined that some deceased individuals' required minimum distribution were taken by the surviving spouses.
- 15 individuals (16 percent) were either deceased and beneficiary information was not available to assess compliance for inherited IRAs or information was not available[28] for us to determine compliance. The instructions for Form 5498 indicate that custodians must include the decedent's name on a Form 5498 issued to a nonspouse beneficiary, for example, "Brian Willow as beneficiary of Joan Maple." However, the Forms 5498 issued to the deceased individuals are not required to, and did not include, any beneficiary information. Without a beneficiary name or Taxpayer Identification Number (TIN), we cannot research tax information to determine if the beneficiary took a required minimum distribution for an inherited IRA. The instructions for Form 1099-R indicate that distributions to a beneficiary must include the beneficiary's name and TIN, not the decedent's name and TIN. In a related matter, the Information Reporting Program Advisory Committee's[29] 2009 report recommended the IRS provide guidance and/or instructions to address Form 5498 reporting with respect to a successor beneficiary of a deceased IRA beneficiary. The report further indicated that the IRS is not ready to provide such guidance or instructions, but will study the background and recommendation and add the issue to its current priority guidance list.
- 12 individuals (12 percent) had erroneous information reported by custodians.

Yearly minimum distributions from traditional IRA accounts are required when an individual reaches age 70½. These distributions are generally taxed as ordinary income on the individual's tax return. Roth IRA accounts are not subject to the required minimum distribution rules. IRA custodians must identify on Form 5498 if an individual is subject to a minimum distribution for

[28] For example, we could not determine if one individual took a required minimum distribution for TY 2007 because the fair market value of the IRA was not reported. The fair market value is needed to compute the required minimum distribution.

[29] The Information Reporting Program Advisory Committee, which was established in 1991, serves as an advisory body to the IRS Commissioner. The Committee provides a public forum for discussion of information reporting issues of mutual concern between IRS officials and representatives of the public. Committee members research; analyze; provide recommendations regarding specific information reporting issues, current or proposed IRS information reporting policies, programs, and procedures; and suggest improvement to information reporting operations and/or administration of the Information Reporting Program through a final report.

the next year by checking Box 11. Any portion of the required minimum distribution not taken by an individual may be subject to a 50 percent excise tax which is reported on the tax return.[30]

IRS Actions to Date Have Not Reduced Noncompliance With Required Minimum Distribution Rules

In our prior review, we recommended the IRS consider using the indicator shown on Form 5498, Box 11 (see Appendix VI), to identify individuals who were subject to required minimum distributions. This data could be compiled into a file that could be used later to compare against the tax returns processed during the subsequent filing season[31] to determine whether individuals were in compliance with the required minimum distribution rules. In addition, we recommended that the IRS consider requiring custodians to report estimated required minimum distribution amounts on Form 5498 in the blank box to the left of Box 10. This data could then be combined with the indicator from Box 11 and used as part of the AUR Program to prioritize noncompliant individuals who fail to report their required minimum distributions.

The IRS agreed with both of these recommendations and requested that data from Box 11 be included in its study of TY 2007 required minimum distributions. The results of the study will dictate what actions, if any, the IRS will take related to the Form 5498, Box 11 data. In addition, the IRS is including information from Form 5498 in the design of its data collection instrument for the National Research Program (NRP) study of TY 2007 individual returns. Information produced by this study should be available for analysis beginning in late 2010. To date, the IRS has not required custodians to report estimated the required minimum distribution amount on Form 5498.

When the IRS issued the regulations for required minimum distributions in 2002, it expressed concerns about the overall level of compliance in this area. The IRS indicated that it intended to monitor the effect of the reporting requirements for minimum distributions on compliance to determine whether it would be appropriate to modify the process in the future.[32]

Apart from the four studies the IRS initiated, the IRS Employee Plans Compliance Unit[33] conducted a project to identify individuals with IRA account balances of $1 million or more who did not appear to have taken their required minimum distributions. The study identified

[30] In some instances, taxpayers may be able to waive the penalty due to reasonable cause.
[31] The period from January through mid-April when most individual income tax returns are filed.
[32] Notice 2002-27, Reporting Required Minimum Distributions From IRAs, 2002-18 I.R.B. (May 6, 2002) and T.D. 8987, Required Distributions from Retirement Plans, 2002-19 I.R.B. (May 13, 2002).
[33] The Employee Plans function is organized under the IRS Tax Exempt and Government Entities Division. The Employee Plans function helps retirement plan sponsors, plan participants, and practitioners working in the retirement benefits arena understand and comply with the pension law. The Employee Plans Compliance Unit focuses on compliance projects, performs data analysis, and increases its presence through "soft contacts" and compliance checks. The IRS mails soft contacts (i.e., notices) to potentially noncompliant taxpayers to inform them of what information the IRS has and to request they review their records and take appropriate action to remedy the condition.

111 individuals. The Unit sent these 111 individuals a compliance letter requesting that they take their required minimum distributions. As of December 31, 2009, 88 (79 percent) of the individuals have taken their required minimum distributions totaling $6.1 million. The Unit is continuing to work with the remaining 23 (21 percent) individuals to ensure they take their required minimum distributions totaling $2.4 million during Fiscal Year 2010.

Attorneys and accountants commented that the IRS' project to identify individuals noncompliant with required minimum distributions has created an IRS presence in an area where one was needed.

The 88 individuals' reasons for failing to take their required minimum distribution appeared to meet the "reasonable error" standard (such as illness or a major life event) for a waiver of the excise tax. The only remaining standard for a waiver requires that the individual takes reasonable steps to remedy the shortfall. As of December 31, 2009, no excise tax has been assessed since 79 percent of the individuals appear to be eligible for a waiver and the Employee Plan Compliance Unit is still working with the remaining 21 percent of individuals to secure their required minimum distributions. Any individual who fails to take their required minimum distribution could be referred to the IRS Wage and Investment Division for appropriate future action, including assessment and collection of the excise tax. The IRS also informed us that a number of attorneys and certified public accountants have commented that this project has created an IRS presence in an area where one was needed.

A Service-wide strategy is the key to reducing IRA noncompliance

The IRS should develop a Service-wide strategy to address growing IRA noncompliance. Of particular concern is the lack of functional ownership within the IRS for addressing IRA noncompliance. Our discussions with IRS management in the AUR Program and the Examination function found that IRA noncompliance is largely overlooked in these functions because workload is based on the tax effect of an individual tax return rather than the total amount of revenue lost due to IRA noncompliance.

Based on our analyses of IRA contributions and required minimum distributions, noncompliance will likely continue to grow and continue to result in significant revenue loss. By 2030, the number of people aged 65 and over is expected to double to about 20 percent of the population, or more than 71 million people. The number of people aged 85 and older will be the fastest growing segment of the U.S. population.[34] Incomes increasingly transition from wages to investment and retirement benefits as individuals reach retirement age.

The IRS has developed Service-wide strategies to address other issues that significantly affect tax administration, such as the Earned Income Tax Credit and identity theft. To better

[34] U.S. Census Bureau, Population Division, Population Projections Branch from *The Wage and Investment Strategy and Program Plan FY 2007–FY 2008.*

understand the issues, the IRS formed Program Offices to develop policy and procedures in an attempt to consistently manage the issues.

Recommendation

Recommendation 1: The Deputy Commissioner for Services and Enforcement should ensure a Service-wide strategy is developed to address retirement provision noncompliance. This strategy should include the development of processes to identify individuals who do not comply with retirement provisions along with compliance efforts to address the noncompliance.

> ***Management's Response:*** IRS management agreed with this recommendation. Wage and Investment and Tax Exempt and Government Entities Divisions agreed to work together to develop a long-term strategy to reduce retirement provision noncompliance. The Wage and Investment Division Compliance Office will also reach out to other IRS stakeholders for support as this strategy will contain compliance, education/guidance, and outreach components.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to assess IRS actions to identify and correct individual excess contributions to IRAs and nondisbursements of required minimum distributions from IRAs. To accomplish our objective, we:

I. Evaluated actions the IRS has taken to address prior audit report[1] findings on excess IRA contributions and required minimum distributions.

   A. Obtained and reviewed the Joint Audit Management Enterprise System Corrective Action Forms to determine the status of planned corrective actions associated with the TIGTA prior review of IRAs.

   B. Obtained and reviewed audit findings pertaining to traditional and Roth IRAs reported by the Government Accountability Office.

   C. Reviewed IRS publications and forms, Information Returns Master File[2] documentation, and other pertinent documents for information regarding excess IRA contributions and required minimum distributions.

   D. Determined if IRS information being collected as part of the current IRS NRP study will address the findings in prior TIGTA and Government Accountability Office reports.

      1. Contacted NRP officials to determine the status of the NRP study and identify what IRA information is being collected and how it will be used in the study.

      2. Obtained IRA data from 5,452 closed NRP cases. We sorted the data and found incomplete or inconsistent information.

   E. Obtained and reviewed the IRS AUR Program office's study of excess traditional or Roth IRA contributions for TY 2006.

[1] *Individual Retirement Account Contributions and Distributions Are Not Adequately Monitored to Ensure Tax Compliance* (Reference Number 2008-40-087, dated March 28, 2008); *INDIVIDUAL RETIREMENT ACCOUNTS, IRS Enforces Some but Not All Key Rules, and Opportunities Exist to Strengthen Taxpayer Compliance* (GAO-07-1059SU, dated September 2007); and *INDIVIDUAL RETIREMENT ACCOUNTS, Additional IRS Actions Could Help Taxpayers Facing Challenges in Complying with Key Tax Rules* (GAO-08-654, dated August 2008).

[2] The Information Returns Master File contains tax information reported from third parties for the current and prior 5 tax years.

II. Performed computer analyses on IRA Contribution Information (Form 5498) data and Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R) data for TY 2006 and TY 2007 to identify individuals with traditional or Roth IRA contributions in excess of the maximum annual limit of $5,000.[3] See Appendix V for a detailed explanation of our audit methodology.

III. Identified individuals who did not take their required minimum distributions for TY 2006 and TY 2007. Specifically, we:

A. Performed computer analysis to identify all TY 2005 Forms 5498 with a check in Box 11, which indicated a required minimum distribution was required for TY 2006. We captured the payee (individual) TIN reported on these Forms 5498 and matched them against the payee TINs reported on the TY 2006 Forms 1099-R. We identified 284,723 individuals that were required to take a required minimum distribution for TY 2006, but did not have a TY 2006 Form 1099-R distribution.

B. Performed computer analysis to identify all TY 2006 Forms 5498 with a check in Box 11, which indicated a required minimum distribution for TY 2007. We captured the payee TIN reported on these Forms 5498 and matched them against the payee TINs reported on the TY 2007 Forms 1099-R. We identified 313,516 individuals that were required to take a required minimum distribution for TY 2007, but did not have a TY 2007 Form 1099-R distribution.

C. Reviewed a statistical sample of 96 individuals that were randomly selected from both tax years. We performed additional research of the individuals' data stored on the IRS Integrated Data Retrieval System[4] to determine if a minimum distribution was required and taken. Our sampling criteria included:

Population = 598,239[1]
Confidence Level = 95 percent
Desired Precision = ± 7.5 percent[2]
Estimated Error Rate = 17 percent[3]
Sample Size = 96[2]

[3] IRA contributions are limited to $4,000 per year ($5,000 if age 50 or older) for TY 2006 and TY 2007. To avoid erroneously identifying individuals age 50 or older as having exceeded their IRA contribution limit, we used the maximum limit of $5,000 in our analysis.
[4] IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

[1] = Sum of 284,723 for TY 2006 plus 313,516 for TY 2007.
[2] = Various precisions and sample sizes were considered, but our final selection was based on available audit resources.
[3] = This was the actual error rate observed in our prior review of IRAs.

D. Projected the results of the statistical sample to the population.

IV. Evaluated the reliability of IRS computer-processed data by performing run-to-run balancing and counts on the data to ensure all records were accounted for, verifying the Form 5498 and Form 1099-R data against the IRS Information Return Master File, and researching other individual data stored on the IRS Integrated Data Retrieval System. We concluded that the computer-processed data were sufficiently reliable to support the audit finding, conclusion, and recommendation.

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 Wage and Investment Division's policies, procedures, and practices for processing Forms 5498 and 1099-R and, more specifically, the traditional and Roth IRA reporting requirements. We evaluated these controls by interviewing management and analyzing traditional and Roth IRA data reported on the Forms 5498 and 1099-R.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell P. Martin, Director
Tina M. Parmer, Audit Manager
Sharon A. Buford, Lead Auditor
Van A. Warmke, Senior Auditor
Kim I. McMenamin, Auditor
Richard Hilleson, Information Technology Specialist

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Tax Exempt and Government Entities Division SE:T
Commissioner, Wage and Investment Division SE:W
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI
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:PRA:PEI

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; $202,333,250 in excise tax over 5 years due to 295,141 individuals not reporting more than $3.9 billion of excess contributions to IRAs (see page 5).

Methodology Used to Measure the Reported Benefit:

We performed an analysis of traditional and Roth IRA contributions for TY 2006 and TY 2007 and identified a total of 295,141 individuals who exceeded the annual maximum IRA contribution limit of $5,000[1] and did not report excise tax on these excess contributions.

These 295,141 individuals had excess contributions[2] totaling $1,569,131,766.[3] The unreported 6 percent excise tax on each individual's excess contributions totaled $94,150,444.[4]

We believe these individuals could continue to make the same excess contributions in subsequent years, and that over 5 years, $202,333,250 in potential excise tax revenue would not be collected. This amount was calculated by computing the average excise tax amount for both years of $47,075,222, multiplying the average by 5 years, then reducing the result by $33,042,860. Our prior report[5] included the $33,042,860 as an outcome measure for potential unreported excise tax for TY 2006 through TY 2010. In this report, we computed the outcome

---

[1] IRA contributions are limited to $4,000 per year ($5,000 if age 50 or older) for TY 2006 and TY 2007. To avoid erroneously identifying individuals age 50 or older as having exceeded their IRA contribution limit, we used the maximum limit of $5,000 in our analysis.
[2] Contributions greater than the $5,000 maximum contribution limit for TY 2006 and TY 2007 are defined as "excess" IRA contributions.
[3] This amount was averaged for both TY 2006 and TY 2007 totaling $784,565,883. This amount over 5 years equals $3,922,829,415.
[4] For TY 2006 and TY 2007, the 6 percent excise tax was calculated for each individual, rounded, and totaled. Because of rounding for each individual, the results will not match the total excess IRA contributions multiplied by 6 percent.
[5] *Individual Retirement Account Contributions and Distributions Are Not Adequately Monitored to Ensure Tax Compliance* (Reference Number 2008-40-087, dated March 28, 2008).

measure for potential unreported excise tax for TY 2008 through TY 2012. We reduced our current outcome measure by the $33,042,860 to prevent overstating the amount.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $28,539,960 in income tax over 5 years on an estimated cumulative amount of $169,978,476 in unreported interest on excess contributions to IRAs (see page 5).

Methodology Used to Measure the Reported Benefit:

In addition to the $94,150,444 loss in excise tax for TY 2006 and TY 2007, there is a potential future compound interest effect as it relates to revenue loss from unreported interest on excess contributions over the next 5 years.

We calculated estimated unreported interest of $62,765,271 on the excess contributions of $1,569,131,766 identified for TY 2006 and TY 2007 using an interest rate of 4 percent. We divided the $62,765,271 by 2 to get an average of $31,382,635 for each tax year. We computed compound interest on the $31,382,635 over 5 years for a total of $169,978,476.

We calculated estimated unreported income tax of $47,593,973 on the estimated unreported interest of $169,978,476 using a 28 percent tax rate.[6] We reduced the $47,593,973 by $19,054,013. The difference was $28,539,960 in potential income tax that could be unreported over the next 5 years. Our prior report included the $19,054,013[7] of unreported income tax as an outcome measure for TY 2006 through TY 2010. In this report, we computed the outcome measure for TY 2008 through TY 2012. We reduced our current outcome measure by the $19,054,013 to prevent overstating the amount.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $174,249,074 in excise tax for required minimum distributions that were not taken by 255,498 individuals from their IRAs (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified 598,239 individuals who did not appear to have taken their required minimum distributions for TYs 2006 and 2007 and reviewed a statistically valid sample of 96 individuals. Our preliminary results identified 41 individuals (43 percent) who appeared to be noncompliant. For each of the 41 individuals, we computed the amount of required minimum distribution not taken by dividing the sum of the IRA account balances by the individual's applicable life expectancy rate and reducing the result by distributions, if any, that were taken from the IRA

---

[6] We used the same tax rate of 28 percent that the IRS used in its study of TY 2006 IRA contributions.
[7] In our prior report, we used a 15 percent tax rate to compute the $19,054,013 of unreported income tax.

accounts. The estimated amount of required minimum distributions not taken by these 41 individuals totaled $55,921 and the 50 percent excise tax was $27,962.

Based on the statistical sample results, we estimate the population contains 255,498 noncompliant individuals who did not take required minimum distributions totaling $348,480,200. We are 95 percent confident that the number of noncompliant individuals in the population is between 195,996 and 315,000 (the margin of error is ± 59,502). In addition, we are 95 percent confident that the amount of required minimum distributions not taken is between $172,597,789 and $524,362,611 (the margin of error is ± $175,882,411), and the estimated amount of 50 percent excise tax is between $86,301,885 and $262,196,263 (the margin of error is ± $87,947,189).

Appendix V

Methodology to Compute Estimated Revenue Loss Associated With Excess IRA Contributions

This appendix details TIGTA's data analysis methodology used to identify individuals making excess IRA contributions for TY 2006 and TY 2007. This analysis was further refined from our prior review[1] to better identify the underreported excise tax. Our refined analysis is similar to the concept of the IRS AUR Program, which uses third-party reporting documents to identify potentially noncompliant individuals.

TIGTA Methodology for Tax Years 2006 and 2007

The following information describes how we identified the 151,165 individuals with $812.3 million in excess contributions above the maximum limit of $5,000 for age 50 or older for TY 2006 and the 143,976 individuals with $756.8 million in excess contributions above the $5,000 maximum limit for TY 2007. Combined, we identified 295,141 individuals with over $1.5 billion in excess contributions above the $5,000 maximum limit. The $1.5 billion equates to an IRS revenue loss of more than $202.3 million in additional unreported excise tax that we previously reported would not be collected over 5 years. Specifically, we:

- Identified 220,572,392 IRA Contribution Information (Form 5498) returns filed with the IRS for TY 2006 and TY 2007. We used IRS data files to identify these Forms 5498.
- Eliminated from the population of 220,572,392 the following Forms 5498:
    - 12,028 Forms 5498 reporting a payee (individual) TINs with all zeros (i.e., 000-00-0000) or reporting both traditional and Roth IRA contributions. These were eliminated because they are reporting errors.
    - 190,866,746 Forms 5498 that did not report a traditional or Roth IRA contribution. Forms 5498 are used to report other IRA transactions, for example, roll over contributions, recharacterized contributions, etc.
    - 89,696 Forms 5498 containing a case duplicate/amended indicator of 'D' (duplicate), 'G' (amended), or 'R' (original replaced by amended). These Forms 5498 were replaced by other Forms 5498 so they were eliminated to prevent double counting.

[1] *Individual Retirement Account Contributions and Distributions Are Not Adequately Monitored to Ensure Tax Compliance* (Reference Number 2008-40-087, dated March 28, 2008).

- Analyzed the remaining 29,603,922[2] Forms 5498 that reported a traditional or Roth IRA contribution. These Forms 5498 had a case duplicate/amended indicator of 'F' (original), 'C' (corrected), or 'O' (amended replacing original).

We analyzed the remaining 29,603,922 Forms 5498 as described below:

- Identified 23,893,260 payee TINs (individuals) associated with the 29,603,922 Forms 5498. An individual can have several Forms 5498, for example, one for a traditional IRA account and another for a Roth IRA account. We counted each individual only once in our computer analysis.
- Identified individuals having the following conditions:
  - 1 or more Forms 5498 reporting a traditional IRA contribution greater than $5,000.
  - 1 or more Forms 5498 reporting a Roth IRA contribution greater than $5,000.
  - 1 or more Forms 5498 reporting traditional IRA contributions totaling $5,000 or less, and 1 or more Forms 5498 reporting Roth IRA contributions totaling $5,000 or less, but the combined IRA contributions totaled more than $5,000.
- Eliminated individuals' IRA contributions that appeared to be roll overs by matching the Form 5498 IRA contribution amount to a gross distribution amount reported on Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R) for the same tax year. For the amounts that matched, we assumed the custodian made an error by reporting an IRA roll over as an IRA contribution.
- Reduced individuals' IRA contributions that were withdrawn by matching the IRA account number on the Form 5498 to the same IRA account number on a Form 1099-R for the same year and subtracting the gross distribution amount from the IRA contribution amount.
- Computed the amount of excess IRA contribution,[3] if any, for each individual by calculating the difference between the total IRA contributions reported on their Forms 5498 minus misreported roll overs, IRA contributions that were withdrawn, and the $5,000 maximum limit. We also computed the 6 percent excise tax on the excess contributions for each individual. The results for TY 2006 and TY 2007 are shown below.

---

[2] We computed this number as 220,572,392 - 12,028 - 190,866,746 - 89,696 = 29,603,922.
[3] IRA contributions greater than the maximum limit of $5,000 for TY 2006 and TY 2007 are defined as "excess" IRA contributions. To avoid erroneously identifying individuals age 50 or older as having exceeded their IRA contribution limit, we used the maximum limit of $5,000 in our analysis.

Individuals With Excess IRA Contributions	TY 2006	TY 2007	Combined
Number of Individuals	159,283	152,162	311,445
Total Excess Contributions	$893,984,152	$873,750,890	$1,767,735,042
Total 6% Excise Tax[4]	$53,640,493	$52,426,358	$106,066,851

- Eliminated individuals that reported an amount on line 60 of U.S. Individual Income Tax Return (Form 1040) (used to report excise tax) for the same tax year they were identified as having excess IRA contributions. This elimination was very conservative since line 60 is used to report other excise tax.[5]

Elimination of Individuals Reporting an Amount on Form 1040, Line 60	TY 2006	TY 2007	Combined
Number of Individuals	8,114	8,180	16,294
Total Excess Contributions	$40,489,862	$39,628,346	$80,118,208
Total 6% Excise Tax	$2,429,496	$2,377,807	$4,807,303

We conducted further analysis of the TY 2006 Forms 5498 and determined that 46,455 (31 percent) of the 151,169 individuals (159,283 minus 8,114) had only 1 Form 5498 with excess IRA contributions totaling $511,551,922 and estimated 6 percent excise tax of $30,693,366. The remaining 104,714 (69 percent) individuals had 2 or more Forms 5498 with excess IRA contributions totaling $341,942,368 and estimated 6 percent excise tax of $20,517,631.

Further analysis of the TY 2007 Forms 5498 showed that 48,325 (34 percent) of the 143,982 individuals (152,162 minus 8,180) had only 1 Form 5498 with excess IRA contributions totaling $532,550,416 and estimated 6 percent excise tax of $31,953,185. The

[4] The excise tax amounts in the table will not equal the excess contributions multiplied by 6 percent because we multiplied each individual's excess IRA contributions by 6 percent, rounded the result to the nearest dollar, and totaled the amounts. This explanation applies to all 6 percent excise tax amounts included in Appendix V.
[5] An amount reported on Form 1040, line 60, is supported by attaching Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts (Form 5329). Form 5329 includes additional taxes on early distributions; certain distributions from education accounts, excess accumulation in qualified retirement plans, including IRAs; and excess contributions to traditional IRAs, Roth IRAs, Coverdell education savings accounts, Archer medical savings account, or health savings accounts. Data were only available for the amount reported on Form 1040, line 60. Data were not available for amounts reported on Form 5329.

remaining 95,657 (66 percent) individuals had 2 or more Forms 5498 with excess IRA contributions totaling $301,572,128 and estimated 6 percent excise tax of $18,095,366.

- Sorted the list of individuals in descending order beginning with the largest amount of excess IRA contribution to the smallest amount. We selected the top 10 individuals for each tax year, researched the individuals' IRA information on the Information Returns Master File,[6] and adjusted our data analysis results as needed.[7] An example of an adjustment is where the sum of several type 'G' (direct roll over to an IRA) distributions of differing amounts equals an amount reported as an IRA contribution. We could not perform this type of analysis of the Form 5498 IRA contributions and Form 1099-R distributions data using the computer. (**Note**: In its study of excess IRA contributions for TY 2006, the IRS excluded 1 case with an excess traditional IRA contribution of $247,316,000. The case was considered a data anomaly.)

Elimination of Individuals Based on Additional Research of Forms 5498 and Forms 1099-R	TY 2006	TY 2007	Combined
Number of Individuals	4	6	10
Total Excess Contributions	$41,154,568	$77,330,500	$118,485,068
Total 6% Excise Tax	$2,469,274	$4,639,830	$7,109,104

- Summarized the results of the above analyses is shown on the following page:

[6] The Information Returns Master File contains tax information reported from third parties for the current and prior 5 tax years.
[7] We limited our review to the top 10 individuals with the greatest amount of excess contributions for each tax year. There may be other individuals with excess IRA contributions that could be adjusted. However, we did not have the resources to research Information Returns Master File data for each individual with excess IRA contributions.

	Number of Individuals	Total Excess Contributions	Total 6% Excise Tax
TY 2006			
Computer Analysis of Forms 5498	159,283	$893,984,152	$53,640,493
Less: Results of Form 1040, Line 60, Match	8,114	$40,489,862	$2,429,496
Less: Results From Additional Research of the Information Returns Master File	4	$41,154,568	$2,469,274
Final Results for TY 2006	**151,165**	**$812,339,722**	**$48,741,723**
TY 2007			
Computer Analysis of Forms 5498	152,162	$873,750,890	$52,426,358
Less: Results of Form 1040, Line 60, Match	8,180	$39,628,346	$2,377,807
Less: Results From Additional Research of the Information Returns Master File	6	$77,330,500	$4,639,830
Final Results for TY 2007	**143,976**	**$756,792,044**	**$45,408,721**
Combined			
Computer Analysis of Forms 5498	311,445	$1,767,735,042	$106,066,851
Less: Results of Form 1040, Line 60, Match	16,294	$80,118,208	$4,807,303
Less: Results From Additional Research of the Information Returns Master File	10	$118,485,068	$7,109,104
Final Results for Both Tax Years	**295,141**	**$1,569,131,766**	**$94,150,444**

The final results showed that 295,141 individuals made excess contributions totaling more than $1.5 billion for TYs 2006 and 2007. The total estimated excise tax on the excess contributions was more than $94 million (average of $319 per individual).

Six Percent Excise Tax on Excess IRA Contributions

- Computed 6 percent excise tax of $94,150,444 on excess IRA contributions for TY 2006 and TY 2007. We calculated this amount by multiplying each of the 295,141 individuals' excess IRA contributions by 6 percent, rounding each result to the nearest dollar, then totaling the amounts for all 295,141 individuals. Because we rounded for each individual, the $94,150,444 total excise tax for both years will not equal the total excess IRA contributions of $1,569,131,766 multiplied by 6 percent.

Income Tax Avoidance on Estimated Unreported Interest Income on Excess IRA Contributions

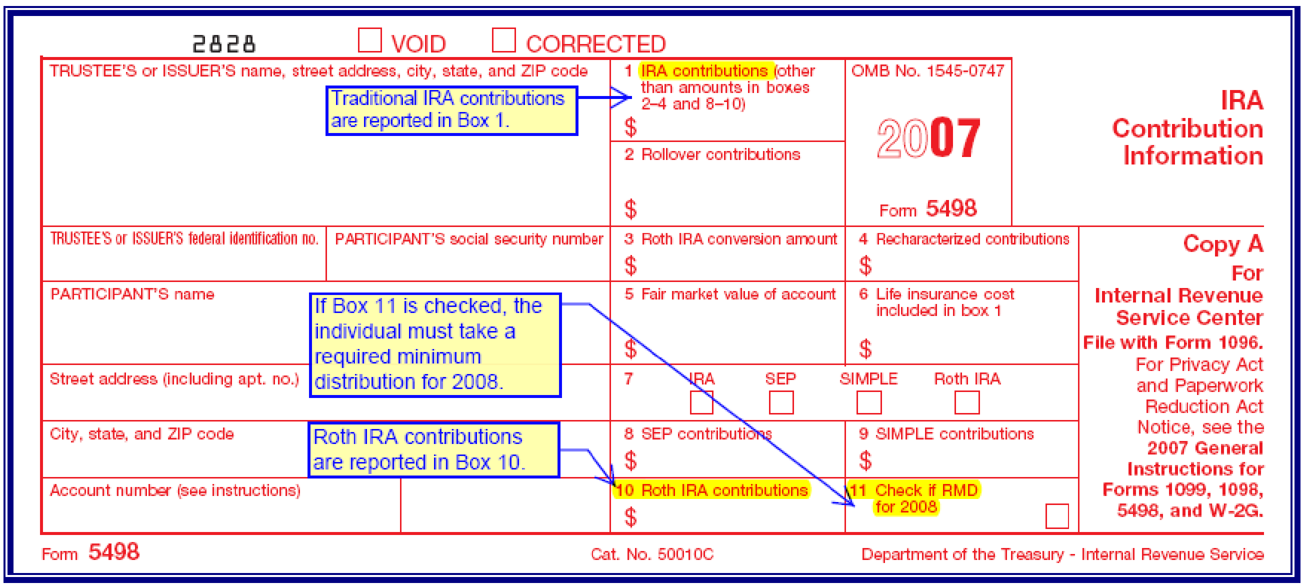
- Calculated average excess IRA contributions of $784,565,883 for TY 2006 and TY 2007 by dividing $1,569,131,766 by 2.
- Calculated $169,978,476 of estimated unreported compound interest over 5 years using a 4 percent interest rate on the $784,565,883 average excess IRA contributions.
- Calculated $47,593,973 of potential income tax over 5 years by multiplying the $169,978,476 by a 28 percent income tax rate.
- From the $169,978,476, we subtracted $127,026,756, which we previously reported as unreported interest on excess contributions over 5 years using a 7 percent interest rate. The difference is $42,951,720, which is our revised estimate of potential unreported interest income over 5 years.
- From the $47,593,973, we subtracted $19,054,013, which we previously reported as potential tax on unreported interest over 5 years using a 15 percent tax rate. The difference is $28,539,960, which is our revised estimate of potential income tax on unreported interest income on excess IRA contributions over 5 years.

Appendix VI

IRA Contribution Information (Form 5498)

Figure 1 shows Copy A of a blank IRA Contribution Information (Form 5498) for TY 2007. Copy A is filed with the IRS. Not shown are Copy B, which is provided to the IRA owner, and Copy C, which is kept by the IRA custodian who prepared the Form 5498.

Figure 1: Form 5498


2828 VOID CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

Traditional IRA contributions are reported in Box 1.

1 IRA contributions (other than amounts in boxes 2–4 and 8–10) $

2 Rollover contributions $

OMB No. 1545-0747

2007

Form 5498

IRA Contribution Information

TRUSTEE'S or ISSUER'S federal identification no.

PARTICIPANT'S social security number

3 Roth IRA conversion amount $

4 Recharacterized contributions $

Copy A For Internal Revenue Service Center

File with Form 1096.

For Privacy Act and Paperwork Reduction Act Notice, see the 2007 General Instructions for Forms 1099, 1098, 5498, and W-2G.

PARTICIPANT'S name

If Box 11 is checked, the individual must take a required minimum distribution for 2008.

5 Fair market value of account $

6 Life insurance cost included in box 1 $

Street address (including apt. no.)

7 IRA SEP SIMPLE Roth IRA

City, state, and ZIP code

Roth IRA contributions are reported in Box 10.

8 SEP contributions $

9 SIMPLE contributions $

Account number (see instructions)

10 Roth IRA contributions $

11 Check if RMD for 2008

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Source: TY 2007 Form 5498.

<u>Traditional IRA</u> – Box 1 shows traditional IRA contributions for 2007 that are made in 2007 and through April 15, 2008. "IRA" may be checked in Box 7.

<u>Roth IRA</u> – Box 10 shows Roth IRA contributions for 2007 that are made in 2007 and through April 15, 2008. "Roth IRA" may be checked in Box 7.

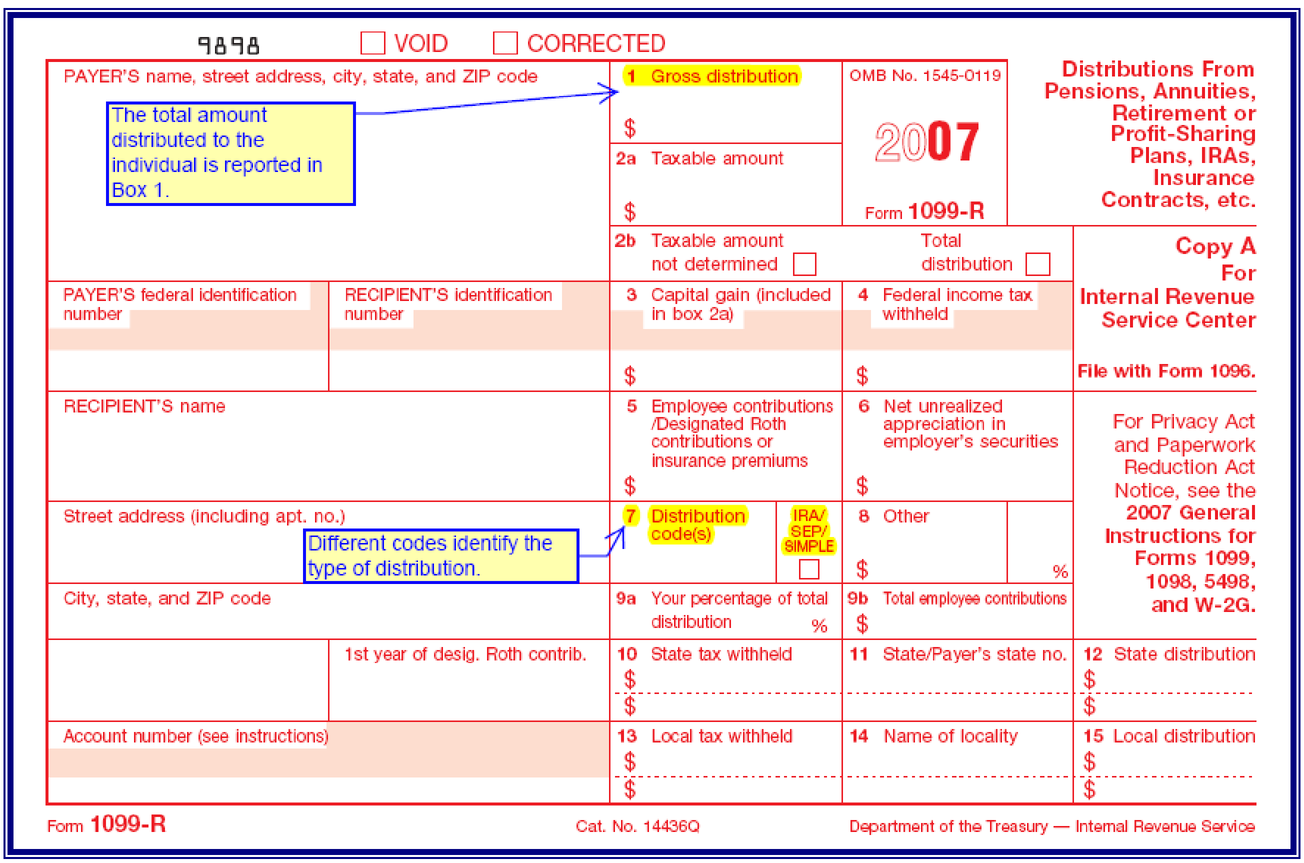
<u>Required Minimum Distribution</u> – If Box 11 is checked, the individual must take a required minimum distribution for the next tax year. The custodian may include the required minimum distribution amount in the blank box to the left of Box 10 or furnish the individual with a calculation of the amount if requested by the individual.

Appendix VII

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R)

Figure 1 shows Copy A of a blank Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R) for TY 2007. Copy A is filed with the IRS. Not shown are Copies 1 and 2, which are provided to be filed with a State, city, or local income tax return; Copies B and C, which are provided to the IRA owner; and Copy D, which is kept by the IRA custodian who prepared the Form 1099-R.

Figure 1: Form 1099-R



Source: TY 2007 Form 1099-R.

Required Minimum Distributions from Traditional IRA – The IRA custodian must report a traditional IRA distribution in Box 1. Generally, the custodian is not required to compute the taxable amount of a distribution from a traditional IRA. If the custodian does not have all facts needed to compute the taxable amount, Box 2a should be blank and Box 2b should be checked indicating the taxable amount was not determined. The custodian should also check the "IRA/ SEP/SIMPLE" box and enter the appropriate distribution code in Box 7. A Guide to Distribution Codes is included in the IRS' TY 2007 instructions for Forms 1099-R and 5498.

Appendix VIII

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
MAR 25 2010
BY: DAS

MAR 16 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – A Service-wide Strategy Is Needed to Address Growing Noncompliance With Individual Retirement Account Contribution and Distribution Requirements (Audit #200940016)

I appreciate your continuing concern regarding noncompliance with Individual Retirement Account (IRA) contribution and minimum distribution requirements. Because of the potential significant overall revenue losses associated with IRA noncompliance, I agree that a Service-wide strategy is warranted. Executives from the Wage and Investment and Tax-Exempt and Government Entities Divisions recently met and agreed to share responsibility for development of this long-term strategy. This strategy will not only address compliance, but will also include plans for outreach and guidance for individual taxpayers and employee plan organizations. We will also consider amending regulations and pursuing math error solutions.

I agree with the outcome measures outlined in Appendix IV of your report. Full realization of the potential revenue you cite may not be realistic, however; our strategy should have a long-term and positive impact on improving compliance in this area. Attached are our specific comments to your recommendation. If you have any questions, please contact me, or a member of your staff may contact Don Mainwaring, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.

Attachment

Attachment

Recommendation 1

The Deputy Commissioner for Services and Enforcement should ensure a Service-wide strategy is developed to address retirement provision noncompliance. This strategy should include the development of processes to identify individuals who do not comply with retirement provisions along with compliance efforts to address the noncompliance.

Corrective Action

We agree with this recommendation. Wage and Investment and Tax Exempt and Government Entities Divisions agree to work together to develop a long-term strategy to reduce retirement provision noncompliance. The Wage and Investment, Compliance Office will also reach out to other IRS stakeholders for support as this strategy will contain compliance, education/guidance, and outreach components.

Implementation Date

October 15, 2012

Responsible Official

Director, Compliance, Wage and Investment Division

Corrective Action Monitoring Plan

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