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The focus of the Internal Revenue Service (IRS) audits is on the proper reporting and payment of income taxes rather than on the accurate reporting of and payment of social security taxes. There is a need to recognize that any problem affecting social security taxes will grow in importance as these taxes increase in the coming years. Findings/Conclusions: A net underpayment of about $32 million to the Social Security Tax Fund resulted from: the number and quality of IRS audits of social security taxes paid by taxpayers who indicated they had self-employment incomes; problems that the IRS and taxpayers have in determining whether miscellaneous earned income is subject to social security tax and, if so, what kind; and the adequacy of IRS programs to ensure proper reporting and payment of social security taxes. Recommendations: The IRS should: revise its procedures to require classifiers to look at the self-employment tax issue when identifying areas for audit; require quality review staffs to identify and report on all errors so that error patterns and trends are identified and made available for management consideration of program quality; implement on a test basis a service center audit program to identify obvious social security tax errors on returns with attached schedule SE's and expand the program to all service centers if it proves to be cost effective; revise tax auditor and examiner course material to provide more training in social security tax problems; expand the self-employment tax program to include returns reporting "other income" subject to Federal Insurance Contributions Act social security tax; and specify the factors to be included in the service center quality review program audit reports and require the quality review staffs to send reports on their review efforts to appropriate management officials. (Author/SC)

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REPORT BY THE

Comptroller General

OF THE UNITED STATES

Released Date 9-15-78

Additional IRS Actions Needed To Make Sure That Individuals Pay The Correct Social Security Tax

At the request of the Joint Committee on Taxation, GAO reviewed individual taxpayer compliance with the social security tax laws when an employer has not withheld taxes. This report is concerned with

--the number and quality of IRS audits of social security taxes paid by taxpayers who indicated they had self-employment income;

--problems IRS and taxpayers have in determining whether miscellaneous earned income is subject to social security tax and, if so, what kind; and

--the adequacy of IRS programs to ensure proper reporting and payment of social security taxes.

There was a net underpayment of about $32 million to the Social Security Trust Fund because of these issues.

IRS agreed with GAO's recommendations for improvement. As a result of actions to be taken, there should be more correct payment of social security taxes.

GGD-78-70

AUGUST 15, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report, one of a series in response to your Committee's request, addresses additional actions the Internal Revenue Service needs to take to ensure that individuals pay the correct social security tax. The Service generally agreed with the substance of our recommendations. As a result there should be more correct payment of social security taxes.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT
TO THE JOINT COMMITTEE ON
TAXATION
CONGRESS OF THE UNITED STATES

ADDITIONAL IRS ACTIONS NEEDED TO MAKE SURE THAT INDIVIDUALS PAY THE CORRECT SOCIAL SECURITY TAX

D I G E S T

The focus of Internal Revenue Service (IRS) audits is on the proper reporting and payment of income taxes rather than on the accurate reporting and payment of social security taxes. IRS believes it is more cost effective to devote its limited personnel and financial resources to tax compliance problems which offer a larger payoff in terms of added assessments and improved compliance.

IRS, however, should increase its audit coverage of social security taxes. There is a need to recognize that any problem affecting social security taxes will grow in importance as these taxes increase in coming years; the present maximum tax will double by 1982 and continue to grow beyond that.

ERRORS IN PAYMENT

The errors affecting payment of social security taxes include the following.

--Some employers, innocently or intentionally, treat employees as independent contractors, thereby avoiding payment of their share of Federal Insurance Contributions Act (FICA) taxes (and also avoiding the payment of unemployment taxes and the withholding and remittance of income taxes).

--Employees are incorrectly classified as self-employed. They thus pay higher social security under the Self-Employment Contributions Act (SECA) (8.1 percent at present) than they would if classified as employees (6.05 percent).

--Some taxpayers, treated correctly as independent contractors, report their

self-employment earnings for income tax purposes but not for SECA tax purposes.

--Some taxpayers report and pay SECA taxes on income exempt from social security taxes.

--Some taxpayers correctly report self-employment income but incorrectly compute the amount of SECA tax due.

--In the course of their examinations, IRS auditors introduce additional errors affecting social security taxes.

By GAO's estimate, these various errors affected the payment of about $96 million in social security taxes.

MINIMAL IRS AUDIT EFFORTS TO IDENTIFY INCORRECT SOCIAL SECURITY TAX PAYMENTS BY INDIVIDUALS

IRS audits of social security taxes are essentially peripheral to, and generally only applied in connection with, audits aimed at other tax compliance problems.

Three audit programs provide IRS an opportunity to look into social security tax problems:

--Normal audits of business tax returns.

--Normal audits of individual returns.

--Special audits of individual returns showing "other income" but no payment of social security tax.

Business audits

As part of its business audits, the Service requires auditors--under the so-called package audit concept--to specifically examine the issues of employee independent contractor classification and social security tax payment. GAO has no reason to question this approach; however, the percentage

of businesses audited each year is small and the program misses nonbusiness taxpayers who are treated as employers for social security tax purposes. For example, GAO's analysis of a sample of 1974 returns with attached schedule SE's not selected for audit by IRS showed that 12 percent contained social security tax errors. These errors represent erroneous payments of SECA tax by taxpayers of $29.3 million, which they are entitled to have refunded. They also represent nonpayment of FICA tax by employers of $61.8 million. (See p. 10.)

Normal audits of individual returns

In the course of its normal selection procedures, the Service selects for audit for unrelated reasons many returns that have schedule SE's attached, thus indicating some self-employment income. In 1974, there were about 6.5 million such returns. IRS had audited about 110,000 of these returns when GAO did its review. About 10 percent of the audited returns contained social security tax errors that IRS did not detect. These errors represent erroneous payments by taxpayers of $1.3 million in SECA tax and nonpayment by employers of $1.1 million in FICA tax. (See p. 14.)

Special audits of individual returns

In 1974 IRS initiated a program at its 10 service centers to identify for possible audit those individual returns showing "other income," but with no schedule SE attached and no SECA tax paid. The program not only provides an opportunity to identify instances of SECA tax nonpayment, but also to uncover situations where employees are incorrectly treated as independent contractors.

The program could be improved. IRS had screened about 251,500 such returns at the time of GAO's review and had selected about 66,000 for audit. GAO estimates that of the returns audited, about 12,100 contained

social security tax errors after audit. These errors represent erroneous payments of SECA tax by taxpayers of $1.5 million and underpayments of FICA tax by employers of $1.4 million. (See pp. 23 and 24.) Further, at least 49,000 of the 251,500 returns contained FICA tax errors that were not corrected because, at least in part, IRS auditors were focusing their attention on SECA tax issues with little regard being given to possible FICA-related problems. (See p. 29.)

As a result of these social security tax problems, there was a net underpayment of about $32.2 million to the Social Security Trust Fund. These problems evidence a need for IRS to reconsider its strategy for coping with the incidence of errors in the reporting and payment of social security taxes. But the cost effectiveness of more stringent enforcements should be determined before the Service makes extensive procedural changes in its audit approach.

GAO makes recommendations in the body of the report on this and other actions which should be taken to improve the quality of IRS auditing of individual returns as it relates to the correct payment of social security taxes. (See pp. 21 and 32.) IRS generally agreed with these recommendations. As a result, there should be more correct payment of social security taxes. (See app. I.)

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ABBREVIATIONS

FICA	Federal Insurance Contributions Act
GAO	General Accounting Office
IRS	Internal Revenue Service
SECA	Self-Employment Contributions Act

CHAPTER 1

INTRODUCTION

A taxpayer's employment status determines the amount of his or her social security contribution rate. The importance of social security taxes can be seen in the magnitude of the programs they finance. According to the Internal Revenue Service (IRS), the revenue they produce finances insurance and medical programs affecting over 90 percent of the Nation's population. Granting or denying benefits that are to be derived years later is dependent on the proper payment of the taxes today. An error of only a few dollars in income reporting may cause the annuitant to gain or lose several thousand dollars in benefits over her or his lifetime. Because of this, the Joint Committee on Taxation asked us to review IRS's administration of taxes on self-employment income, including the classification of persons as self-employed or employees.

This is the second of two reports resulting from the Joint Committee's request. Our first report 1/ dealt with (1) difficulties faced by employers and IRS in determining who is an employee and who is self-employed and (2) retroactive assessments against employers who IRS believed had misclassified employees.

This report deals with individual taxpayer compliance with social security tax laws when the tax has not been withheld by the employer. The report addresses the quality of IRS audits of social security taxes paid by those taxpayers who indicated by filing a schedule SE that they had self-employment income. It also addresses the problems IRS and taxpayers have in determining (1) whether miscellaneous earned income is subject to social security tax and, if so, (2) whether the income is subject to the tax under the Federal Insurance Contributions Act (FICA) or the Self-Employment Contributions Act (SECA). The income in question, in most instances, represents a second income to the taxpayer and is usually reported on the form 1040 as "other" income.

1/"Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions" (GGD-77-88, Nov. 21, 1977).

SOCIAL SECURITY TAXES

Social security taxation began in 1935 when the Congress began enacting the national social insurance programs. The programs were designed to provide a degree of security for individuals and their families in the form of old-age pensions, disability benefits, and survivor benefits. To finance the programs' benefits, the Federal Insurance Contributions Act imposed an equal tax on both employers and employees. The Congress, in 1950, extended social security coverage to most persons who were self-employed by enactment of the Self-Employment Contribution Act.

Although FICA and SECA taxes finance the same program benefits, the rates and methods of computing the taxes are different.

FICA tax

For calendar year 1978, FICA tax is imposed at a rate of 6.05 percent on both employers and employees. The tax is computed on the employee's gross wages, up to the maximum amount of earnings subject to the tax. (See app. II.) Employers are responsible for withholding the FICA tax from their employees' wages and, together with the employer's portion, depositing the taxes in a Federal depository. The employer is liable for payment of the employee's share of the tax whether or not it is actually withheld.

SECA tax

Unlike employees who, under the pay-as-you-go system, have FICA tax withheld from their paychecks, self-employed persons make periodic tax payments (combined income and SECA taxes) to IRS. Although the 1978 SECA tax rate--8.1 percent--is higher than the employee's FICA tax rate--6.05 percent--it is less than the combined employer and employee rate of 12.1 percent. Another difference is that the SECA tax is computed on the taxpayer's net earnings up to the maximum amount of income subject to the

tax. 1/ (See app. II.) Further, if the self-employed person has a net loss for the taxable year, she or he may in some cases report self-employment earned income for credited earnings base purposes. Certain types of investment income and capital gains are excluded both from wages subject to withholding of FICA tax and from net self-employment earnings.

If a taxpayer earned both FICA wages and self-employment income, he or she must subtract the amount of wages earned from the social security tax base limitation ($17,700 for 1978) to determine the amount of self-employment income subject to SECA tax. For example: If a taxpayer had $15,000 of net earnings from his or her business during 1978 and $5,000 in wages subject to FICA tax, only $12,700 of the $15,000 net earnings ($17,700 minus $5,000) is subject to SECA tax. Total net earnings from self-employment for the year must be at least $400 to be taxable. Self-employed persons compute their SECA tax on a schedule SE, which is attached to and filed with the form 1040 return.

The number of self-employed persons paying SECA tax has remained relatively constant--from 6.1 to 6.8 million individuals annually over the past 10 years. During this period, SECA tax collections have increased over 124 percent--from $1.5 billion in tax year 1966 to about $3.4 billion in tax year 1975. The increase in collections is attributable to increases in both the SECA tax rate and the maximum income base to which the tax is applied.

IRS RESPONSIBILITIES IN ADMINISTERING SOCIAL SECURITY TAX LAWS

IRS administration of the social security tax law involves more than collecting the tax. IRS also communicates the requirements of the law to the public, processes returns,

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1/FICA tax and income tax withholding is assessed on "wages," which is defined by law (26 U.S.C 3121(a) and 26 U.S.C. 3401(a)) as all remuneration for employment. SECA tax is assessed on "self-employment income," which is defined by law (26 U.S.C. 1402(b)) as net earning from self-employment. This latter amount is greater than wages subject to withholding to the extent that self-employment income reflects income derived from capital invested in the business as well as income from the performance of personal services.

and determines the extent of noncompliance. Its enforcement activities include auditing returns, collecting delinquent taxes and penalties, and recommending prosecution of individuals who evade their tax responsibilities. Of all enforcement activities, IRS considers the audit of returns to be the greatest stimulus to voluntary compliance with the tax laws.

Processing of returns

Taxpayers send their completed returns to one of 10 IRS service centers located throughout the country. When the returns are received by the centers, they are edited and coded for computer processing and possible later selection for audit. Although most of the centers' processing functions are automated, some of the functions are performed manually. IRS employees

--compare taxes owed with amount paid;

--check returns for completeness and identify certain obvious errors, such as claiming a partial exemption or duplicate deductions;

--enter information, such as the taxpayer's name and address, gross income, withheld credits, and any refund due, into the computer.

Selecting returns for audit

Based on data entered, the computer scrutinizes the returns to check the accuracy of the taxpayer's arithmetic. In addition, the primary method of selecting returns for audit is a computer program of mathematical formulas--the discriminant function system. This system measures the probability of tax error in each return. Using the system's formula, the computer assigns numeric values to certain basic return characteristics and totals the values to arrive at a score for each return. The greater the score, the higher the probability that the audit of the return will result in a tax change.

IRS audits of tax returns are carried out by its 58 district offices and 10 service centers. A district covers part or all of one State while a service center covers a number of district offices.

Service center audit of returns

Service center audits of tax returns involve relatively simple and readily identifiable problems that can be resolved by mail. The returns are selected for audit because they have special features, such as an unallowable item or self-employment income reported but no SECA tax paid (done under the self-employment tax program on returns without attached schedule SE's). The number of returns audited 1/ under the various programs from July 1975 through June 1976 were as follows.

Program	Number of returns	Percent of total
Unallowable items	1,473,879	78
Head of household	135,105	7
DIF correspondence	86,680	5
Self-employment tax	66,296	3
Information returns	43,030	2
Form 843 or amended return	31,768	2
Multiple filers	14,869	1
All other	30,550	2
Total	1,882,177	100

After the computer has identified returns for audit, a classifier from the audit division reviews them to determine which returns warrant audit and which do not. For example, under the self-employment tax program a classifier would decide that a return should not be audited if the taxpayer had paid maximum FICA tax. Once a taxpayer has paid the maximum social security tax, any additional earned income, whether or not from self-employment, would not be subject to additional social security tax.

Classifiers are tax auditors from the service center's audit division who are temporarily detailed to review the returns. They are not required to have special training. They use judgment based on experience to make their determinations.

1/IRS does not consider all of these to be audits. Our differing positions are discussed on pp. 56-58 of our report, "How the Internal Revenue Service Selects Individual Income Tax Returns for Audit" (GGD-76-55, Nov. 5, 1976).

Service center audits are performed both by tax auditors and by tax examiners. 1/ Service center tax auditors have the same qualifications as those in district offices. Tax examiners must have at least a high school education; they perform most of the service center audits. Tax examiners are not specialists; even though a return has tax issues applicable to more than one service center program, all of the issues are worked by the same examiner.

A service center audit generally involves sending the taxpayer a letter which (1) notifies him of the problem with his return, (2) advises him of the impact of the problem on his tax liability, and (3) tells him what to do if he agrees or disagrees. If the taxpayer agrees, the audit is closed. If he disagrees, he can (1) submit information to support his claim, which the service center will evaluate, (2) request that the case be transferred to a district examiner, or (3) take advantage of his appeal rights.

District office audits

Most returns audited by district offices involve issues that are not as readily identifiable or as easily resolved as those audited by service centers. Some returns are selected because of some special feature, such as a preparer whom IRS has reason to believe is unscrupulous. Most, however, are selected because IRS has determined through the discriminant function system that the return has good audit potential. Returns with the highest computer score are sent from the service center to the district for audit. Classifiers manually review the returns to make sure an audit is warranted.

Most audits of computer-selected individual returns are not comprehensive, but are limited to certain questionable items on the return. The scope of audit of business returns audited by tax auditors and all returns audited by revenue agents is determined by the examiner. IRS has no special program directed toward identifying taxpayers who pay SECA tax on FICA income or either SECA or FICA tax on exempt income. Rather, the correctness of any SECA tax paid is to be considered during an audit of the individual income tax return.

1/Where appropriate, revenue agents, tax auditors, and tax examiners will be referred to collectively as examiners.

Revenue agents usually have a college education with a major in accounting. Agents conduct their audits by interview, usually at the taxpayer's home or at the taxpayer's or his or her representative's place of business. Generally, tax auditors have a college education or its equivalent, but are not required to have accounting or related business subjects. Before advancing to the journeyman level, however, they are required to have six units of accounting and are given IRS training in accounting and auditing techniques that enable them to examine most individual returns. They conduct their audits either by correspondence or by interview, usually at an IRS office.

SCOPE OF REVIEW

We examined IRS policies, procedures, and practices for auditing individual income tax returns with either a schedule SE attached or with reported miscellaneous earned income on which social security tax had not been paid. We reviewed publications IRS uses to communicate SECA tax law requirements to taxpayers, and the training material IRS uses to teach the tax law to revenue agents, tax auditors, and correspondence auditors. We also randomly selected tax returns and reviewed them to determine whether SECA tax assessments made by IRS were proper and whether there were instances in which IRS did not identify social security tax errors made by taxpayers. We discussed returns which we believed contained social security tax errors with an IRS employment tax specialist.

Sampling plan

The returns we reviewed were randomly selected from 1974 individual income tax returns from four national universes, as shown on the following page.

Universe description	Universe size (note a)	Sample size
Returns with schedule SE's not selected for audit	5,785,302	247
Returns with schedule SE's selected for audit and examined	109,659	258
Returns without schedule SE's selected for audit but not examined under the self-employment tax program	185,525	223
Returns without schedule SE's selected for audit and examined under the self-employment tax program	66,004	245

a/Universe size as of April 30, 1976, when the samples were drawn by IRS.

Our review concentrated on service center activities because the centers audited about 65,500 (60 percent) of the 1974 individual tax returns with a schedule SE attached included in our universe. They also audited the 66,000 returns examined under the self-employment tax program. These returns did not have attached schedule SE's but showed possible SECA taxable income. From the data collected, we made numerical and dollar projections to the universe at the 95-percent confidence level.

Our work was done at the IRS national office in Washington, D.C.; IRS regional office in Cincinnati; IRS service centers in Austin, Cincinnati, Kansas City, and Memphis; and the IRS district office in Detroit.

CHAPTER 2

RETURNS WITH ATTACHED SCHEDULE SE'S REQUIRE ADDITIONAL AUDIT EFFORTS TO CORRECT SOCIAL SECURITY TAX ERRORS

Additional IRS audit activity for ensuring both compliance with the social security tax law and correct payment of the tax is needed. We estimate that

--under current audit selection criteria, over 1 million of 5.8 million 1974 returns filed with attached schedule SE's that were not selected for audit have or could have social security tax errors; and

--11,500 of 109,700 returns audited by IRS have social security tax errors.

As a result of definite errors, we estimate that there was a net underpayment to the Social Security Trust Fund of about $32.3 million.

Although the audit of returns solely to correct social security tax errors will not offer IRS the greatest return for audit effort spent, the magnitude of the problem indicates that something more needs to be done.

RETURNS NOT SELECTED FOR AUDIT CONTAIN SOCIAL SECURITY TAX ERRORS

Many employers incorrectly choose to treat all or part of their workers' wages as self-employment income. Following this incorrect action, they fail to withhold income and FICA taxes from their employees' wages or to report and remit their own share of the FICA tax. As a result, many of the workers are reporting this wage income as self-employment income on their individual returns and incorrectly paying SECA tax on it.

Taxpayers attached schedule SE's to approximately 6.5 million of the 81.6 million 1974 individual income tax returns filed. Of the 6.5 million returns, about 5.8 million were not selected for audit by IRS because the discriminant

function system had indicated that these returns had the least probability of a significant tax change. 1/

We randomly sampled 247 of the 5.8 million nonselected returns to see if these taxpayers were correctly paying their social security taxes. We had questions on 17 percent (43) of the returns. We determined that 12 percent (29 returns) contained social security tax errors and that another 6 percent (14 returns) could contain errors.

On the basis of our sample results, we estimate that 679,200 of the 5.8 million returns contained social security tax errors. These errors represent erroneous payments of SECA tax by taxpayers of $29.3 million, which these taxpayers are entitled to have refunded. They represent also nonpayment of FICA tax by employers of $61.8 million. One-half of this amount represents the employees' share, which was or should have been withheld and paid over. One-half represents the employers' share, which, when paid over, is deductible for income tax purposes. These two types of errors represent an estimated net underpayment of $32.6 million to the Social Security Trust Fund. On the other hand, since the employers' share of FICA tax is deductible as a business expense, correcting these errors would cause the general revenue fund to lose by reducing the employers' income tax liabilities by $14.8 million. In addition, with respect to another 328,000 returns, we had insufficient information to determine whether or not social security tax errors had been made.

The definite errors we identified in the 247 randomly sampled returns included:

--Two percent of the taxpayers (5 returns) paid SECA tax on FICA income, while 3 percent (7 returns) paid SECA tax on income exempt from social security tax.

--Six percent of the taxpayers (15 returns) under or over paid their SECA tax liability, and 1 percent (2 returns) did not pay the SECA tax due.

1/When we selected our sample, about 109,700 returns had been audited, about 302,000 returns were to be audited, and about 274,000 returns had been screened out of the audit process.

In addition, the possible errors identified involved 13 taxpayers (5 percent of the returns) who paid SECA tax on FICA income and 1 taxpayer who reported self-employment income but did not pay the tax.

Misclassified employees or exempt employees who have paid SECA tax in error are eligible for full refund of the SECA tax, provided the 3-year statute of limitation has not expired. Most such employees, however, do not claim their refund because they do not know they are entitled to one. Misclassified employees still are liable to pay the FICA tax on wages received and from which the FICA tax was erroneously not withheld. Under current tax law, employers must pay over both their share and the employees' share of FICA tax due, whether or not the employees' share of FICA tax was in fact withheld. An employer can collect from her or his employees their share of FICA tax not withheld on a current basis. 1/

Audit program needed to correct social security tax errors not identified by IRS

The problem of employers and taxpayers not correctly paying their social security taxes is not new to IRS officials. Their approach to correcting this problem has been to identify the employers who have improperly classified as self-employment income the wages they have paid to their workers. These employers have been identified during the audit of their business or corporate returns. This approach, referred to as the package audit concept, requires the auditor to ensure that misclassified employees do not exist by checking expenses for commissions, contract labor, casual labor, etc., and that all employment taxes have been paid.

IRS auditors also perform employment tax audits, independent of the audit of a business' income tax return,

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1/In our Nov. 1977 report to the Joint Committee on Taxation concerning the self-employment problem, we recommended that the Congress amend the law to permit an offset of SECA tax paid against FICA tax liability due. We also recommended that IRS automatically refund to the taxpayer the balance of any SECA tax paid in excess of FICA tax due. If this recommendation is implemented, it will make the correction of SECA tax error by IRS easier.

to ensure that the employer is properly paying all employment taxes. As part of this audit, the IRS auditor will check to ensure that employees are not misclassified.

While we do not have any problem with IRS checking for misclassified income through its package audit concept and employment tax audits, more needs to be done. This is evident from our estimate that over 7 percent of all 1974 returns filed with schedule SE's contain, or could contain, social security misclassification type errors.

In our November 21, 1977, report to the Joint Committee, we recognized that some employers had difficulty classifying their workers using the common law factors and, because of this difficulty, some employees were misclassified. We proposed criteria which we believed were more precise and easier to understand and, therefore, could be more accurately applied than the common law rules. If adopted, these or similar criteria should do much to eliminate this social security tax problem. Even so, some employers will still classify all or part of the wages paid to employees as self-employment income. Also, the proposed criteria will not correct the problem of taxpayers who pay SECA tax on exempt income.

Therefore, IRS should consider taking other corrective actions to better control this problem. The difficulty, however, is how can IRS best identify the returns which normally would not be selected for audit and successfully (1) obtain payment of the FICA tax due from employers and (2) refund to individual taxpayers any SECA tax paid in error.

One method would be for IRS to implement a program to identify returns with attached schedule SE's that have not reported the correct social security tax. Such a program could be implemented at its service centers. Service center personnel, in editing and coding returns for computer processing, look at the returns which contain the social security tax errors. Persons having knowledge of social security taxes could identify those returns in which it appears that the source of the income is wages earned as an employee. The examiners could also identify those instances in which the taxpayer paid SECA tax on exempt income.

This preliminary screening could be done by personnel in the examination branch who, in a similar manner, currently identify returns for the other service center audit programs,

such as the self-employment tax program or the unallowable items program.

A program of this type is feasible because many of the errors we identified (both definite and possible) appeared to have the same characteristics as errors currently being corrected under service center audit programs. The errors were obvious and could be recognized by adequately trained personnel, and most represented procedural or simple technical errors which should present little difficulty in obtaining corrective action. Most of the errors involved SECA tax that

--was paid on additional income received from the same employer who had paid the taxpayer wages on which FICA tax had been withheld;

--was paid on lease or rental, interest, disability, and other exempt income;

--was underpaid through the erroneous use of the optional method 1/ of computing the tax;

--was not being paid on self-employment income from clergy fees and partnerships.

Based on our sample returns, we estimate that IRS could obtain corrective action for as many as 796,000 returns which are not now being identified. Of these, about 304,000 returns represent taxpayers who may be misclassified.

We recognize that some errors in the returns which pertain to misclassified employees will be complex and too difficult to be handled by a service center audit program. In these instances, the return could be audited by a district office.

IRS officials stated that it is not cost effective to audit individual tax returns for many of the social security tax errors we identified. They said that greater tax dollars can be obtained through the audit of individual returns with high discriminant function scores. They said that the

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1/The optional method of computing SECA tax increases the tax based on the net income earned. This is an obvious error which can be readily identified. Six of 15 returns with computation errors involved incorrect application of this method.

package audit concept is the more effective means of correcting social security tax problems.

IRS AUDITS OFTEN DO NOT CONSIDER SOCIAL SECURITY TAX ERRORS ON RETURNS WITH ATTACHED SCHEDULE SE'S

IRS audited about 109,700 of the 6.5 million 1974 returns with schedule SE's at its 58 district offices and 10 service centers. Most of these returns were selected for audit for reasons other than a specific SECA tax question.

We randomly sampled 258 of the 109,700 audited returns with schedule SE's. District office examiners audited 104 of the 258 returns. The remaining 154 were audited at the 10 service centers. We determined that after audit 10 percent of the returns (27 of 258) contained social security tax errors which IRS had not detected. An IRS tax specialist confirmed our findings. Projecting the sample returns, we estimate that 11,500 of the 109,700 returns have social security tax errors which IRS did not detect. These errors represent erroneous payments by taxpayers of $1.3 million in SECA tax and nonpayment by employers of $1.1 million in FICA tax, one-half of which is deductible by the employer for income tax purposes. These two types of errors represent a net estimated overpayment of $259,000 to the Social Security Trust Fund. Additionally, since employers can deduct their share of the FICA tax as a business expense, correcting these errors would cause the general revenue fund to lose about $255,000 by reducing their income tax liabilities.

Some errors on returns audited at district offices involved payment of SECA tax on FICA income

The Internal Revenue Manual requires examiners to determine and verify the self-employment income earned and self-employment tax liability incurred on income tax returns audited only when the classifier has indicated these items to be a problem. However, classifiers did not always look for or identify such problem areas. As a result, some audited returns contained SECA tax errors not identified by IRS.

District office examiners made SECA tax adjustments to 28 of the 104 returns. The adjustments were correct in 26 instances and incorrect in 2 instances. The incorrect adjustments involved IRS assessing SECA tax (1) on income

subject to FICA tax and (2) in excess of the amount of tax owed. In addition, eight other audited returns contained SECA tax errors (described below) which IRS examiners did not identify.

Type of error	Number of returns
SECA tax paid on FICA income	2
SECA tax paid in excess of amount owed	4
Underpayment of the amount of SECA tax owed	2

Although all of the taxpayers indicated that the income was from self-employment, the two returns where payment of SECA tax was made on FICA income involved earnings from activities defined by the Internal Revenue Code or IRS revenue rulings as employment. For example:

> Taxpayer A reported $1,375 of wage income and $6,500 of commission income on which $514 SECA tax was paid. During an examination of the return, the auditor established that the taxpayer was vice-president of the corporation which paid him the wages and commissions. Although a corporate officer is defined as an employee by the Internal Revenue Code (section 3121(d)(1)), the auditor did not question the commission income and adjust the SECA tax paid in error. As a result, the taxpayer paid $514 SECA tax he did not owe. The corporation should have withheld and paid over $921 FICA tax from the taxpayer's wages, including commission. In fact, the corporation withheld and paid over $161 FICA tax on the $1,375 wages only. The result is that the taxpayer overpaid his social security tax liability by $134. 1/ The appropriation to the trust fund was less by the amount of $246 ($674.88 in fact credited from $921 which should have been credited). And

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1/The taxpayer paid $514 SECA tax on the $6,500 commission income, whereas he should have paid $380 FICA tax on this income; he thus made an overpayment of $134.

general revenues gained $182 1/ by virtue of the corporation's failure to pay and take as an expense deduction its share of the FICA tax payable on the commission payments.

Other SECA tax errors were not identified by tax auditors during their examination because the classifiers who selected the returns for audit did not include the SECA tax question in the scope of the audits. Although the tax auditor has the option of increasing the audit's scope, IRS discourages such action except in unusual circumstances. The chief of the quality review staff in one district office said that an auditor would be advised not to pursue small issues during an audit examination because they are not cost beneficial. The auditor would be instructed that the time might better be spent correcting the large dollar errors in other returns identified for audit. As a result, some SECA tax errors were not corrected. For example:

Taxpayer B reported $13,640 of commission income from selling real estate and claimed business expenses of $2,515. The maximum earned income base for the tax year was $13,200. In determining his net self-employment income, the taxpayer reported the expenses as miscellaneous itemized deductions rather than as an offset against gross income. As a result, the taxpayer erroneously paid SECA tax on an earned income base of $13,200 instead of on an earned income base of $11,125 and overpaid social security taxes by $164. The classifier did not identify this error. His checksheet to the examiner indicated "medical and dental expenses" and "entertainment and travel expenses" as the audit issues. The examiner addressed these issues during the audit examination, but did not apply the business expenses against gross self-employment income to correct the taxpayers SECA tax computation error.

1/By not paying its $380 share of FICA tax on the $6,500 commission income, the corporation's expenses were $380 less than they otherwise would have been, and its taxable income that much more. At the corporate tax rate of 48 percent, the increase in taxable income added $182.40 to the taxes paid to the general revenues.

District office officials' comments

The audit division chief said that tax auditors are expected to examine only the issues identified by the classifiers. However, he said that more experienced tax auditors would identify additional tax issues on their own. He also stated that the classifiers who prepared the check-sheets instructing the auditors what to examine should have identified the SECA tax issues.

The quality review staff chief said that he would not expect his staff to identify and correct the social security tax errors we described because most of the errors were not significant. He said that his staff reviews the quality of the audit performed in terms of the issues pursued during the examination. He said that normally the quality review staff would not raise questions on errors not addressed in the examination unless they were very significant--involved large tax dollar amounts or involved an error that would be repetitive from one year to the next. Additionally, the problem of employers who fail to withhold social security tax from income paid to workers is addressed in audits of employers under the package audit concept. Under this concept, when a business tax return is audited, the auditor is to check both that FICA social security tax has been paid on all employees and that employees are not being treated erroneously as self-employed persons. IRS also performs employment tax audits, independent of package audits, which address these same issues.

In addition to using its package audits and employment tax audits to determine that employers have properly classified their employees, IRS should also look at the social security tax issue when it audits returns with schedule SE's.

Erroneous payments of SECA tax on FICA income not addressed by service center examiners

Returns with schedule SE's attached were audited by service center examiners for reasons other than the fact that an error was present in the taxpayer's computation and payment of social security tax. If the return was audited under the unallowable items program--as 78 percent of all service center audited returns were--only items on the return which appeared to be obviously unallowable by

law were audited. If the return was audited under the head of household program, then only this tax issue was examined.

During these audits, some adjustments were made to the SECA tax paid by the taxpayer. These SECA tax adjustments resulted from the examiner changing items in the return which increased the taxpayer's net self-employment income. Therefore, the auditor recomputed the SECA tax owed by the taxpayer.

The service center auditor's examination of the 154 returns in our sample with schedule SE's attached resulted in SECA tax adjustments for 17 individuals. The adjustments were incorrect in three instances. The three incorrect adjustments involved IRS increasing the amount of SECA tax the taxpayer paid (1) on FICA income, (2) on exempt income, and (3) in excess of the amount of tax owed. In addition, 14 other returns reflected SECA tax errors (described below) which IRS examiners did not identify during their audit of the return.

Type of error	Number of returns
SECA tax paid on FICA income	3
SECA tax paid on income exempt from social security tax	2
SECA tax paid in excess of amount owed	6
Underpayment of the amount of SECA tax owed	3

An example of SECA tax being paid on FICA income:

Taxpayer C reported $2,584 in wages earned as a domestic on which FICA tax had been withheld. In addition, the taxpayer reported $600 earned as a domestic on which FICA tax had not been withheld. The taxpayer erroneously computed and paid $48 in SECA tax on this latter amount. The service center audited the taxpayer's return because the tax table used in the computation of the income tax did not agree with the taxpayer's filing status. The examiner did not question the erroneous payment of SECA tax on the FICA income.

Errors not identified because of single tax issue programs

The SECA tax errors were not identified because of the single issue programs under which the returns were audited. These programs, although not intended to correct SECA tax errors, served their purpose by providing IRS an opportunity to correct small errors which were considered too costly to correct through a full-fledged district office audit.

The programs, however, also provide IRS with an opportunity to review the social security tax issue. Classifiers review returns with attached schedule SE's--identified for audit under the various service center programs--to determine if the returns warrant audit. During their review of the returns, classifiers could also consider the social security tax issue to determine if the correct tax has been paid. Such reviews could be limited to obvious social security tax errors. The identified returns could then be audited by service center examiners under the social security audit program discussed on page 12.

Service center officials' comments

Officials at two service centers said that they believed a verification of self-employment tax could be made when returns with schedule SE's attached were reviewed by classifiers. The officials stated that approval for such a verification would have to come from the national office. In addition, they said that if classifiers were required to consider social security type errors during their review of each return, it would take longer and could reduce the total number of returns they could classify for each of the programs. Similarly, if examiners were required to consider this tax issue, it would reduce the number of returns they could audit.

CONCLUSIONS

The errors we identified on individual 1974 tax returns with attached schedule SE's indicated that social security tax compliance is a problem of greater magnitude than can be effectively controlled by IRS through its package audit concept and employment tax audits. This is not a criticism of the package audit concept or employment tax audits. Rather, the problem of ensuring that taxpayers are paying correct social security tax requires that more be done than can be accomplished through auditing employers.

IRS management must deal with those taxpayers whose returns have not been selected for a full audit. IRS should, on a test basis, implement a new program at several of its service centers to identify obvious instances of SECA tax errors. The program could operate similarly to other service center audit programs that have proven successful. If such a program proves cost effective, it could be expanded to other service centers. Such a program, in conjunction with IRS' other audit efforts, could do much to eliminate the problem of taxpayers' paying the wrong type and amount of social security taxes.

In addition to the problem of social security tax errors on returns not selected for audit, neither the district office nor the service center audits of individual tax returns adequately ensure that the correct social security tax in the right amount has been paid by the taxpayers. Most of the errors IRS auditors failed to identify on returns with schedule SE's attached involved payment of SECA tax on FICA income or incorrect adjustments in computing the tax. The errors were missed during district office audits of the returns because tax auditors (1) relied on classifiers to identify all audit issues and (2) were not required by manual procedures to verify the self-employment income and self-employment tax liability.

Management may have identified and corrected these weaknesses if it had a system that effectively pinpointed problem areas. The district quality review staff provides the mechanism for such a system. Since the value of a quality review staff lies in its providing management with meaningful and accurate information for assessing audit quality, it is important that the staff identify all errors. By doing this, the staff can report cumulative, systemic error patterns and trends to management. Only then can management appreciate the extent of a quality audit problem and take appropriate corrective action.

Errors on returns with schedule SE's were overlooked during service center audits because of the limited nature of these audits. These returns were examined under one of the service center's programs which had identified other issues for audit. As such, social security tax errors would not be considered under these single tax issue audit programs.

We do not quarrel with the service center carrying out single issue audit programs. These programs met their

objectives by correcting a number of errors in taxpayer returns. However, we believe that IRS should consider verifying that the correct social security tax has been paid when a return with a schedule SE has been identified for audit under one of its programs. Returns in error could be audited under the test program.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS:

--Revise its procedures to require classifiers to look at the self-employment tax issue when identifying areas for audit and to alert district office tax auditors of (1) the potential for problems regarding both the amount of self-employment income reported and the amount of social security tax paid and (2) the need to consider looking at this issue while auditing returns.

--Require quality review staffs to identify and report on all errors so that error patterns and trends are identified and made available for management consideration of program quality.

--Implement, on a test basis to assess cost effectiveness, a service center audit program to identify obvious social security tax errors on returns with attached schedule SE's and expand the program to all service centers should it prove to be cost effective.

INTERNAL REVENUE SERVICE COMMENTS

The Commissioner of Internal Revenue, in a June 13, 1978, letter, stated that IRS agreed with the substance of most of our recommendations. (See app. I.)

IRS agreed to revise its procedures so that classifiers will consider the self-employment tax issue during screening when schedule SE's are attached to returns. The Service will also amplify its instructions to make the results of quality review staff efforts more useful to management.

Regarding our recommendation that IRS implement, on a test basis, a service center program to identify obvious social security tax errors, IRS stated that such a program would not be sufficiently practicable to justify testing. IRS believes social security errors on returns with attached

schedule SE's are too often not obvious ones that are suited to mass production capabilities of service center operations. IRS noted that several examples of the "errors" cited in the report were not ones that could be corrected without securing additional information from taxpayers.

We recognize that it may be difficult in some cases for classifiers to pinpoint some self-employment tax problems. Nevertheless, on the basis of our review, we are still convinced that there are enough errors that should be obvious to experienced IRS classifiers to warrant IRS implementing a program to test the efficiency and effectiveness of using a service center audit program to identify certain social security tax errors.

As noted earlier in this chapter, on the basis of our review we identified 12 percent of the sampled returns as having definite social security tax errors. We did not find it necessary to contact taxpayers to establish that there were definite social security tax errors in any of these cases. In some cases IRS would have to contact taxpayers to determine whether an actual error had been made, but such contact should not preclude IRS from running a test. IRS already has established procedures for contacting taxpayers in its other service center audit programs.

While there may be some problems regarding the extent to which taxpayers would have to be contacted and the extent to which certain errors would be obvious to IRS classifiers, we believe that these problems should not preclude a test of the program. The purpose of a test is to find out the extent to which there are problems and how they could be overcome before undertaking a full-scale program. Thus, our recommendation should be implemented.

CHAPTER 3

INCORRECT SELF-EMPLOYMENT TAXES ARE PAID BECAUSE OF IRS AUDITOR ERRORS

IRS's primary method for determining whether taxpayers are paying the proper amount of taxes--income, social security, unemployment, etc.--is by audit of filed income tax returns. However, the audit of tax returns under the self-employment tax program at IRS service centers does not always ensure that social security taxes have been correctly paid. Our analysis of sample returns showed that

--12,100 audited returns contained social security tax errors and

--12,900 audited returns could contain social security tax errors based upon misclassification of taxpayers.

TAXPAYERS PAID SECA TAX IN ERROR AS A RESULT OF SELF-EMPLOYMENT TAX PROGRAM AUDITS

IRS first used its unallowable items program to handle the problem of taxpayers who reported income from part-time or sideline activities as "other income," but did not pay the SECA tax due on such income. However, experience indicated that service center personnel were not consistently identifying this tax issue. Beginning with the 1974 returns, IRS initiated a separate self-employment tax program at its 10 service centers to deal with the problem. Returns were identified for audit under the program if a schedule SE was not attached to the return and the return reflected potential self-employment income on which SECA tax had not been paid.

During the first year of the program, IRS service centers identified 255,000 individual 1974 tax returns with potential for audit. Service center classifiers determined that 185,500 of the returns did not warrant audit. Another 66,000 returns were selected for audit, while the remaining 3,500 returns had not been reviewed by the classifiers at the time we selected our sample.

To determine the accuracy of IRS SECA tax assessments, we randomly sampled 245 of the 66,000 audited returns on which IRS had collected over $7 million in additional SECA tax. We questioned IRS' SECA tax assessment on 91 returns, determining that IRS was in error on 18 percent of them

(43 of 245) and that another 19 percent could contain errors. In addition, two returns contained errors not identified by IRS auditors.

On the basis of our sample results, we estimate that 12,123 of the 66,000 returns contained social security tax errors. These errors represent erroneous payments of SECA tax by taxpayers of $1.5 million and underpayments of FICA tax by employers of $1.4 million. This represents a net estimated overpayment of $132,000 to the Social Security Trust Fund. Correction of these errors would result in a loss of $326,000 to the general revenue fund because the employers could then deduct their share of FICA as a business expense. The identified errors included:

--Taxpayers being assessed SECA tax on income subject to FICA tax or on income exempt from social security taxes.

--Taxpayers reporting self-employment income but not paying the tax.

In addition, we estimate that another 12,900 could contain social security tax errors based upon misclassification of taxpayers. In these instances, the case files indicated that a social security tax error was made, but there was insufficient information for us or IRS to make a definite determination.

Some of the errors occurred because IRS service center examiners did not follow program procedures in auditing the returns. Other errors occurred because the examiners lacked a good understanding of social security tax issues.

Contrary to procedures, taxpayers were not asked about income source

Internal Revenue Manual procedures for the self-employment tax program require classifiers to identify whether the income in question is subject to SECA tax or if additional information is needed before a determination can be made. If the questioned income is identified as definite self-employment income, examiners are instructed to send a letter and audit report advising the taxpayers of the proposed SECA tax assessment. If the income is classified as possibly from self-employment, examiners are to send a query letter to the taxpayer soliciting additional information about the income's source. If the taxpayer's response does not provide sufficient information, the examiner is

supposed to transfer the case to a district office for further followup.

Service center classifiers, however, generally assumed that earned income not reported as wages or salaries was subject to the SECA tax. As a result, examiners sent the taxpayers a letter and audit report proposing a SECA tax assessment. Of 91 taxpayers in our sample who received IRS' proposal letters and audit reports and paid the SECA tax assessment, only 19 were first sent a query letter. This procedure creates an aura of finality--the taxpayers receive a letter which advises them of IRS' proposed audit assessment, where to sign the audit report if they agree, and how to appeal if they do not agree with the proposed assessment. All 91 taxpayers who received the letter and audit report agreed to pay IRS' proposed assessment, even when the assessment was wrong. For example:

> Taxpayer D reported $1,000 as "other income." His explanation indicated that it was a bonus from his employer who also had paid him $11,884 in FICA wages. The IRS examiner assessed the taxpayer $79 of SECA tax on this bonus, which the taxpayer paid without protest. FICA tax was neither withheld from the bonus nor paid by the employer. The result is that the taxpayer overpaid his social security tax liability on the $1,000 bonus by $20.50 ($79.00 minus $58.50) and the employer did not pay his FICA tax share of $58.50.

For many of the 91 taxpayers, the service center examiners should have questioned the circumstances under which the income was earned. Our review of the returns and case files of these taxpayers revealed that 48 case files did not contain sufficient information for either us or IRS to determine whether the income in question was subject to the SECA tax which IRS assessed. But, on the basis of other indicators in the file, the income apparently was not from self-employment, and therefore the SECA tax may have been paid in error. For example, unlike self-employment income, the income often was earned with no apparent expenses. In other instances, the income was from occupations such as building trades, laborers, janitors, and musicians--sources identified in IRS employment tax training materials as income most likely to be subject to FICA tax.

We discussed IRS' use of letters and audit reports with service center officials who told us that service center audit programs are high volume, minimum contact programs. Officials stated that they believed that if the income was not subject to the tax, the taxpayer will let them know.

We question the validity of this assumption. In most instances, taxpayers apparently did not know whether the income in question was from self-employment, and they believed IRS' proposed assessment was correct. Although the taxpayers had included the income on their return and paid income tax on it, they failed to pay any social security tax. If they were knowledgeable about social security taxes, it seems only logical that they would have paid the appropriate tax. In view of this, IRS' reliance on the taxpayers to make accurate determinations concerning whether SECA taxes are owed is unrealistic.

Greater emphasis needed on social security taxes during training

Shortcomings in the tax auditors' and tax examiners' training programs contributed to their making SECA tax errors. The programs apparently do not provide them sufficient information in the areas of FICA tax noncompliance and income exempt from social security taxes.

Our review of the tax auditor course training material during April 1977 revealed a lack of emphasis on differentiating income subject to FICA tax, SECA tax, or exempt from social security taxes. Although the course allocates 5 hours to self-employment income and social security tax issues, these issues need additional emphasis during presentation of the material. The course defines self-employment income as the net profit from a sole proprietorship or share of partnership income. In addition, interest, dividends, rents, capital gains, and other investment income is defined as not being subject to SECA tax. Although the course material recognizes that SECA tax is due on self-employment income, it does not address the possibility that some employers do not pay FICA tax on their workers' wages and that an employee may have erroneously paid SECA tax on it. Further, the material did not discuss that income from certain nonprofit organizations is exempt from social security taxes and that a taxpayer usually does not pay SECA tax on it. 1/

The social security tax errors which many of the auditors did not identify indicates that they may not have acquired a good understanding of this tax area. Lacking this

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1/Since then, IRS officials told us that both the tax auditor and tax examiner training programs are being revised. As part of the revisions, training materials covering the FICA and SECA tax issues are being reviewed to determine if better coverage should be provided.

understanding, the auditors often do not consider whether the social security tax paid is correct.

Similar to the training material provided tax auditors, the course material presented to service center tax examiners 1/ does not adequately address all aspects of social security taxes. The training material's weakness is highlighted by the type of errors examiners made on returns audited under the self-employment tax program. In the sample cases we reviewed, examiners frequently considered FICA and exempt income subject to SECA tax. Of 43 returns sampled which contained SECA tax errors, 25 returns involved examiners erroneously assessing SECA tax on income earned from such jobs as farm laborers or janitors. Such income is usually considered wages and subject to FICA tax. Eleven returns contained errors due to the examiners assessing SECA tax on income which was exempt from social security taxes. Examples include income earned working for nonprofit organizations or as an executor of an estate. The remaining seven returns involved math errors or procedural errors made by the examiners in computing the SECA tax.

The need for greater emphasis on social security taxes during training is further illustrated through the examiners' use of query letters. As explained on page 24, IRS examiners are supposed to send the taxpayer a query letter requesting information on how the income was earned if it was not clear whether the income was subject to SECA tax. IRS examiners sent query letters to 6 of the 43 taxpayers erroneously assessed SECA tax. On receiving the letter, one taxpayer paid SECA tax on the income in question. The remaining five taxpayers provided IRS with sufficient information to show that the income in question was not subject to the tax. For example, one of the taxpayers replied that his wife had earned the income as the choir director for a local church. The code provides that income earned working for certain nonprofit organizations be exempt from social security taxes or, if the organizations waive the exemption, subject to FICA tax. Apparently unaware of this, the examiner assessed the taxpayer SECA tax on the income.

In discussions with the assistant regional commissioner for audit, the regional training officer, and the chief of compliance training programs concerning the errors we found, they agreed that the tax auditor material emphasizes income

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1/The tax examiner course provides essentially the same social security tax information as the tax auditor course.

tax issues and does not stress social security taxes. The officials said that this is consistent with IRS' approach of fostering employment tax compliance through the package audit concept. That is, when a business, corporate, or partnership return is audited, the examiner is to ensure, by checking expenses for commissions, contract labor, casual labor, etc., that no employees are misclassified. They said that this approach was a more effective way of pursuing the problem.

IRS should improve the reporting of its review of audited returns

Neither the supervisory review nor the more formal quality review carried out by the service centers detected the errors we found on our sample returns. The supervisory review is performed by the section chief who supervises audit division examiners. Formal guidelines for this review do not exist and the practices vary among service centers. For example, one supervisor stated that she reviews one return per examiner per month which could have been audited under any of the service center's audit programs. Another supervisor said he reviewed three to five audited returns per examiner per month.

The results of supervisory reviews are not formally recorded; supervisors keep only temporary records to evaluate the examiners. The review is to determine how well the examiners handled the tax issue identified by the classifier and, for the self-employment tax program, whether the correct social security tax status had been determined. Because formal records were not prepared or maintained, we could not evaluate how well supervisors performed their reviews.

The two supervisors referred to above said that during the first year of the program, examiners had problems differentiating between income subject to SECA or FICA tax. They believe that yearly refresher training and on-the-job training has overcome this shortcoming. In their opinion, the problem of SECA tax being assessed erroneously on FICA or exempt income has been eliminated. However, because reports measuring the quality of service center audit programs are not prepared, the supervisors were unable to substantiate this opinion.

The quality review function is carried out by an independent review staff in the service center audit division. However, during the first year of the self-employment tax program when 1974 returns were audited, this function was performed by the various branches within the audit division. The reviews were performed by the same examiners

(temporarily detailed to review) who performed the audits. Data was not available to evaluate the review staff's finding for the 1974 self-employment tax program returns.

Quality review staffs at the service centers review audited returns from all audit programs. Normally the reviewers only address the audit issue which was dealt with on the return. For the self-employment tax program, however, taxpayer employment status is also considered.

We reviewed the reports currently being prepared by the quality review staff to advise service center managers of the quality of the audit programs. Although quality review reports are one of the primary means for IRS managers to evaluate the quality of service center audit programs, the reports are not required to be submitted to high level IRS managers. Instead, the reports are provided on a regular basis only to branch chiefs within the audit division. A copy of the report is provided to the chief of the audit division only on an exception basis. Unless IRS managers receive information on the results of quality review staff efforts on a systematic basis, they cannot ensure high quality tax return audits. In addition, the reports lack information needed by managers to determine the quality of the audits being performed. The reports are computer printouts which show, on a weekly and on a cumulative year-to-date basis, information on (1) how many returns were reviewed by the quality review staff for each of the audit programs and (2) how many returns had errors. The reports do not include information on the number of errors identified, the number of errors per return, or whether the errors were procedural or technical in nature.

Although the information in the reports is sufficient for IRS to compute an accuracy rate for each of the programs and thus to see whether the rate improves as a program progresses, it is not adequate for IRS managers to evaluate program quality. To so evaluate, information such as we have indicated is needed. Of equal importance to managers is that indicators of program quality will help them to identify problems within the programs and to take appropriate corrective actions.

IRS SHOULD CONSIDER EXPANDING THE SELF-EMPLOYMENT TAX PROGRAM TO INCLUDE FICA TAX PROBLEMS

IRS classifiers at the service centers did not identify returns for audit under the self-employment tax program if the issue involved obvious FICA tax noncompliance. If it was

determined during the audit of a return that the income in question was subject to FICA tax rather than SECA tax, no additional action was taken. Personnel at two service centers said that if enough money were involved, the case might be referred to the appropriate district office in hopes that an audit would be made of the employer. (Employment tax audits are not included in the scope of service center audit programs since they are normally conducted at the employer's place of business.)

By not identifying returns with FICA tax owed the Government, IRS allows employers to continue to not withhold social security tax from the wages they pay their employees. Of the 251,500 returns screened by IRS classifiers for the self-employment tax program, we estimate that as many as 49,300 contained social security tax errors. For example:

> Taxpayer E's return showed "other income" of $1,337. Responding to a service center request, the taxpayer stated that the income was earned working for a law practice under circumstances which made him an employee and that FICA tax had not been withheld from this income nor paid by his employer.

In all likelihood, the service centers look at most returns with nontaxed FICA income. The examiners coding the returns for the self-employment tax program use a list of occupations provided by the national office. The list includes many occupations where the worker is more likely to be an employee than self-employed. Since the income on these returns is being looked at, these returns could be identified for audit under the self-employment tax program if the program were expanded to deal with both SECA and FICA problems. Classifiers could consider both issues when they review returns to determine those which warrant audit. This procedure is feasible because it is currently being done in a limited manner.

For example, officials at one service center said that they had implemented a district office referral program for obvious FICA tax noncompliance problems. Returns with nontaxed FICA income where the employer is identified are referred directly to the appropriate district office for audit. If the employer is not identified, the service center corresponds with the taxpayer to secure the employer's name and then refers the case to the district office. The program only refers cases involving $1,500 or more of nontaxed FICA income. Officials at a second service center stated that

their program refers those cases where taxpayers report "other income" earned from the same companies which have paid them wages on which FICA taxes have been withheld.

It appears that service centers could handle many of the obvious FICA tax issues, thus precluding those cases from being sent to district offices. Service centers could (1) identify the employer and (2) send a letter and audit report explaining the tax issue and requesting the FICA tax owed be paid. This procedure would be essentially the same as that used to request additional tax due from taxpayers. This effort by IRS should be successful because the returns contain clear-cut employer errors. Of the audited and non-audited sampled returns we reviewed with improper treatment of FICA wages, 75 percent involved income which was earned in an employer-employee relationship as defined by the code or IRS revenue rulings. The remaining 25 percent of the returns involved situations where an elementary application of the common law factors was required. An IRS employment tax specialist agreed with our classification of the income in the returns as wages. As such, only the more complex cases would need referral to district offices.

With the significant increase in social security taxes to be paid by employers and employees in the coming years, this FICA tax problem will become even more significant. Our suggestion may be one method IRS can use to effectively control the problem.

CONCLUSIONS

The self-employment tax program is a good program for identifying "other income" subject to social security tax which has not been paid. The program can be more effective, however, if IRS examiners become more aware of the various social security tax situations and if they do not rely on taxpayers as the means to ensure that social security tax payments proposed are correct. Many of the program errors we identified were attributable to examiners' lack of awareness of social security tax matters. Other errors resulted because the examiners did not follow program procedures which required them to determine that the income was definitely from a self-employment occupation before sending a letter for a SECA tax assessment.

Furthermore, a review of "other income" reflected in some returns is an excellent means of identifying income subject to FICA tax. Those returns indicating nontaxed FICA income should be audited by the service center and,

if necessary, the return sent to the district office for a more complete tax audit. The referral program being implemented by two service centers appears to be a first step and, if properly implemented, could do much to control the problem of nontaxed FICA income.

To adequately assess and control the quality of service center audit programs, IRS needs to improve its reporting of quality review efforts and to more effectively use the evaluative information that quality reviews can provide. Quality review reporting was inadequate because the reports did not contain information necessary to evaluate the quality of service center audit programs. These reports can be improved by including information on the number and type of errors identified and the number of errors per return.

To obtain the proper benefit from quality review reports, IRS must ensure that management at all appropriate levels is apprised of the results of their efforts. Unless it has knowledge of these matters, management cannot adequately assess either the quality of service center audit programs or the adequacy of any quality control efforts.

Concerns over the Social Security Trust Fund's future solvency and the enormous increase in social security taxes during the next decade require IRS corrective actions.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that IRS:

--Instruct its service center tax auditors and examiners to follow the existing self-employment tax program procedure of sending a query letter to taxpayers requesting additional information about the source of income in question.

--Revise tax auditor and examiner course material to provide more training in social security tax problems. Specifically, such training should include differentiating between FICA, SECA, and exempt income on returns where income has been reported but no social security tax paid.

--Expand the self-employment tax program to include returns reporting "other income" subject to FICA social security tax.

--Specify the factors to be included in the service center quality review program audit reports and require the quality review staffs to send reports on their review efforts to appropriate management officials.

INTERNAL REVENUE SERVICE COMMENTS

IRS agreed with all of the above recommendations and will take action which, if effectively implemented, should solve the respective problems.

COMMISSIONER OF INTERNAL REVENUE
Washington, DC 20224

JUN 13 1978

Mr. Victor L. Lowe
Director
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Lowe:

We appreciate the opportunity to review your draft report entitled "Additional IRS Actions Are Needed to Assure That Individuals Pay the Correct Social Security Tax." The findings and recommendations have received careful consideration.

I hope our attached comments will be useful to you. As you will note, we agree with the substance of most of your recommendations.

With kind regards,

Sincerely,

GAO Draft Report, Pages 12 and 13

The draft report reflects GAO estimates of errors derived from small samples of returns.

IRS Comment

In general, GAO's sampling approach appears to have been valid, although the resulting estimates may be on the conservative side because some categories of returns were not sampled. The estimates of total magnitude are also subject to a large potential "sampling error," due to the small sample size used, as indicated in GAO's draft Appendix II entitled "Statistical Projections of Social Security Tax Errors."

APPENDIX I

GAO Draft Report, Page 26, Recommendation 1

"We recommend that IRS. . .revise its procedures to require classifiers to look at the self-employment tax issue when identifying areas for audit and alert district office tax auditors of the potential for problems regarding the amount of self-employment income reported and the amount of social security tax paid and of the need to consider looking at this issue when auditing returns."

IRS Comment

We agree with this recommendation and will revise the Internal Revenue Manual to provide that classifiers consider the self-employment tax issue during screening when Schedule SE is attached to returns.

GAO Draft Report, Page 26, Recommendation 2

"We recommend that IRS. . .require quality review staffs to identify and report on all errors so that error patterns and trends are identified and made available for management consideration of program quality."

IRS Comment

Our instructions in IRM 4412.2 provide for identifying and reporting on all errors. However, we will amplify those instructions to require that correction and advisory reports (Forms 3990) be analyzed quarterly to identify error trends and patterns, including failure of classification to identify items for examination. The results of the analysis will be provided to management for use in evaluating the return classification and examination activities.

GAO Draft Report, Page 26, Recommendation 3

"We recommend that IRS. . .implement, on a test basis to assess cost/effectiveness, a service center audit program to identify obvious social security tax errors on returns with attached Schedule SE's and expand the program to all service centers should it prove to be cost/effective."

IRS Comment

Our judgment, on balance, is that such a program would not be sufficiently practicable to justify testing. The social security errors on returns with attached Schedules SE are too often not obvious ones suited to the mass production capabilities of service center operations. For example, several of the "errors" cited on pages 16[1/], 19[2/], and 34[3/] of the GAO draft report are not obvious ones that can be adjusted without securing additional information from taxpayers. Whether SECA tax should be paid on rental income, interest income, partnership income, clergy income, officers commissions, or executor's commissions, is not a black and white determination that can be made simply by scanning the return.

We do agree that we should do more to deal with the obviously erroneous use of the optional method of computing SECA tax, which you point out. We will explore the possibility of using code and edit personnel to identify returns on which taxpayers have incorrectly used the optional method, so that these errors can be corrected during returns processing.

1/ The draft report states on page 16 that most of the errors identified by GAO involved such things as "SECA tax paid on lease or rental, interest. . .and other exempt income. . .[and] SECA tax not being paid on self-employment income from clergy fees and partnerships."

Although lease and rental income not received in a trade or business is generally exempt from SECA, section 1402(a)(1) of the Code provides that such income is subject to SECA if there is material participation by the owner in the production, or management of the production, of agricultural or horticultural commodities. Because of this exception, as well as the possibility that the taxpayer may have received lease or rental income in a trade or business (even though reported on other than Schedule C or F), tax examiners at the service centers cannot make a determination, simply by looking at the return, that lease or rental income was incorrectly treated as self-employment income.

Similarly, although the general rule is that interest income is not self-employment income, section 1402(a)(2) of the Code provides that interest is self-employment income if received in the course of a

trade or business as a dealer in stocks or securities. It may not be obvious, simply from looking at a return, that the taxpayer is not a dealer in securities.

Although the clergy are generally subject to SECA, it is conceivable that some of the "errors" found by GAO involved clergyman who are exempt from the self-employment tax by reason of filing a Form 4361 under the provisions of section 1402(e) of the Code.

Also, although partnership income is generally subject to SECA, sections 1402(a)(10) and (12) of the Code--effective for taxable years beginning after December 31, 1977--provide that certain forms of partnership income are not subject to SECA.

2/ The draft report, on page 19, refers to a Taxpayer A, an official of a corporation, who reported $1,375 of FICA wages and $6,500 of commissions from that corporation. The IRS auditor did not challenge the taxpayer's treatment of the commissions as self-employment income. On these facts, the GAO draft report concludes that IRS erred in not reclassifying the commissions as wages.

There is, however, the possibility that the commissions might be correctly reported by the taxpayer as self-employment income, even though received from the same corporation that paid him wages. In Rev. Rul. 58-505, 1958-2 C.B. 728, it is held on the basis of the facts stated therein that an individual who serves a corporation in two different capacities, as an officer as well as a salesman, is an employee in his function as an officer but self-employed in his sales function for the same corporation.

3/ The draft report, on page 34, notes that examiners erroneously assessed SECA tax on income which was exempt from social security tax, and mentions as an example income earned as an executor of an estate.

There are some conditions under which a nonprofessional executor should be treated as self-employed. Revenue Ruling 58-5 1958-1 C.B. 322 outlines such conditions.

GAO Draft Report, Page 42, Recommendation 1

"We recommend that IRS. . .instruct its service center tax auditors and examiners to follow the existing self-employment tax program procedure of sending a query letter to taxpayers requesting additional information about the source of income in question."

IRS Comment

We agree with this recommendation, and will remind all service center audit divisions that the procedures in IRM 4(13)(16)4:(2) must be followed when income reported on the tax return is not readily identifiable as self-employment income. These procedures provide for sending a letter to the taxpayer to solicit additional information regarding the source of the income before proposing an adjustment to self-employment tax.

GAO Draft Report, Page 42, Recommendation 2

"We recommend that IRS. . .revise tax auditor and tax examiner course material to provide more training in social security tax problems. Specifically, such training should include differentiating between FICA, SECA and exempt income on returns where income has been reported but no social security tax paid."

IRS Comment

We basically concur with this recommendation.

The current tax auditor training program includes classroom instruction covering FICA, FUTA, SECA, employer/employee relationships, and procedures that a tax auditor follows when examining an employment tax issue. The course also addresses the likelihood that more employers are shifting workers from the classification of employee to self-employed.

The tax examiner training program covers self-employment tax and application for exemption from self-employment tax.

Both the tax auditor and tax examiner courses are being revised. The issue of income subject to neither SECA nor FICA will be included in the revisions, and examiners will be advised that employees sometimes pay SECA tax on income subject to FICA. As part of these revisions, we will review the training materials to determine if they should be expanded to give more coverage to FICA and SECA taxes.

APPENDIX I

GAO Draft Report, Page 42, Recommendation 3

"We recommend that IRS. . .expand the self-employment tax program to include returns reporting 'other' income subject to FICA social security tax."

IRS Comment

We will explore the feasibility of implementing this recommendation by conducting a test to determine whether we can develop adequate identification criteria and to assess the cost effectiveness of the recommended expansion. As part of our existing self-employment tax program at service centers, we will attempt to identify returns on a test basis where the taxpayer has reported "other" income which might be subject to FICA tax. These returns will be transferred to the districts where contact will be made with the employer/payor to determine if an employer/employee relationship exists, and if the employer has responsibility for paying the additional FICA tax.

APPENDIX I

GAO Draft Report, Page 42, Recommendation 4

We recommend that IRS. . .specify the factors to be included in the service center quality review program audit reports and require the quality review staffs to send reports to appropriate management officials."

IRS Comment

A revision to IRM 4(13)CO, Audit Operations at Service Centers, is now in process to establish technical and quality review staffs in the service center audit divisions. The independent review staff will report directly to the Chief, Audit Division (Service Center). This revision also establishes guidelines for a manual reporting system providing data for each correspondence audit program until a mechanized review reporting system is implemented. The manually-prepared report will show the number of returns reviewed, the number of returns on which a Form 3990 (Correction Report) was issued disclosing a tax or income change, and the error rate.

We will provide instructions in the IRM requiring service center review staffs to prepare an analysis of correction reports when the error rate for any program exceeds a pre-established alarm rate. This analysis will show the type of errors made and whether they were technical or procedural. The analysis will be sent to the Chief, Audit Division, (Service Center), for consideration in determining corrective action.

SOCIAL SECURITY RATE SCHEDULE

1971 to 1987

Calendar year	Maximum taxable income	SECA Tax rate percent	SECA Maximum tax	FICA (note a) Tax rate percent	FICA (note a) Maximum tax
1971	$ 7,800	7.5	$ 585.00	10.4	$ 811.20
1972	9,000	7.5	675.00	10.4	936.00
1973	10,800	8.0	864.00	11.7	1,263.60
1974	13,200	7.9	1,042.80	11.7	1,544.40
1975	14,100	7.9	1,113.90	11.7	1,649.70
1976	15,300	7.9	1,208.70	11.7	1.790.10
1977	16,500	7.9	1,303.50	11.7	1,930.50
1978	17,700	8.1	1,433.70	12.1	2,141.70
1979	22,900	8.1	1,845.90	12.26	2,807.54
1980	25,900	8.1	2,097.90	12.26	3,175.34
1981	29,700	9.3	2,762.10	13.3	3,950.10
1982	31,800	9.35	2,973.30	13.4	4,261.20
1983	33,900	9.35	3,169.65	13.4	4,542,60
1984	36,000	9.35	3,366.00	13.4	4,824.00
1985	38,100	9.9	3,771.90	14.1	5,372.10
1986	40,200	10.0	4,020.00	14.3	5,748.60
1987	42,600	10.0	4,260.00	14.3	6,091.80

a/Combined employer/employee rate.

STATISTICAL PROJECTIONS OF SOCIAL SECURITY TAX ERRORS

To obtain statistically reliable data on the extent to which individual taxpayers and employers were making SECA and FICA tax errors on a national basis, IRS randomly selected for us

--247 of the 5,785,302 tax year 1974 individual returns with attached schedule SE's not audited,

--258 of the 109,659 tax year 1974 individual returns with attached schedule SE's which were audited, and

--245 of the 66,004 tax year 1974 individual returns audited under the self-employment tax program.

These returns were identified from IRS' individual master file as of April 30, 1976. We reviewed the returns to identify incorrect or nonpayments of SECA tax and FICA tax.

Our review of the sample returns showed that 29 of the 247 returns with schedule SE's which were not audited contained social security tax errors, 27 of the 258 returns with schedule SE's which were audited contained social security tax errors, and 45 of the 245 returns which were audited under the self-employment tax program contained social security tax errors. An IRS employment tax specialist agreed with our findings.

To determine the revenue effect of the errors for each of the three samples, we totaled the income erroneously taxed and/or not taxed for the various categories of errors. We then multiplied these amounts by the applicable social security tax rates to obtain the total amounts of the social security tax errors.

We made our projections using the simple blow-up procedure. For the amounts projected, we found the mean dollar amounts per case in each sample. We then multiplied the mean dollar amounts by the number of cases in the universes to show universe estimates. The same procedure was used to estimate the number of returns with social security tax errors in the three universes. Details follow.

Schedule SE returns not audited

For the 29 returns, the errors consisted of erroneous payment of $1,783 of SECA tax on FICA income, nonpayment of $1,320 of employers' share of FICA tax, nonpayment of $1,320 employees' share of FICA tax, nonpayment of $1,490 of SECA tax on self-employment income, and erroneous payment of $956 of SECA tax on exempt 1/ income. The employers' share of FICA tax is deductible as a business expense for income tax reporting purposes. The erroneous payment of SECA tax on FICA income and exempt income should have been refunded. We computed the revenue effect of the errors on the 29 returns as follows.

FICA tax not paid:			
Employers' share		$1,320	
Employees' share		1,320	
			$2,640
SECA tax paid in error:			
Paid on FICA income	($1,783)		
Paid on exempt income	(956)		
		($2,739)	
Less: SECA tax not paid		1,490	
			(1,249)
Net additional deposits due to trust fund			$1,391
Refund from general revenue for FICA tax deduction by employers (.48 of employers' share)			$(634)

Projecting the 29 errors, we estimate that 679,200 of the 5.8 million nonaudited returns contained social security tax errors. Projecting the dollar amounts of the errors, we estimate an overpayment of $29.3 million of SECA tax by individual taxpayers and an underpayment of $61.8 million of

1/For report purposes, exempt income includes all situations where SECA tax was overpaid. This includes mathematical errors and improper adjustments in addition to payment of SECA tax on earned income exempt from social security tax.

FICA tax by employers. These two amounts represent an estimated $32.6 million underpayment to the trust fund. The estimated refund from general revenue for the employers' FICA tax deductions is $14.8 million.

The sampling errors follow.

Returns with attached schedule SE's not audited	Social security tax payments Mean		Sampling errors
	(millions)		
Net amount of FICA tax underpaid	$61.849	±	$56.568
Net amount of SECA tax overpaid	29.250	±	52.339
Underpayment to the Social Security Tax Fund	32.595	±	39.923
Amount refundable from -general revenue because employer's share of FICA tax is a deductible business expense	14.843	±	13.576

Schedule SE returns audited

For the 27 returns, the errors consisted of erroneous payment of $1,769 of SECA tax on FICA income, nonpayment of $1,252 of the employers' share of FICA tax, nonpayment of $1,310 of the employees' share of FICA tax, nonpayment of $667 of SECA on self-employment income, and erroneous payment of $2,069 of SECA tax on exempt income. The employers' share of FICA tax is deductible as a business expense, and the erroneous payment of SECA tax on FICA and exempt income should have been refunded. We computed the revenue effect of the errors on the 27 returns as follows.

FICA tax not paid:			
Employers' share		$1,252	
Employees' share		1,310	
			$ 2,562
SECA tax paid in error:			
Paid on FICA income	$1,769		
Paid on exempt income	2,069		
		$3,838	
Less: SECA tax not paid		667	
			$(3,171)
Net refunds due from trust fund			$(609)
Refund from general revenue for FICA tax deduction by employers (.48 of employers' share)			$(601)

Projecting the 27 errors, we estimate that 11,500 of the 109,700 audited returns with schedule SE's contained social security tax errors. Projecting the dollar amount of the errors, we estimate a net overpayment of $1.347 million of SECA tax by individual taxpayers and an underpayment of $1.088 million of FICA tax by employers. These two amounts represent an estimated $259,000 overpayment to the trust fund. The estimated refund from general revenue for the employers' FICA tax deduction is $255,000.

Sampling errors follow.

Returns with attached schedule SE's audited by IRS	Social security tax payments Mean	Sampling error
	(millions)	
Net amount of FICA tax underpaid	$1.088	± $1.061
Net amount of SECA tax overpaid	1.347	± 1.018
Overpayment to the Social Security Trust Fund	.259	± .812
Amount refundable from general revenues because employer's share of FICA tax is a deductible business expense	.255	± .255

Self-employment tax program audits

For the 45 returns, the errors consisted of erroneous payment of $3,400 of SECA tax on FICA income, nonpayment of $2,518 of the employers' share of FICA tax, nonpayment of $2,518 of the employees' share of FICA tax, nonpayment of $41 of SECA tax on self-employment income, and erroneous payment of $2,167 of SECA tax on exempt income. Once again the employers' share of FICA tax would have been deductible as a business expense for income tax reporting purposes. Also the erroneous payment of SECA tax on FICA and exempt income is refundable. We computed the revenue effects of the errors on the 45 returns as follows.

FICA tax not paid:			
Employers' share		$2,518	
Employees' share		2,518	
			$ 5,036
SECA tax paid in error:			
Paid on FICA income	$3,400		
Paid on exempt income	2,167		
		$5,567	
Less: SECA tax not paid		41	
			5,526
Net refunds due from trust fund			$(490)
Refund from general revenue for FICA deduction by employers (.48 of employers' share)			$(1,209)

Projecting the 45 errors, we estimate that 12,100 of the 66,000 returns contained social security tax errors. Projecting the dollar amounts of the errors, we estimate an overpayment of $1.489 million of SECA tax by individual taxpayers and an underpayment of $1.357 million of FICA tax by employers. These two amounts represent an estimated $132,000 overpayment to the trust fund. The estimated refund from general revenue for the employers' FICA tax deduction is $326,000.

Sampling errors follow.

Returns audited under the self-employment tax program	Social security tax payments Mean	Sampling error
	(millions)	
Net amount of FICA tax underpaid	$1.357	± $ .787
Net amount of SECA tax overpaid	1.489	± .726
Overpayment to the Social Security Trust Fund	.132	± .579
Amount refundable from general revenues because employer's share of FICA tax is a deductible business expense	.326	± .189

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