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TAX ADMINISTRATION

Profiles of Major Components of the Tax Gap

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The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

In response to your June 21, 1989, request for information on the Internal Revenue Service's (IRS) gross tax gap estimates for 1987, this briefing report reflects information provided to the Subcommittee in a December 15, 1989, briefing. IRS defines the gross tax gap as the difference between the amount of income tax that taxpayers owed and the amount they voluntarily paid. IRS estimated this tax gap to be $84.9 billion for 1987, the most recent year of IRS' estimates.

The 1987 estimate and our analysis of it compared with IRS' past estimates have been used in congressional hearings and other forums to debate IRS' enforcement programs and budgets.[1] Since IRS' estimates provided little descriptive information beyond identifying components of the gap and related dollar amounts, you asked us to compile detailed information on four major components, which accounted for $45 billion of the 1987 gap. These components are (1) sole proprietors, or those reporting business income on a Schedule C of an income tax return, (2) informal suppliers, or those operating on a cash basis without formal books and records, (3) small corporations, or those with assets under $10 million, and (4) large corporations, or those with assets of $10 million or more. For each component, we compiled information on the types of taxpayers who were noncompliant, issues of noncompliance, IRS' enforcement programs to pursue noncompliance, and ways in which IRS could better pursue it.

BACKGROUND

IRS' mission is to collect the proper amount of tax revenue at the least cost to the public and in a manner that warrants the highest degree of public confidence in the tax system. To help do this, IRS periodically attempts to measure the extent of noncompliance with tax laws. The resulting tax gap estimate provides insights on challenges IRS faces in collecting taxes that are not voluntarily paid.

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[1] Tax Administration: IRS' Tax Gap Studies (GAO/GGD-88-66BR, Mar. 25, 1988).

IRS periodically updates its tax gap estimates to reflect the impact of new tax legislation, the availability of current data, and improved estimating methods. To date, IRS' estimates have been limited to income taxes. In an estimate planned for completion in 1990, IRS will incorporate other types of taxes, such as employment taxes.

Since the tax gap estimates rely on IRS' examinations of tax returns, the accuracy of the estimates relies on the quality of the examinations. For example, IRS based estimates for sole proprietors and small corporations on results from its Taxpayer Compliance Measurement Program (TCMP), which uses detailed examinations across a random sample of taxpayers. IRS based the estimate for large corporations on detailed examinations in its Coordinated Examination Program (CEP), which uses teams of examiners and specialists. IRS could not use examinations to estimate informal suppliers' noncompliance since little documentation existed to identify unreported income among those who operate on a cash basis.

While IRS used examinations for its estimates where possible, its tax gap report does not allow for detailed analyses on the nature of noncompliance. This is because the estimate for each component excludes information on the types of taxpayers or noncompliance involved. As a result, IRS' report does not have data, for example, on the $5.2 billion estimate for small corporations by type of business or by type of noncompliance, such as which deductions are overstated the most.

RESULTS IN BRIEF

The components of the estimated tax gap for 1987 differ in the types of noncompliance and the taxpayers who were noncompliant. For example, IRS' estimates show that sole proprietors have extensive amounts of unreported income, while large corporations, for the most part, report their income but improperly allocate it among their foreign and domestic operations. Across the components, factors responsible for the noncompliance include the absence of third-party reporting and withholding on business transactions of small businesses and the complexity or vagueness of the nation's tax laws.

Although IRS' enforcement programs generally are not designed to pursue specific tax gap components, the programs do pursue the general examination program, (2) by specific types of taxpayers, such as sole proprietors through the special examination program, and (3) for specific types of noncompliance, such as unreported income through the document-matching program. This program matches individuals' income as reported on income tax returns and on information returns, which third parties, such as banks, send to IRS to report payments to individuals. Even so, each program has limitations. For example, the document-matching program covers payments to individuals but not corporations, since information returns are not required on payments to corporations.

IRS, GAO, and others have proposed ways to improve enforcement. For example, we recommended that IRS develop a business document-matching program to, among other things, identify corporations' unreported income.[2] IRS is studying the program's feasibility for implementation in 1991. An IRS official suggested working with state and local authorities to verify that informal suppliers who apply for business licenses have filed tax returns. Highlights of the four components follow with details provided in appendixes III and IV.

ANALYSIS OF THE MAJOR TAX GAP COMPONENTS

Sole Proprietors--Unreported Income of $16.6 Billion

Sole proprietors underpaid 23 percent of their tax liability, reflecting both unreported income as well as overstated business deductions. They included those who provided services, such as doctors, lawyers, or accountants; who produced goods, such as manufacturers; and who sold goods at fixed locations, such as car dealers and grocers. While sole proprietors with the least income had lower amounts of unreported income than other sole proprietors, their percentage of unreported income was greater. This was particularly apparent for sole proprietors in fixed-location sales and in transportation.

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[2]The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987).

Informal Suppliers--Unreported Income of $7.7 Billion

Because informal suppliers often operate on a cash basis, their income is not documented in formal books and records. Their income also is unlikely to be subjected to third-party reporting. The types of informal suppliers who account for the largest parts of this tax gap are those who make home repairs, provide child care, or sell food at roadside stands.

Small Corporations--Unreported Income and Overstated Deductions of $5.2 Billion

Small corporations are those with under $10 million in assets. Their noncompliance was about equally divided between unreported income and overstated deductions, such as for depreciation and repairs. The smaller a corporation's asset size, the greater its percentage of noncompliance, especially for those in services or retail sales.

Large Corporations--Improperly Accounted for Income or Expenses of $15.8 Billion

The noncompliance of large corporations, those with $10 million or more in assets, generally involves the improper accounting of reported income and deductions rather than unreported income. For example, a large corporation may misallocate income between its foreign and domestic subsidiaries or misstate the period over which assets should be depreciated or expensed. The large corporations with the highest noncompliance, as identified in IRS' examinations, were those in the petroleum and banking industries.

Research on Reasons for Noncompliance--Not Conclusive

Research by IRS and others has not been conclusive on the reasons that these taxpayers were noncompliant. Further, the reasons vary somewhat by component. For sole proprietors and small corporations, the tax gap was attributed to the complexity of tax laws and intentional noncompliance to survive in competitive business environments. The lack of wage withholding for sole proprietors and information reporting for payments made to corporations also may contribute to the tax gap. Large corporations also may not comply because of vagueness in tax laws, such as exactly which expenses are deductible in calculating the research credit. Informal suppliers may not report income because their transactions often occur in cash, are not documented, and are not subjected to third-party controls, such as wage withholding or information reporting.

IRS USES ENFORCEMENT PROGRAMS TO IMPROVE COMPLIANCE

The most common IRS enforcement program, known as the general examination program, involves examinations of income tax returns from all types of taxpayers. IRS also has special examination programs at both national and district office levels to look at returns from specific types of taxpayers who have exhibited high degrees of noncompliance. In addition, IRS has a computer program to match individuals' tax returns against information returns to identify those who do not report all of their income or file their tax returns.

IRS' enforcement programs have been critical to its efforts to improve compliance. While IRS officials believe the programs have been effective in reducing noncompliance, each program has limitations. For example, because of resource constraints, IRS has been doing fewer examinations under its general examination program, which has lowered the examination rate to about 1 percent of all tax returns filed by individuals. IRS' information returns program, while used extensively to identify individuals' unreported income, has not expanded to include payments to businesses, such as corporations. IRS has ongoing initiatives to improve the enforcement programs. For example, IRS has a special examination program to concentrate on probing for unreported income in examinations of sole proprietors. In addition, IRS is testing the feasibility of using information returns to identify unreported income by sole proprietors, partnerships, and corporations.

PROPOSALS FOR HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

GAO, IRS, and others have suggested ways to improve tax compliance. While many of these ideas are not specifically directed at the four components, they still have potential for reducing the tax gap. For example, we recommended using information returns to identify other types of noncompliance, like misclassifying employees as independent contractors, which may result in taxes not being withheld from these workers' income and not being reported by them. Others, such as participants at an American Bar Association tax compliance seminar, have proposed information reporting on payments by households, and withholding on certain payments, such as interest and dividends. Another idea, raised by an IRS Assistant Commissioner, favored getting assistance from state and local authorities to verify that federal tax returns have been filed by sidewalk vendors or other informal suppliers who are seeking licenses for businesses.

OBJECTIVE, SCOPE, AND METHODOLOGY

As agreed with the Subcommittee, our objective was to compile information on the four major components--sole proprietors, informal suppliers, and small and large corporations--that IRS included in its most recent tax gap report. IRS' estimates for these components include unreported income and overstated business deductions, but exclude unpaid taxes due to nonfilers. Although this report provided dollar estimates for 1987 on each component and explained how the estimates were computed, IRS did not intend for the report to have detailed information, such as the types of taxpayers who were noncompliant or types of enforcement programs to reduce noncompliance.

Because our objective was to compile detailed information on the four components and not to redo IRS' estimates, we asked IRS for the most recent data that had the details we needed. We used various sources within IRS to collect the best data available on the components. For the sole proprietor and large corporation components, these data were more current than those available to IRS when it estimated the tax gap.

IRS officials responsible for the estimates or enforcement programs provided information on IRS' various enforcement programs, as well as legislative or administrative proposals for more effectively reducing noncompliance in these or other components of the tax gap. We reviewed GAO reports and studies by others, such as the American Bar Association, to also identify ways to improve IRS' programs. Since we did not evaluate the ideas proposed by IRS and the others, we are not endorsing or recommending them but include them to assist the Subcommittee to further debate ways in which IRS could better pursue noncompliance and thereby reduce the tax gap.

We discussed our approach with IRS officials who estimated the tax gap and provided most of the data we used. They said our approach was acceptable. Appendix I describes more fully our objective, scope, and methodology. We did our work between July 1989 and December 1989 in accordance with generally accepted government auditing standards.

AGENCY COMMENTS AND OUR EVALUATION

In a February 28, 1990, letter, the Commissioner of the Internal Revenue provided comments on a draft of this report in which he clarified the tax gap estimates and further explained initiatives IRS has under consideration or underway to address the tax gap. (See app. IX.)

The Commissioner noted that for the sole proprietor component our figures do not agree with IRS' tax gap estimate. He stated that IRS' $16.6 billion estimate derived from 1982 TCMP data differs from the $7.4 billion in underreported taxes based on the 1985 TCMP data used in our analysis. He observed that IRS adjusts its tax gap estimate for sole proprietors upward to account for unreported income that its TCMP examinations did not detect. We did not intend to use the 1985 TCMP data to compute a new tax gap estimate and agree with IRS that these numbers should differ. Rather, we relied on these data to provide a more up-to-date picture of the nature of noncompliance by sole proprietors. We have discussed the comment in appendix I to further clarify that we did not intend to compute a tax gap estimate.

The Commissioner said IRS' estimate was more comprehensive because it included all income from sole proprietorship activities. Our analysis, however, used returns where the principal source of income was from sole proprietor activities. We believed that this basis was more appropriate because our goal was to focus on types of noncompliant sole proprietors.

The Commissioner also noted that our draft report did not mention IRS' alternate estimates of the tax gap, which reduce the 1987 tax gap to $71.2 billion due to recommended tax assessments that are conceded in appeals or lost in litigation. He said IRS was studying whether these amounts should cause the tax gap to be lower, particularly for large corporations. IRS needs to determine how much of the amounts lost in appeals or litigation are due to incorrect assessments of noncompliance or to IRS management decisions not to pursue disputed cases for other reasons, such as avoiding the creation of legal precedents. Until the study is completed, we believe it is premature to suggest that a substantial part of the conceded or lost amounts should not be part of the tax gap. When completed, the study can help identify ways to reduce the tax gap--like changes to vague tax law provisions or guidance for examiners to develop support for their decisions--as well as to refine the tax gap estimates.

IRS identified additional initiatives that address the four tax gap components. We have incorporated, as appropriate, these initiatives, such as technical assistance and education provided to small businesses, in the section on how IRS could better pursue noncompliance. (See app. III.) The initiatives that are not targeted to the four components have been included in our list of ideas from GAO, IRS, and others to improve overall compliance. (See app. VI.) Finally, the Commissioner pointed out that later this year IRS will issue a report on the net income tax gap--the gross income tax gap less the amount of income taxes collected from IRS enforcement. This report will also estimate the portion of the net tax gap that would be cost effective to recover with expanded IRS enforcement. As you requested, we will review this report upon its issuance.

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As agreed with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of issuance. At that time, we will send copies of this briefing report to the Commissioner of Internal Revenue and other interested parties. We will also make copies available to others upon request.

Major contributors to this briefing report are in appendix X. If you have questions, please call me on 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

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ABBREVIATIONS

ABA	American Bar Association
CEP	Coordinated Examination Program
GAO	General Accounting Office
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISP	Industry Specialization Program
TCMP	Taxpayer Compliance Measurement Program

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective: To profile the four major tax gap components in 1987 of sole proprietors, informal suppliers, and small and large corporations.

Scope:

-- IRS' data on (a) who was noncompliant, (b) issues of noncompliance, and (c) how IRS pursues noncompliance.

-- Proposals by IRS, GAO, and others on ways to better pursue tax noncompliance.

Methodology: Profiled the best available data.

-- Sole proprietors: IRS' 1985 TCMP data.

-- Informal suppliers: 1985 study by the University of Michigan.

-- Small corporations: IRS' 1980 TCMP data.

-- Large corporations: 1988 and 1989 data on examinations.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to profile major components of IRS' 1987 gross tax gap estimates. The components--selected in meetings with the Subcommittee--include sole proprietors, informal suppliers, small corporations, and large corporations. For each component, we compiled descriptive information on

-- types of taxpayers who were noncompliant,

-- issues of noncompliance identified by IRS,

-- how IRS pursues noncompliance, and

-- how IRS could better pursue noncompliance.

IRS' tax gap report did not provide this descriptive information on the major components of the tax gap. Instead, the report provided gross estimates for each component and generally explained how IRS arrived at the estimate. For example, the report provided a $16.6 billion estimate for unreported income by sole proprietors and explained that the estimate was based largely on 1982 Taxpayer Compliance Measurement Program (TCMP) data. TCMP measures compliance through a random sample of comparable taxpayers based on detailed examinations of selected tax returns.

IRS' report did not have the detailed information because of the aggregations and adjustments it made to compute the overall estimates. For example, IRS aggregated detailed data, such as that from TCMP on the amount of unreported income among all sole proprietors. IRS also made adjustments to the aggregate, such as using a multiplier to account for unreported income that TCMP examinations have difficulty identifying without third-party information--such as information returns from banks.

Because our objective was to compile the detailed information on the four components and not to redo IRS' tax gap estimates, we asked IRS for the most recent, available data that were not aggregated and adjusted. For the sole proprietor and large corporation components, these data were more current than was available to IRS when it made its estimates.

To collect these detailed data, we had to visit various sources. For example, we met with officials in Assistant Commissioners' offices--particularly the Assistant Commissioner (Planning, Finance, and Research) whose office has responsibility for the tax gap estimates--to get the best data available to profile the components. IRS' estimates and our descriptive information on the types of noncompliant taxpayers and issues involved for the four major components of the tax gap were based primarily on the following:

-- Sole proprietors: IRS based its $16.6 billion estimate in 1987, for the most part, on the 1982 TCMP results. Our descriptive information was based on 1985 TCMP data, which were not available to IRS when it did its estimates. Although these data indicate $7.4 billion in understated taxes for sole proprietors, this figure should not be viewed as a separate tax gap estimate nor compared with IRS' estimate because it reflects a different year and does not reflect the adjustments and projections made by IRS.

-- Informal suppliers: IRS based its $7.7 billion estimate on a University of Michigan study on 1985 gross receipts of informal suppliers. Our descriptive information was based on this study's results from interviews with households on their purchases from informal suppliers.

-- Small corporations: IRS based its $5.2 billion estimate, for the most part, on the results of its 1980 TCMP examinations. Our descriptive information was based on details from these examination results. We also got details on the types and amounts of unreported income and overstated deductions from the TCMP data.

-- Large corporations: IRS based its $15.5 billion estimate in 1987, for the most part, on actual examination results from Coordinated Examination Program (CEP) cases completed up through 1986. Our descriptive information was based on CEP examinations that were completed in 1988. The examinations' results were not available to IRS when it did its estimates. Although the examinations used in our analysis recommended taxes of $8.9 billion, this figure should not be viewed as a separate tax gap estimate and should not be compared with IRS' estimate because its estimate includes other adjustments and smaller corporations on which IRS did not have the details we needed. The details on the issues of noncompliance used in our study were compiled from IRS' Examination and Chief Counsel data on CEP examinations and the Industry Specialization Program (ISP), which IRS uses to track major industry issues.

After we profiled these components, we discussed our results with officials of the Assistant Commissioners' offices. They agreed that the data on which we based our results were the best available and were profiled in an acceptable manner. Appendix V contains tables that show many of these results.

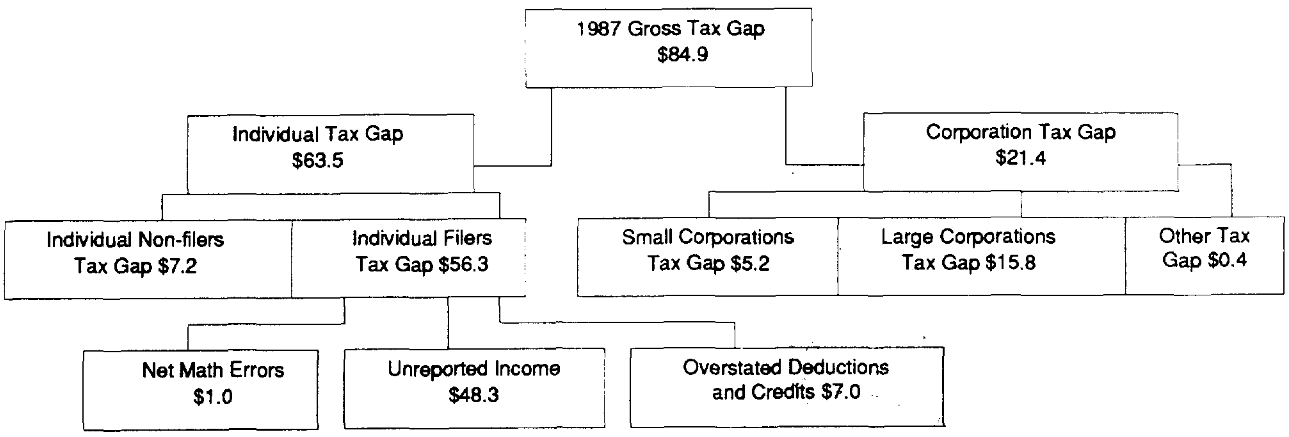
We asked these IRS officials for ideas that IRS or others have proposed to help IRS improve its enforcement programs to better pursue noncompliance in these or other tax gap components. We also reviewed GAO reports and studies by others--such as the American Bar Association--to identify these ideas. We compiled ideas brought to our attention during this review, but we did not intend to list every idea that has been proposed. Since we did not evaluate the proposals from IRS or others, we are not endorsing or recommending them, but we have included them to assist the Subcommittee in further debating ways in which IRS could better pursue noncompliance. Appendix VI lists ideas that have not been discussed in our profiles of the four components.

BACKGROUND

COMPONENTS OF THE 1987 GROSS TAX GAP

Figure II.1:

Components of the Gross Tax Gap and Estimated Amounts, 1987 (Dollars in billions)

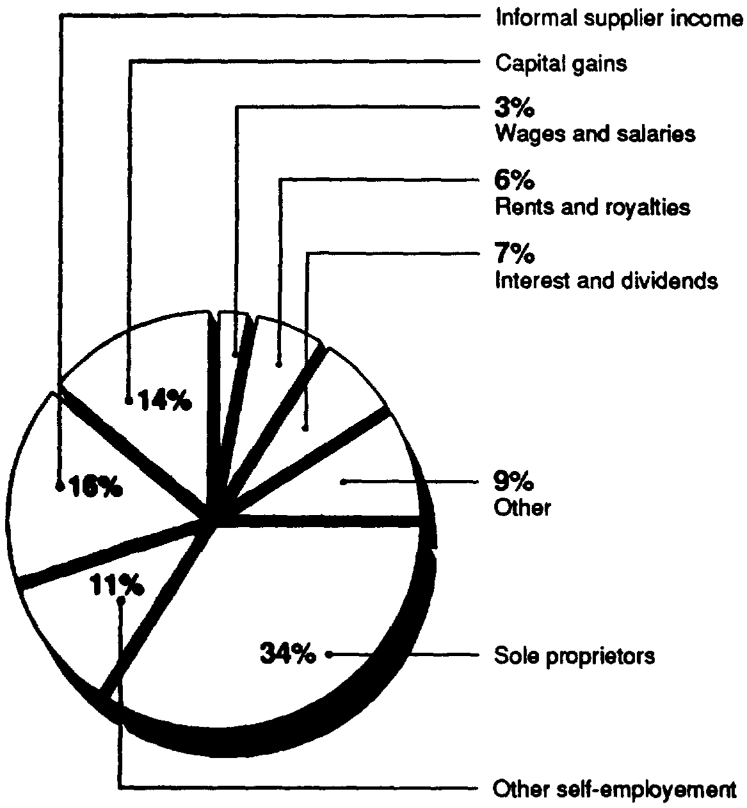


IRS' estimate of the gross tax gap is divided among individuals and corporations. The individual tax gap is further divided between those who do not file required income tax returns, or nonfilers, and those who do file but do not voluntarily pay the amount of income tax owed because they made math errors on their tax returns, failed to report all of their income, or claimed more deductions and credits than were allowable. The corporation tax gap is divided among small corporations, large corporations, and other corporations. IRS defines small corporations as those with assets under $10 million and large corporations as those with $10 million or more in assets. Other corporations include tax-exempt organizations and fiduciaries.

1987 GROSS TAX GAP: UNREPORTED INCOME BY INDIVIDUALS

Figure II.2:

1987 Unreported Income Tax Gap by Individual Filers
($48.3 billion)



Informal supplier income is cash income received by individuals through informal arrangements,such as those for home repair or day care.It is also referred to as "off the books" income.

Other income includes pensions and annuities,estate and trust income,state tax refunds,alimony,and other unspecified income.

Other self-employment income includes partnership,small corporation,and farm income.

The $48.3 billion estimate for unreported income was by far the largest single component of the tax gap for 1987. Of this amount, the largest portions of unreported income were attributed to sole proprietorships (an estimated $16.6 billion) and informal suppliers (an estimated $7.7 billion).

1987 GROSS TAX GAP: MAJOR COMPONENTS

Type of Component

-- Sole proprietors: $16.6 billion tax gap.

-- Informal suppliers: $7.7 billion tax gap.

-- Small corporations: $5.2 billion tax gap.

-- Large corporations: $15.8 billion tax gap.

1987 GROSS TAX GAP: MAJOR COMPONENTS

Four major components of the 1987 gross tax gap accounted for $45 billion of the $85 billion estimated by IRS--sole proprietors, informal suppliers, small corporations, and large corporations.

IRS defined sole proprietors and informal suppliers as self-employed individuals who differ in how they operate their businesses. Examples follow:

-- Sole proprietors operate in a formal manner. They report business gross receipts and business expenses on a Schedule C attached to their income tax return.

-- Informal suppliers usually rely on "off-the-books," cash transactions to sell goods or services along sidewalks or door-to-door. Receipts from such transactions may serve as the only source of income or as a secondary source (e.g., income from moonlighting) for those who have another, more formal, job or business. A tax gap occurs when they do not file a Schedule C or when they do file but only report income from a formal business operation or a portion of their informal operations.

IRS' tax gap report stated that the estimates for these two components resulted from unreported income. These two components accounted for over $24 billion of the $48 billion tax gap caused by individuals not reporting income. The report did not provide detailed information on the types of taxpayers who did not report income or the reasons they did not report it.

For corporations, IRS estimated a $21.4 billion tax gap including

-- small corporations (i.e., assets under $10 million),

-- large corporations (i.e., assets of $10 million or over), and

-- others, such as fiduciaries and tax-exempt organizations.

Of the $21.4 billion, IRS attributed $15.8 billion to large corporations, $5.2 billion to small corporations, and the remainder to the others. IRS' tax gap report did not provide detailed information on the types of noncompliant businesses or the issues of noncompliance except for small corporations, where unreported income and overstated deductions almost equally accounted for the estimate.

IRS' CURRENT ENFORCEMENT PROGRAMS

-- Regular and special examinations.

-- The Coordinated Examination Program and Industry Specialization Program.

-- Document matching on individuals' income.

-- IRS' district projects.

-- Service center compliance teams.

IRS' CURRENT ENFORCEMENT PROGRAMS

-- IRS annually examines income tax returns from individuals and corporations, selecting returns that have the highest likelihood for error from each taxpayer class. IRS also annually does special examinations, which focus on specific noncompliance. For example, IRS is doing special examinations of self-employed individuals, known as direct sellers, to reduce misreported income and deductions.

-- IRS created the CEP and ISP to coordinate examinations of the largest corporations. Under CEP, teams of experienced revenue agents and specialists, such as engineers, examine complex domestic and multinational corporations. CEP mostly includes corporations with assets over $250 million. ISP contributes to these and other corporate examinations by developing and tracking tax issues in industries requiring central coordination. Coordination occurs through experts in the Examination Division and Office of Chief Counsel, who develop uniform positions on handling key issues.

-- IRS' Information Returns Program relies on third-parties to report payments to individuals, such as interest from banks or for services to businesses. IRS matches information returns with tax returns to identify discrepancies in reported income. If a discrepancy exists, IRS generally follows up to attempt to resolve the discrepancy.

-- To pursue "local" noncompliance--such as unreported income--IRS' district offices may choose to create selected projects. The most recent available data show that IRS' 63 districts had 717 projects in June 1989. The IRS national office's only regular information on the projects is a list of titles by district. IRS disseminates this list quarterly so that districts may contact each other about the projects.

-- During the 1988 filing season, IRS created teams of employees in service centers to review compliance on returns filed by individuals and businesses. In 1989, IRS began selecting a random sample of these returns so the teams could systematically identify trends in noncompliance. IRS' goal is to identify these trends "up-front"--instead of relying on audits that occur a few years later--and develop strategies to address the noncompliance through legislative proposals, clearer tax forms, tax simplification, taxpayer education, and enforcement.

IRS' EFFORTS TO IMPROVE COMPLIANCE

-- Probing for unreported income in Schedule C examinations.

-- Assisting small businesses in complying.

-- Identifying future compliance approaches.

-- Modernizing computer systems for tax administration.

IRS' EFFORTS TO IMPROVE COMPLIANCE

-- In 1985, IRS started a special examination program of Schedule C filers who annually report $100,000 or more in gross receipts. This program is intended to better identify unreported income from these filers by affording the examiners more time to probe into the taxpayers' accounts and operations. IRS plans to collect and analyze the results until 1991 to determine whether additional probing will allow examiners to better identify unreported income.

-- As part of IRS' increased efforts to encourage tax compliance among small businesses, the Taxpayer Services Division gives workshops for small businesses seeking clarification about taxes. In 1989, IRS' Research Division began evaluating other ways to help small businesses comply, such as newsletters, hotlines, and visits, among others.

-- In 1988, IRS organized a Service-wide executive committee to develop compliance strategies for the short term and for the year 2000 and beyond. As of October 1989, the committee staff had completed data collection and was in the midst of analyzing data to identify the best strategies. The original completion date, October 1988, was not met because of other priorities and discussion among committee members about the direction that should be taken.

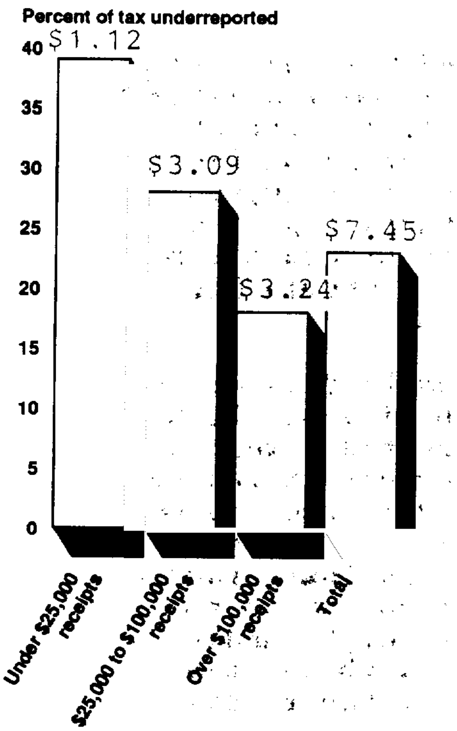
-- IRS has an ongoing, massive effort to modernize computer systems used to administer the tax system. This effort has numerous initiatives, all of which are intended to use technology to enhance IRS' ability to achieve its mission. The effort, however, is not expected to be completed before 1996. A successful modernization will enable authorized IRS employees to readily use any information received by IRS to do their jobs.

RESULTS OF REVIEW

SOLE PROPRIETORS--WHO DOES NOT COMPLY

Figure III.1:

Sole Proprietors--Percent of Tax Dollars Underreported by Schedule C Class, 1985 (Dollars in billions)



Schedule C classes by total gross receipts.

Source: IRS' 1985 TCMP data.

SOLE PROPRIETORS--WHO DOES NOT COMPLY

Schedule C Classes

Sole proprietors are self-employed individuals who should file a Schedule C to report profits and losses from their business. IRS relied on 1982 TCMP data to estimate the $16.6 billion tax gap for sole proprietors in 1987. However, IRS' estimate did not include a description of the types of sole proprietors who failed to report income.

To develop this description, we used TCMP data from 1985, which has become available since IRS published its estimate. These data showed underreported tax liabilities for three classes of Schedule C filers based on reported gross business receipts of (1) under $25,000, (2) $25,000 to under $100,000, and (3) $100,000 and over. Underreported taxes represent the difference between tax liabilities that sole proprietors reported on their income tax return and those that they should have reported, as identified through TCMP examinations.

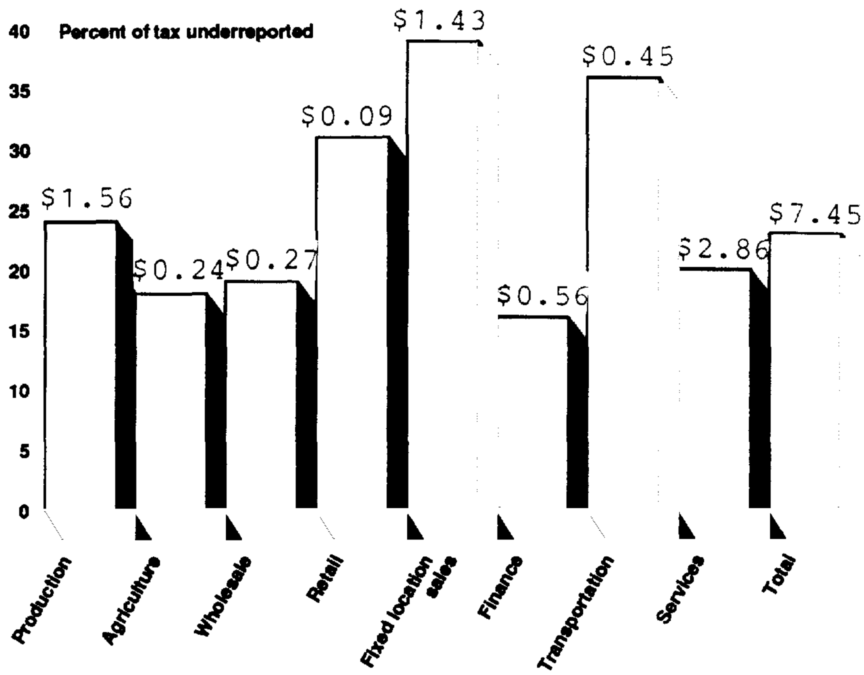
The 1985 TCMP data showed that Schedule C filers underreported 23 percent of their income tax liabilities. Although this represents $7.4 billion in underreported taxes for 1985, this amount is not a tax gap estimate because it has not been adjusted upward to account for the unreported income missed by TCMP. In dollar amounts, Schedule C filers in the highest income class underreported more taxes than those in lower income classes. However, underreporting was more prevalent at the lower income classes, as those with the lowest receipts underreported almost 40 percent of their tax while those with the highest receipts underreported less than 20 percent of their tax.

In commenting on our draft report, the Commissioner pointed out that an analysis of 1979 TCMP data showed that those in the middle income class had the highest compliance levels when the classes are recomputed on the basis of the amount of corrected income--the amount that should have been reported on the tax return, as established by TCMP examinations. (See app. IX.) Our analysis classified taxpayers on the basis of the amount of income reported. We used this classification because IRS provided data in this format when we asked for data to profile this component. In addition, we noticed that IRS published an analysis in 1989 that used 1985 TCMP data and found that the highest income class had the highest compliance level followed by the middle and lowest income classes, which was the distribution we found when measured by the percentage of underreported taxes.

SOLE PROPRIETORS--WHO DOES NOT COMPLY

Figure III.2:

Sole Proprietors--Percent of Tax Dollars Underreported by Principal Industrial Activity, 1985
(Dollars in billions)



Production includes construction and manufacturing.
Agriculture includes forestry and fishing.
Fixed location sales includes stores and restaurants.
Finance includes real estate and insurance.
Transportation includes communication and utilities.
Services includes doctors, lawyers, and accountants.

Source: IRS' 1985 TCMP data.

SOLE PROPRIETORS--WHO DOES NOT COMPLY

Type of Business

IRS' 1985 TCMP data also had details on the business activities of sole proprietors who underreported their tax liabilities. The TCMP data captured the types of business activity through the Principal Industrial Activity code. These data showed the following:

-- Those who provided services, produced goods, or sold goods from fixed locations--such as car dealerships, restaurants, and clothing stores--underreported the most taxes. These three types of sole proprietors accounted for about $5.9 billion of the total $7.4 billion in unreported taxes disclosed by TCMP examinations.

-- Those who sold goods from fixed locations underreported the greatest proportion of their taxes, followed by those in transportation and retail. These three types of sole proprietors plus those who produced goods represented the industries in which the percentage of underreported taxes exceeded the overall average of 23 percent.

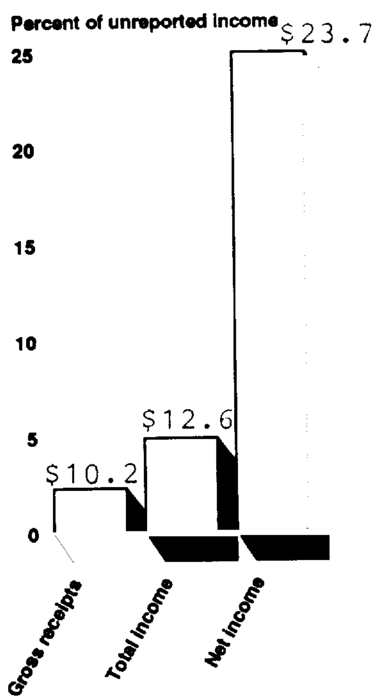
Although sole proprietors in the service industries had the most underreported tax dollars, they only underreported by about 20 percent. As a result, doctors, barbers, lawyers, and other service providers accounted for a large amount of sole proprietors' underreported taxes, but a relatively small percentage of their taxes were underreported. Sole proprietors that IRS categorized as in fixed-location sales underreported the greatest percentage of their taxes, or 39 percent. Even so, these sole proprietors underreported about half of the amount of taxes compared with those who offered services.

SOLE PROPRIETORS--AREAS OF NONCOMPLIANCE

Unreported Income

Figure III.3:

Sole Proprietors--Type of Unreported Income by Percent Unreported, 1985
(Dollars in billions)



Gross receipts equals income generated from providing goods or services.

Total income equals receipts plus other income minus the cost of goods sold and allowances.

Net income equals total income minus business expense deductions and net operating losses.

Source: IRS' 1985 TCMP data.

SOLE PROPRIETORS--AREAS OF NONCOMPLIANCE

Unreported Income

The $16.6 billion tax gap estimate is comprised of sole proprietors who failed to report all of their income. IRS' tax gap report did not provide detailed information on the types and amounts of this unreported income.[1]

As with underreported tax, we used IRS' 1985 TCMP data to identify the amounts of unreported gross receipts, total income, and net income among sole proprietors who filed a Schedule C. Of these three types of income, sole proprietors underreported a much higher amount and percentage of net income during 1985. The greater noncompliance for net income can be attributed, in part, to overstated deductions from total income. Total income can be offset with a number of deductions for business expenses and other special deductions to arrive at net income.

As we did with underreported tax, we also analyzed 1985 TCMP data to identify any variances in unreported income by the amount of income that sole proprietors reported on their Schedule Cs. For all three types of income, those in the middle income group--with $25,000 to under $100,000 in gross receipts--underreported the highest amount of income while those in the lowest group--with less than $25,000 in receipts--underreported the lowest amount.

In contrast with the amount of income underreported, the underreporting percentage, for each type of income was highest for those with the lower amounts of gross receipts. For example, the 1985 TCMP data showed that those with gross receipts of less than $25,000 underreported 35 percent of their net income while those in the middle and highest income groups underreported 27 percent and 21 percent of the net income, respectively.

While research by IRS and others on the reasons for this noncompliance has not been definitive, sole proprietors' unreported income can stem from both cheating and the complexity of tax laws. On one hand, they may not report income in order to survive in business or to maximize profits. On the other, they may err in reporting because of complex laws and regulations. Overall, a greater chance for unreported income exists since sole

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[1]The estimate excludes tax losses from unfiled returns, which IRS estimated separately. IRS estimated that sole proprietors accounted for about $3 billion of the $7.1 billion nonfilers' tax gap in 1987.

proprietors' income, unlike that for wage-earners, is not subject to income tax withholding by an employer.

Regardless of the reasons, IRS' data offered some examples on ways income is not reported. One way is to underreport daily business receipts by using a certain portion for personal expenditures without replacing the money at day's end; this practice is more likely in businesses where cash transactions are common, such as restaurants, groceries, and bars. Or sole proprietors may shield the income by over-reporting discounts or allowances for items sold. Another way is to underreport receipts from a subordinate part of the formal business. For example,

-- a building contractor may not report all or some receipts from side operations such as the sale of sand, cement, bricks, or used equipment;

-- a computer consultant may not report receipts from speaking at seminars or from giving referrals; or

-- a sporting goods store owner may not report receipts from equipment repairs, endorsements, or officiating.

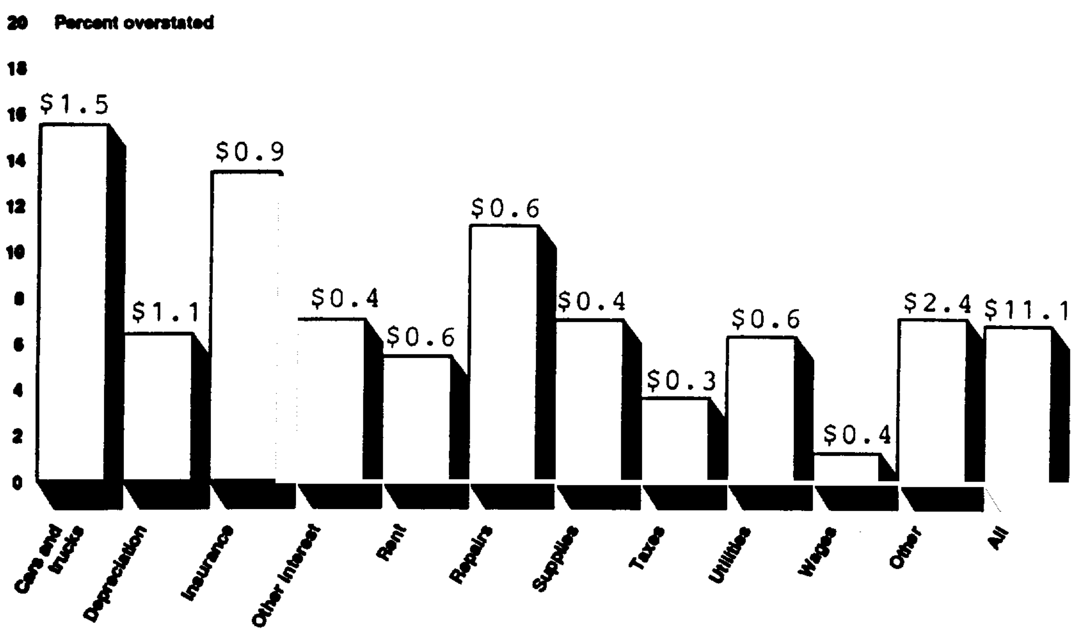
APPENDIX III

SOLE PROPRIETORS--AREAS OF NONCOMPLIANCE

Overstated Deductions

Figure III.4:

Sole Proprietors--Percent by Which Largest Deductions Were Overstated, 1985
(Dollars in billions)



"All" includes these large deductions plus 15 others where the stated and overstated amounts were smaller.

The TCMP checksheet did not identify what "other" included.

"Percent overstated" equals the amount of deductions stated on the tax return divided by the amount that should have been stated.

Source: IRS' 1985 TCMP data.

SOLE PROPRIETORS--AREAS OF NONCOMPLIANCE

Overstated Deductions

The $16.6 billion tax gap estimate for sole proprietors was due to unreported income, according to IRS. This estimate also reflects overstated business deductions, which improperly lower the taxable net income. To develop detailed information on these overstated business deductions, we analyzed 1985 TCMP data and found $11.1 billion in overstated deductions. We also found the following:

-- Deductions for "other," cars and trucks, depreciation, and insurance were overstated in the highest amounts and accounted for $5.9 billion. Overstated amounts ranged from $2.4 billion to $0.9 billion, respectively.

-- Deductions for cars and trucks, insurance, and repairs were overstated to the greatest extent--with cars and trucks overstated by almost 16 percent. These three were the only deductions for which the percentage overstated exceeded the 7 percent average across all deductions.

To illustrate, depreciation expenses may be overstated by sole proprietors--such as building contractors--by including assets that have been fully depreciated or previously expensed, or have been based on an improper "useful life." Such sole proprietors, among others, also may improperly deduct repairs for leased equipment. Or personal expenses may be improperly included in deductions for cars and trucks, repairs, or insurance. Owners of restaurants, groceries, or other stores who live in the store may overstate business deductions by including personal expenses for utilities, rent, insurance, and depreciation. IRS also has found cases in which those who sell food have doubled a deduction for spoilage. Further, deductions may be overstated by not offsetting certain items, such as rebates for insurance and salvage value of assets for depreciation.

We also analyzed the 1985 TCMP data to determine how overstated deductions varied with the gross receipts reported by sole proprietors. We found that those reporting $25,000 to under $100,000 had the highest amounts of overstated deductions. Those reporting under $25,000 overstated the lowest amounts of each deduction. However, those reporting under $25,000 overstated a higher percentage of each deduction. For example, they overstated their insurance deduction by 45 percent while those reporting $25,000 to $100,000 or $100,000 and above overstated it by 18 percent and 10 percent, respectively.

SOLE PROPRIETORS--HOW IRS PURSUES NONCOMPLIANCE

-- General income tax examinations.

-- Special examinations on Schedule C unreported income.

-- Document matching to identify unreported income.

-- IRS district projects.

-- Service center compliance teams.

SOLE PROPRIETORS--HOW IRS PURSUES NONCOMPLIANCE

IRS has several programs to pursue noncompliance among sole proprietors. These follow.

General Examinations: In 1988, IRS examined about 2.4 percent of sole proprietors' income tax returns, which generated about $1.3 billion in tax revenue compared to about 1 percent of all individuals' returns, which generated about $5.3 billion. Sole proprietors with the highest income--compared with the lowest income filers--were about 3 times more likely to be examined and these examinations produced about 12 times more average revenue. Although examinations are a good way to reveal overstated deductions, IRS has not found examinations to be effective for identifying unreported income unless the examiner has third-party information, such as information returns.

Special Examinations: Given the difficulty in identifying unreported income, IRS has started a special examination program on Schedule C filers with $100,000 or more in income. The examinations afford examiners more time to probe for unreported income. Preliminary results show that the extra time has generated more revenue per return and slightly more revenue per examination hour than before the program.

Document Matching: IRS' information returns program helps to identify unreported income through document matching on individual taxpayers such as sole proprietors. This program includes businesses' payments to sole proprietors but does not include payments by individuals who buy goods or services from sole proprietors. Starting in 1990, IRS will use a cross-reference file to better identify unreported income by sole proprietors who have income reported under either their social security number or employer identification number.

District Projects: IRS' list of district projects to pursue noncompliance does not identify which ones focused on sole proprietors. IRS' national office has no central system for capturing details of the projects. At our request, districts furnished summaries of projects on sole proprietors' unreported income. Among the projects, one involves returns from 294 independent contractors. Through September 1989, examiners recommended no change in 23 cases and changes in 129 cases for which the yield averaged $677 per return. In another project, focusing on carpet layers, 47 examinations identified over $600,000 in taxes and penalties.

Compliance Teams: IRS teams examine incoming returns at service centers to identify issues of noncompliance. Through the first half of 1989, the issue identified most often among Schedule C filers dealt with misreporting employee business expenses to avoid limits on this deduction. Other major issues were (1) overstating the deduction for an office in the home, (2) carrying forward too much investment tax credit, and (3) not properly accounting for the capitalization of inventory, construction, and development costs. The early detection of these issues of noncompliance will allow IRS to advise the public of commonly made errors, guide its employees on how to handle these issues, and/or recommend changes to the tax law.

APPENDIX III

SOLE PROPRIETORS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

IRS plans to evaluate the following efforts:

-- special examination program for Schedule C filers,

-- cross-reference file for sole proprietors,

-- compliance teams for early detection of noncompliance, and

-- initiatives to improve customer service.

We have recommended that IRS

-- improve examinations to detect noncompliance with information reporting (GAO/GGD-89-110, Sept. 8, 1989),

-- use information returns to identify misclassified workers (GAO/GGD-89-107, Sept. 25, 1989), and

-- improve nonfiler investigations of businesses (GAO/GGD-88-77, May 24, 1988).

The American Bar Association (ABA) has considered the following proposals:

-- increase the scope of income tax withholding and

-- require information reporting on payments to sole proprietors for services and rent.

SOLE PROPRIETORS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

We compiled the following list of ideas that GAO, IRS, and the American Bar Association have proposed for improving IRS' efforts on compliance by sole proprietors. The list is not all-inclusive but includes those proposals brought to our attention during this review. We have not evaluated the proposals made by IRS or ABA to determine whether they would actually improve compliance. Therefore, we are not endorsing or recommending these proposals for adoption but are listing them to inspire further debate and evaluation of ways in which IRS could improve compliance.

IRS plans to evaluate its recent efforts--such as the special examination program for Schedule C filers, the cross-reference file for identifying unreported sole proprietor income, and the compliance teams for early detection of issues of noncompliance. These evaluations are intended to help IRS determine whether to continue, expand, or terminate these efforts.

IRS' written comments on a draft of this report identified a number of initiatives that its Research Division is testing to improve customer service to small business taxpayers. (See app. IX.) IRS began the initiatives to identify more cost-efficient ways to improve voluntary compliance among small businesses, which account for a substantial portion of the tax gap, according to IRS' estimates. The initiatives include helping small business owners through "hands-on" help in preparing tax returns and records, a computerized calendar of tax responsibilities, and various educational materials and programs that IRS' Taxpayer Services Division offers.

We have made the following recommendations in prior reports to improve IRS compliance efforts:

-- Improve examinations of businesses for their compliance with information return reporting requirements. IRS' examiners are required to check for such compliance during examinations of the businesses' tax returns. Only about 50 percent of the IRS examinations that we reviewed identified businesses that did not submit required information returns to IRS on payments they made to sole proprietors. Without information returns, IRS cannot do its document matching to identify unreported income.

-- Use information returns to identify employers who misclassify employees as independent contractors. Misclassification improperly reduces income tax liabilities since employers do not have to withhold income taxes for independent contractors who--compared with employees--are less likely to report income. Further, those misclassified can report less net income by deducting business expenses that they would not be entitled to deduct as employees. Using information returns to identify misclassification would put IRS in a better position to ensure that income is reported and to assess the taxes owed. IRS has reported, through its written comments, that its Collection Division is using information returns to identify such misclassification. (See app. IX.)

-- Issue only one employer identification number to businesses such as sole proprietorships so that IRS can correctly match information returns and tax returns and avoid unproductive nonfiler investigations that are generated when sole proprietors have more than one identification number. IRS should also ensure that the results of investigations are accurately recorded on the business master file, including the correction of any errors that the investigations uncover, to preclude the generation of unproductive nonfiler investigations. IRS has reported, through its written comments, that its Returns Processing and Accounting function has taken action to avoid issuing multiple numbers. (See app. IX.)

Finally, ABA members extensively discussed the following proposals during a 1988 tax compliance seminar:

-- Increase the scope of income tax withholding at the source of payment. Although the proposal did not specify how this would work, for sole proprietors this could mean that income tax is withheld at the time of payment for services or merchandise.

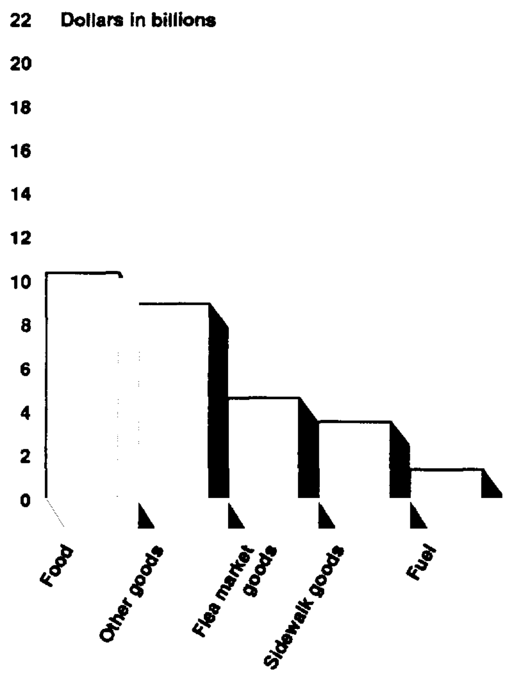
-- Expand information reporting to cover payments made by individuals that amount to $1,000 or more in a year for services or rent. This proposal also suggested that IRS could share this information among other state and local government agencies.

APPENDIX III

INFORMAL SUPPLIERS--WHO DOES NOT COMPLY

Figure III.5

Informal Suppliers--Gross Receipts for Goods, 1985-86



Food includes whatever is sold at farmers' markets and roadside stands.

Other goods includes yard sales and direct sellers, among others.

Flea market includes glassware and clothes, among others.

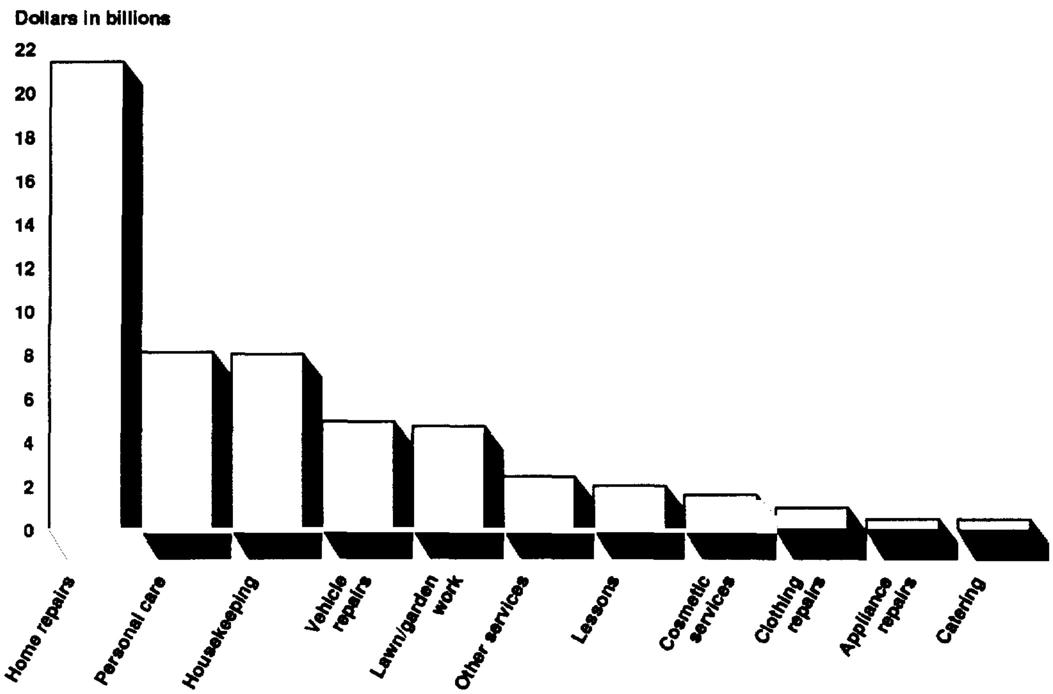
Sidewalk goods includes plants and food, among others.

Source: "The Measurement of Selected Income Flows in Informal Markets, 1981 and 1985-86," the University of Michigan.

INFORMAL SUPPLIERS--WHO DOES NOT COMPLY

Figure III.6:

Informal Suppliers--Gross Receipts for Services, 1985-86



Personal care includes both adults and children.

Other services includes tax preparation and transportation, among others.

Lessons includes music, dance, and driving, among others.

Source: "The Measurement of Selected Income Flows in Informal Markets, 1981 and 1985-86," the University of Michigan.

APPENDIX III

INFORMAL SUPPLIERS--WHO DOES NOT COMPLY

IRS based its $7.7 billion tax gap estimate for informal suppliers on a University of Michigan study. This study primarily relied on interviews with household members to determine how much they purchased from various types of informal suppliers. The estimated $83.7 billion was the midpoint of estimated purchases that ranged from $58.3 billion to $109.1 billion. Home repairs generated the most purchases with $21.4 billion, followed by sales of food and "other goods," such as those bought at yard sales.

Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an "informal" manner. However, they may differ in the following ways:

-- Age and skill: Those who provide home repairs range from teenagers to skilled workers, such as carpenters who "moonlight." On the other hand, those who provide lawn and garden services are largely high school or college age.

-- Licensing: Those who sell goods at flea markets or along sidewalks often do not have a business license. Those who provide personal care, mainly to children, also may operate without licenses. The extent of licensing will vary depending on the state or local jurisdictions in which informal suppliers operate.

-- Location of operations: Those who provide personal care, lessons (e.g., dance), or cosmetics (e.g., hair) often operate either in purchasers' or their own homes. Some operate from a vacant lot or street, or by going door-to-door, such as those who sell fuel--largely firewood. Caterers also fall into this category but often work at purchasers' homes, usually for parties instead of weddings. However, some informal suppliers only provide their services at the purchasers' homes, such as housekeepers and landscapers.

IRS adjusted the estimated $83.7 billion in income to estimate the tax gap. For example, IRS subtracted an estimated $12.8 billion for income of domestics and of friends and relatives who do lawn work or babysitting because such income was part of other tax gap estimates or was too low to create a tax liability. IRS added income from other sources cited in the study--such as $24.9 billion in sales to businesses and $6.2 billion in net bartering income. After other adjustments, IRS estimated that unreported income totaled $41.6 billion in 1985. IRS then projected the amount of unreported income to 1987 and made other adjustments to estimate the $7.7 billion tax gap.

INFORMAL SUPPLIERS--AREAS OF NONCOMPLIANCE

The noncompliance represents unreported income from informal supplier activities in 1987 and

-- excludes an estimated $700 million tax gap from nonfiling;

-- includes unreported income from (1) wage-earners who have a "side job" and (2) self-employed individuals who have informal activities; and

-- occurs because of "cash-and-carry" business transactions.

INFORMAL SUPPLIERS--AREAS OF NONCOMPLIANCE

This tax gap estimate deals with individual taxpayers who filed tax returns but failed to report all income from informal supplier activities.

This estimate excludes informal suppliers who do not file income tax returns. IRS has accounted for these tax losses in another estimate for "nonfilers." Of the estimated $7.1 billion tax gap due to nonfilers, IRS attributed $0.7 billion to informal suppliers. However, IRS does not have details on the types of informal suppliers who were nonfilers.

Informal suppliers should report informal supplier income on a Schedule C to report profits or losses from a business or profession. Noncompliant informal suppliers usually report

-- wages or salaries from a formal job, but do not report any or all informal supplier receipts from a side job or

-- gross receipts from self-employment, but report only a portion of their receipts from informal supplier activities.

In either case, they may avoid reporting informal supplier income because of the nature of business transactions. Informal supplier activities often occur on a cash-and-carry basis. As such, a paper trail of the transaction rarely exists, particularly if the

-- informal supplier does not keep formal books and records or

-- purchaser of the good or service neither receives a receipt nor submits information returns to IRS on the payment made.

For example, IRS has been concerned about unreported income among fishermen. IRS estimates the related annual tax loss to be about $125 million. Under certain conditions, the fishermen are not subject to income tax withholding. This fact, among others, makes enforcement costly and difficult. These fishermen often are transient, working in remote areas, and operate on a cash basis, maintaining few, if any, records. IRS also has found cases where wage-earners--such as in the building trades, nurses, and seasonal workers--work on the side either to generate income that is easier to hide or to create business losses that can be used to lower the tax liability of their wages. IRS' data showed examples of these intentional business losses by wage-earners doing direct sales of goods (e.g., cosmetics) or work on a consumer's yard or house.

INFORMAL SUPPLIERS--HOW IRS PURSUES NONCOMPLIANCE

IRS' national enforcement programs are limited in identifying unreported income. The programs include

-- examinations of income tax returns and

-- document matching of income to identify unreported income.

To better identify unreported income from informal suppliers, IRS has initiated other programs. The programs include

-- special examinations of direct sellers and

-- district projects on informal suppliers' noncompliance.

INFORMAL SUPPLIERS--HOW IRS PURSUES NONCOMPLIANCE

IRS' national programs to identify noncompliance include examinations and document matching. These programs, however, are limited in identifying unreported income by informal suppliers because of the cash-and-carry nature of their businesses. The following examples illustrate this problem:

-- IRS' annual examinations of individuals' tax returns only cover 1 percent of returns filed and do not specifically focus on informal supplier income. Examiners have difficulty identifying unreported income, especially when little documentation exists, such as in a cash and carry business.

-- IRS' information returns program, which matches information returns with individuals' income tax returns, is unlikely to find unreported income among informal suppliers. This is because payments to informal suppliers usually occur on a cash basis with little documentation. Further, individuals who buy goods and services from informal suppliers for personal use are not required to submit information returns. As a result, most payments to informal suppliers are not subject to this program and cannot be identified as income.

To better identify unreported income by informal suppliers, IRS has initiated programs such as the following designed for those in cash-and-carry or other informal businesses.

-- IRS started a special program in 1987 to examine a type of income that informal suppliers generate. This income involves direct sales of home products--such as cosmetics and Tupperware--that are sold over the phone and door-to-door. IRS began this program because direct sellers had been improperly creating business losses to offset income such as wages. This program examines direct sellers who report wages, low gross receipts, and high business deductions. In 1989, the examinations generated recommended taxes of about $7 million.

-- Some IRS district projects to pursue "local" noncompliance cover those informal suppliers listed as of June 1989. Projects on informal suppliers look at unreported income from unlicensed day care; moonlighters in a second job, such as painting, carpentry, or construction; newspaper vendors; flea markets for cars and furniture; and firewood sales. Most of these projects are just starting or are in the midst of examinations. Regardless, projects rarely become national in scope and little central coordination exists, mainly because other enforcement efforts take priority.

INFORMAL SUPPLIERS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

IRS needs more innovative techniques to reduce unreported income among informal suppliers. A list of ideas follows:

-- IRS' research has suggested ways to better use available data, both internal and external, to identify informal suppliers' unreported income.

-- An IRS Assistant Commissioner suggested coordinating with state and local governments to identify noncompliant informal suppliers.

-- ABA has discussed information reporting on payments for service and rent.

INFORMAL SUPPLIERS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

Informal suppliers, because of the way they do business, have more opportunities to not report their income. Traditional IRS methods to detect unreported income are not as effective when dealing with informal suppliers. Since no audit trail exists, more innovative techniques need to be developed to efficiently identify unreported income. The following are ideas proposed by IRS or ABA to help do this. This list is not all-inclusive but contains ideas brought to our attention during this review. Since we have not evaluated them, we are not endorsing or recommending these proposals but are listing them to inspire further debate on how IRS could better pursue this noncompliance.

-- IRS' research studies have identified additional uses of information returns to identify unreported income and have advocated using all available data, both internal and external to IRS. For example, such uses could include expanded matching of third party information reports and taxpayer returns to identify payments to informal suppliers (e.g., licensed child care providers); the external sources mainly would involve states and other federal agencies (e.g., state income or sales tax data and Social Security Administration information on income credited to individuals' accounts).

-- An IRS Assistant Commissioner suggested that IRS coordinate with state and local governments to require proof of federal tax filing before granting any authorization--such as a license or permit--to do business. Informal suppliers may not have a regular business address, so IRS may not be able to locate them. However, they may be required to have a license to operate (e.g., home repairs), which could provide IRS with a lead on their business activities.

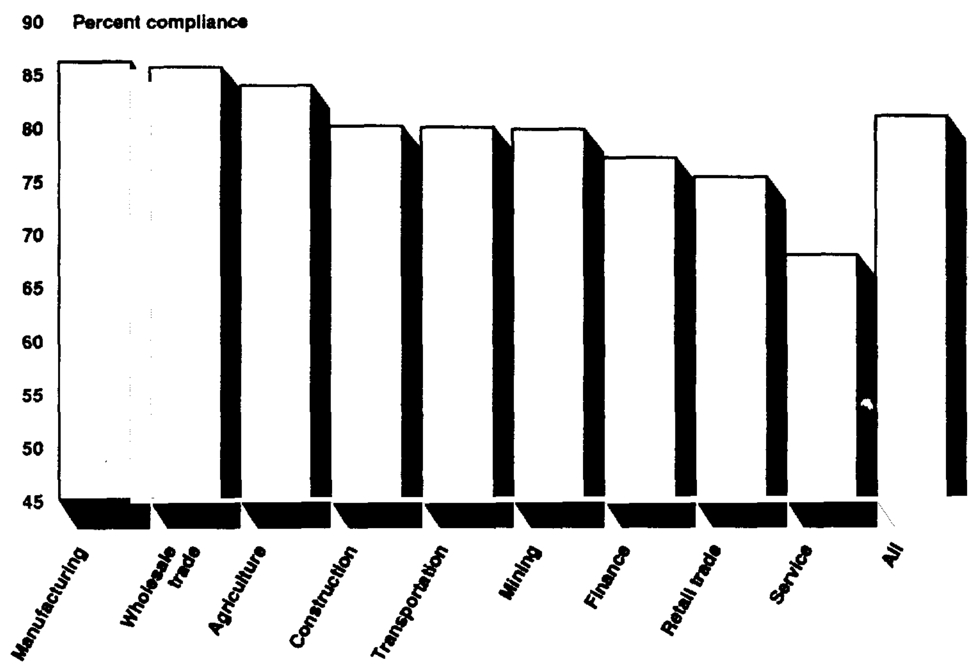
-- During a 1988 ABA tax compliance seminar, a proposal was discussed on expanding the use of information reporting. Under the proposal, a business or individual who makes payments for services (e.g., lawn care) or rent would report the payments on their tax returns. Reporting would include the name, address, and identification number of the person who received payments aggregating $1,000 or more in a year.

SMALL CORPORATIONS--WHO DOES NOT COMPLY

Type of Industry

Figure III.7:

Small Corporations--Voluntary Compliance Levels by Type of Industry, 1980



Agriculture includes forestry and fishing, among others.

Transportation includes communication and utilities, among others.

Finance includes insurance and real estate, among others.

Services includes hotels, doctors, and lawyers, among others.

"Percent compliance" equals the amount of tax voluntarily reported divided by the sum of the tax reported plus additional tax owed.

Source: IRS' 1980 TCMP data.

SMALL CORPORATIONS--WHO DOES NOT COMPLY

Type of Industry

IRS based the estimated $5.2 billion tax gap for small corporations in 1987 on its TCMP data for 1980--the most recent available for small corporations. To estimate this tax gap, IRS made adjustments to the data, which resulted in aggregated data being projected to 1987. IRS' tax gap report did not have details on the types of small corporations that accounted for the $5.2 billion tax gap estimate.

We extracted details from the 1980 TCMP data on the principal industrial activity code, which captures differences in business activities among small corporations. Compliance for voluntarily paying taxes was 80 percent on average for all small corporations but varied by type of industry, as follows:

-- Compliance was highest for small corporations that manufactured various goods. Small corporations in two other industries also complied more often than the average for all businesses. These industries involved wholesale trade and agriculture, which included the forestry and fishing industries.

-- Compliance was lowest for small corporations that provided services, followed by those involved in retail trade and in finance, which included insurance and real estate.

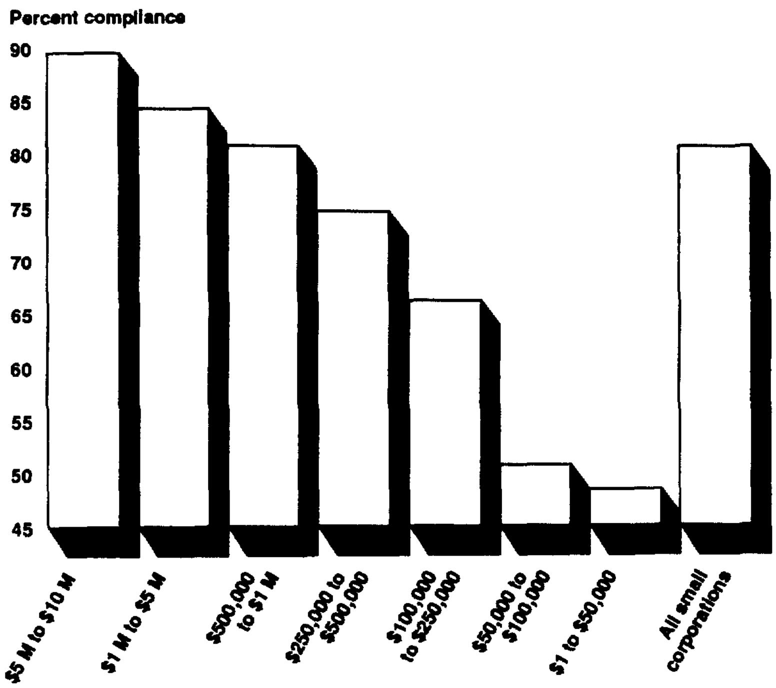
-- Compliance was about average, compared with all industries, for construction, transportation, and mining.

SMALL CORPORATIONS--WHO DOES NOT COMPLY

Asset Size

Figure III.8:

Small Corporations--Voluntary Compliance Levels by Asset Size, 1980



"Percent compliance" equals the amount of tax voluntarily reported divided by the sum of the tax reported plus additional tax owed.

Source: IRS' 1980 TCMP data.

SMALL CORPORATIONS--WHO DOES NOT COMPLY

Asset Size

IRS' 1980 TCMP data also included detailed information on small corporations by asset size that contributed to the estimated $5.2 billion tax gap in 1987. Since 1978, TCMP has treated those with assets below $10 million as "small corporations," and classified them ranging from those with assets under $50,000 to those with assets over $5 million.

According to 1980 TCMP results, small corporations' compliance in paying taxes

-- increased for those with higher asset sizes as compliance ranged from below 50 percent for those with $50,000 or less in assets to 90 percent for those with $5 million to $10 million in assets, and

-- was higher than average for small corporations with assets from $500,000 to $10 million when compared with all small corporations.

We also analyzed compliance by industry type and asset size combined. In doing so, we found that the general pattern--the more the assets, the higher the compliance

-- largely held true for those involved in wholesale trade, manufacturing, construction, and retail trade.

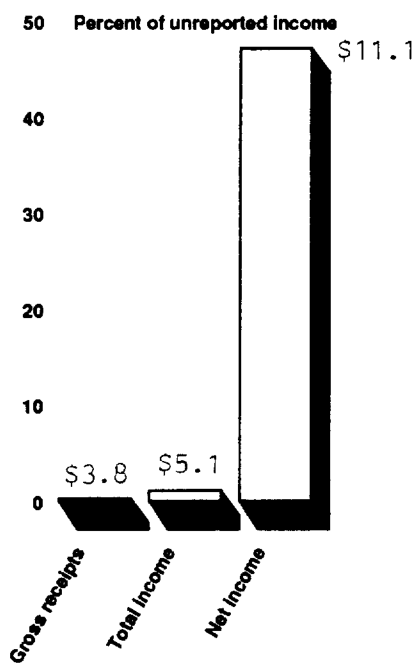
-- did not hold true for the other five types of small corporations. For example, among small corporations in the finance industry, those with assets of $1 to $50,000 had much higher compliance while those with $5 million to $10 million had much lower compliance. A similar reversal occurred for those involved in the service industry.

SMALL CORPORATIONS--AREAS OF NONCOMPLIANCE

Unreported Income

Figure III.9:

Small Corporations--Types of Unreported Income by Percent Unreported, 1980
(Dollars in billions)



Gross receipts equals income generated from providing goods or services.

Total income equals receipts plus other income minus the cost of goods sold and allowances.

Net income equals total income minus business expense deductions and net operating losses.

Source: IRS' 1980 TCMP data.

SMALL CORPORATIONS--AREAS OF NONCOMPLIANCE

Unreported Income

Both unreported income and overstated deductions were about equally responsible for small corporations' $5.2 billion tax gap in 1987. While IRS' tax gap report did not identify the types of small corporations that failed to report income, 1980 TCMP data--the most current available--included some details on the types of unreported income that contributed to this tax gap estimate.

According to TCMP data for 1980, small corporations reported almost all gross business receipts and total income. They reported about

-- $1,302 billion of the $1,306 billion in gross business receipts that they should have reported and

-- $442 billion of the $447 billion in total income that they should have reported.

The unreported amount of total income largely resulted from overstating the cost of goods sold and understating other income such as interest and net capital gains.

However, compliance for net income was much lower, mainly because of overstated deductions. Small corporations only reported $12.5 billion of the $23.6 billion in net income that they should have reported. The $11.1 billion in unreported net income resulted from

-- $5.1 billion in unreported total income,

-- $5.5 billion in overstated business deductions, and

-- $0.5 billion in overstated special deductions and net operating losses.

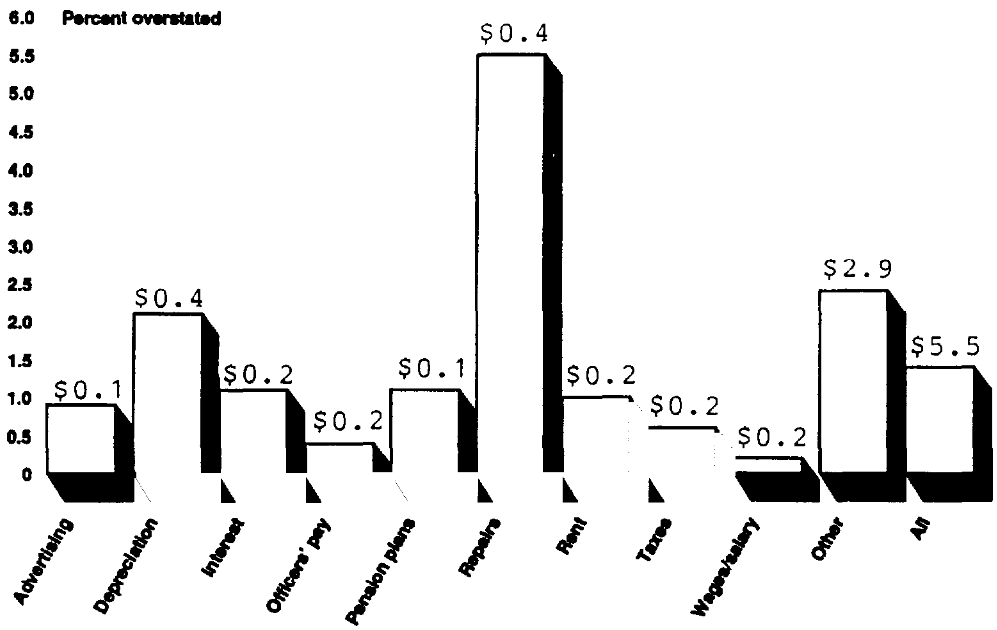
According to IRS' data, the ways that small corporations avoid reporting income are similar to those for sole proprietors. That is, small corporations may not report receipts that are (1) used for daily personal expenditures but not replaced at the end of the day, (2) shielded by over-reporting discounts or allowances for items sold, or (3) generated from a side operation, such as vending machines, newsstands, candy counters, or meeting room rentals that a motel or restaurant may offer.

SMALL CORPORATIONS--AREAS OF NONCOMPLIANCE

Overstated Deductions

Figure III.10:

Small Corporations--Percent With Largest Deductions Overstated, 1980
(Dollars in billions)



The TCMP checklist did not identify what "other" included.

"All" includes the largest deductions plus five not listed here--bad debts,contributions,amortization,depletion,and employee benefits. These amounts were too small to include.

Source: IRS' 1980 TCMP data.

SMALL CORPORATIONS--AREAS OF NONCOMPLIANCE

Overstated Deductions

The TCMP data also showed the types of deductions that small corporations overstated in 1980. For example, small corporations' deductions for

-- "other", depreciation, and repairs were the highest in both the amount and the percentage overstated. These three accounted for $3.8 billion of the $5.5 billion in overstated deductions. In addition, small corporations overstated the deduction for repairs to the greatest extent--5.5 percent.

-- officers' pay, wages and salaries, and taxes were the lowest in both the amount and percentage overstated.

IRS' data show that small corporations overstate deductions in ways similar to sole proprietors. For example, small corporations may try to shift repairs for personal equipment--such as vehicles--into the corporation's books. Or they may try to deduct depreciation expenses for assets that have been fully depreciated or that have a much longer useful life than reported. Small corporations also may overstate deductions in other ways, such as

-- inflating the value of expenses from transactions with a related business entity, which could result in overstating deductions for bad debt, depletion, and depreciation or

-- failing to offset a deduction for abandonment and for depreciation or for bad debt with income from scrap materials sold or from interest or repossession, respectively.

On the other hand, some deductions, such as those for pay or taxes, are harder to overstate because they are direct expenses of the corporation.

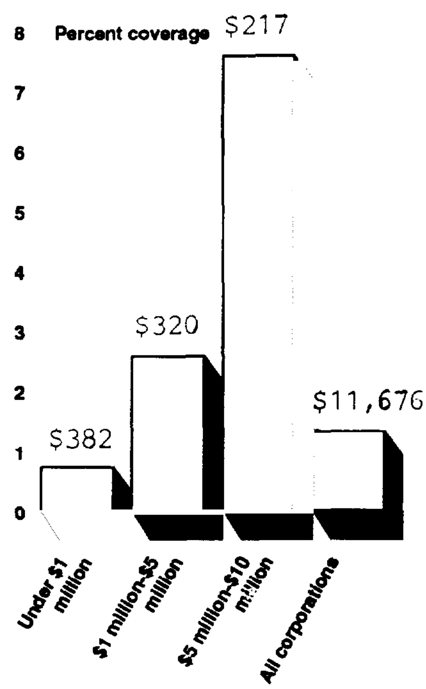
Although unavailable by industrial activity, the TCMP data showed overstated deductions by the asset sizes of small corporations. For all deductions, the pattern showed that small corporations with more assets generally had higher compliance.

Little documentation existed on why small corporations do not comply. Scattered research by IRS and others suggests that their noncompliance comes from trying to survive in a competitive environment. In addition, confusion over complex tax regulations and laws and the lack of accounting or tax law expertise to deal with the complexity appear to contribute to the noncompliance.

SMALL CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

Figure III.11:

Small Corporations--IRS' Examination Coverage by Small Corporations and All Corporations, 1988
(Dollars in millions)



All corporations includes small corporations plus large corporations (i.e. those with assets of $10 million and over).

Dollars represent recommended tax and penalties.

Source: IRS' 1980 TCMP data.

SMALL CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

In 1988, IRS recommended about $919 million in tax from examining small corporations. We noted these trends:

-- IRS' examination coverage rose as asset size increased because those in the largest asset class were almost 10 times more likely to be examined than those in the smallest classes.

-- Examinations produced more dollars in recommended tax and penalty per case as the asset size decreased.

We compared these examination results with those of 1986. In 1986, examination coverage was greater for all classes of small corporations. For example, the coverage for the largest class--$5 million to $10 million in assets--dropped from 13 percent in 1986 to 8 percent in 1988. IRS officials attributed these decreases to limited resources available for small corporation examinations because of a greater focus on tax shelters. The 1988 examinations also generated about $222 million less in tax revenue compared with 1986, except for those with assets of $5 million to $10 million where fewer examinations produced more revenue.

IRS' projects that district offices create to pursue "local" noncompliance do not seem to address small corporations very often. The June 1989 list of projects did not identify those that dealt with small corporations, but on the basis of the projects' titles, very few projects appear to deal with small corporations. IRS' national office did not have any additional information on which of the district projects involve small corporations.

Starting in 1988, teams of IRS employees in service centers--compliance teams--checked for signs of corporate noncompliance as returns were filed. In the first half of 1989, teams identified 13 issues on corporate returns but have not computed any related tax losses. While results are preliminary, major issues involve overstated deductions for meals and entertainment, depreciation on luxury automobiles, and investment tax credits carried over to a new tax year. The teams also have identified improper capitalization of inventory, construction, and development costs. The issues identified by the teams will be used by IRS to advise taxpayers, guide IRS enforcement employees, and identify potential recommendations for tax law changes.

SMALL CORPORATIONS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

The following ideas by GAO, IRS, and others deal with ways IRS could better pursue noncompliance among small corporations.

-- Share information with state and local tax authorities through more cooperative programs and identify corporations that stopped filing tax returns (these are IRS' initiatives).

-- Improve the quality of examinations of small corporations (GAO/GGD-85-26, June 12, 1985).

-- Issue only one employer identification number and correct the business master file (GAO/GGD-88-77, May, 24, 1988).

-- Establish a corporate information returns program to identify unreported income or unfiled returns (GAO/T-GGD-87-4, Mar. 17, 1987).

-- Take action to collect taxes from bankrupt businesses (GAO/GGD-86-20, Feb. 21, 1986).

SMALL CORPORATIONS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

According to IRS, small corporations have much poorer compliance than other corporations. To improve their compliance, GAO, IRS, and ABA have proposed the following ideas. This list of ideas is not all-inclusive but includes those brought to our attention during this review. Since we have not evaluated ideas offered by IRS or ABA, we are not endorsing or recommending them but are including them to inspire further debate on how IRS could better pursue small corporation noncompliance.

IRS has proposed more cooperative efforts with other tax authorities. These include creating a more visible federal/state cooperative program and expanding tax compliance activities, including additional exchanges of tax information. IRS also has a program in its Collection Division to identify corporations that stopped filing tax returns. After it identifies these potential nonfilers, IRS does investigations and sends notices to establish whether a return should have been filed. (See app. IX.)

We have reported on the following improvements that IRS could make to its enforcement efforts over small corporations:

-- Improve the quality of examinations of small corporations by focusing on the issue of unreported income. In 1985, we reported and IRS agreed that such examinations had not met IRS' standards and that problems with quality were not detected by IRS' quality review system.

-- Issue only one employer identification number to businesses such as small corporations so that IRS can correctly match information returns and tax returns and avoid unproductive nonfiler investigations that are generated when small corporations have more than one identification number. IRS should also ensure that the results of investigations and the correction of any errors that the investigations uncover are accurately recorded on the business master file. IRS has reported, through its written comments, that its Returns Processing and Accounting function has taken actions to avoid issuing multiple numbers. (See app. IX.)

-- IRS has been testing the feasibility of a corporate information returns program that we recommended. Under such a program, IRS would match information returns on third-parties' payments to corporations with the corporations' income tax returns to identify unreported income. IRS plans to complete this test by December 1990 using information returns it already receives on a voluntary basis. However, since these returns are not now required on payments to corporations, a tax law change would be needed for IRS to include all corporations in the program.

-- Protect tax revenue when small corporations file for bankruptcy by better monitoring bankrupt businesses and court referrals. Doing so would minimize the accumulation of tax delinquencies and improve the accuracy of claims to the bankruptcy court.

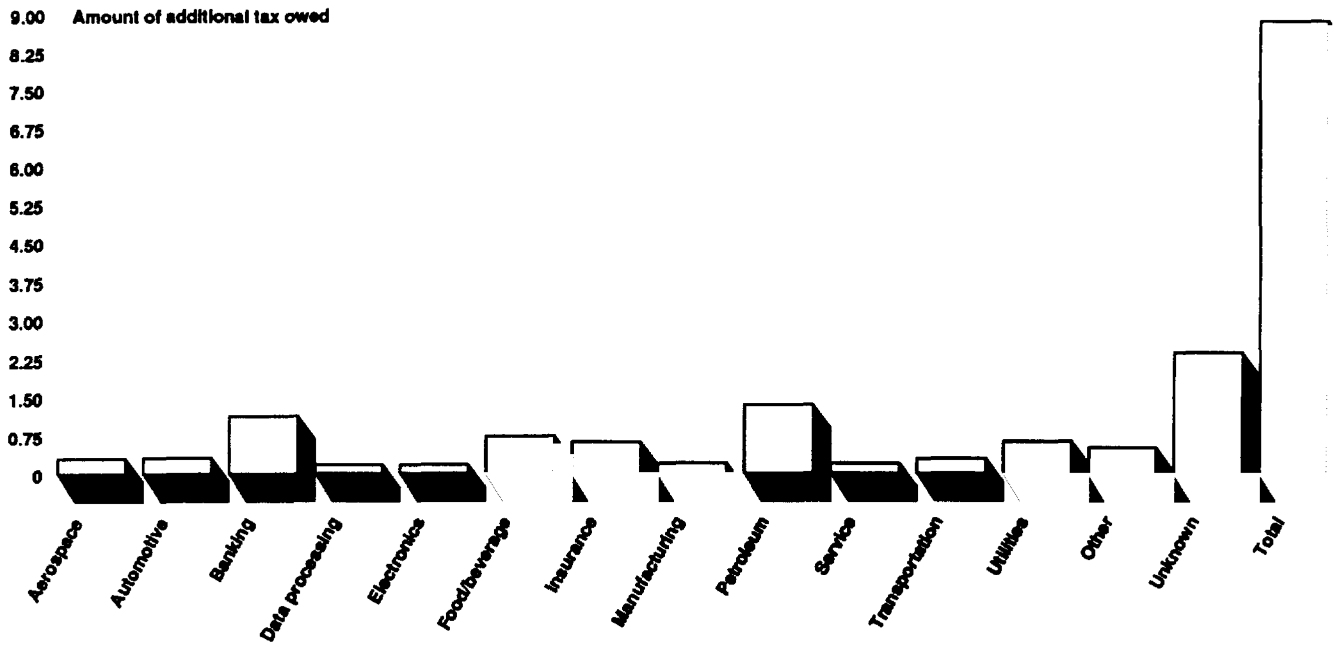
ABA also has supported protecting tax revenue owed by failing businesses. ABA pointed out that taxes withheld from employees often is a tempting source of much needed money to bolster their operations. ABA suggested that IRS take action to collect these withheld taxes before the debt becomes unmanageable for the small corporation.

APPENDIX III

LARGE CORPORATIONS--WHO DOES NOT COMPLY

Figure III.12:

Coordinated Examination Program--
Corporations With Closed Examinations by
Industry and Recommended Tax, 1988
(Dollars in billions)



IRS' CEP data did not show the 1988 examination results by industry for all corporations.

"Other" includes those with small recommended tax amounts for 1988 and those with no closed cases.

Source: IRS' 1988 CEP data.

LARGE CORPORATIONS--WHO DOES NOT COMPLY

IRS attributed a $15.8 billion tax gap in 1987 to large corporations, or those with $10 million or more in assets. For the most part, IRS based this estimate on actual examination results from the Coordinated Examination Program for 1987. CEP uses teams of revenue agents and specialists and usually covers corporations with assets over $250 million but also covers some corporations with $100 million to $250 million in assets. For corporations with assets between $10 million and $100 million, IRS estimated how much tax revenue would be generated if IRS examined them all.

Since IRS' tax gap study did not have details on the corporations that did not comply, we analyzed CEP results for nationally controlled examinations that were closed in 1988--the most recent available. In 1988, IRS completed examinations of 307 of the 1,461 corporations in CEP. From available data, we were able to identify the industry of about two-thirds of the 307 corporations, which accounted for $6.5 billion of the $8.9 billion in recommended taxes. For example,

-- 21 petroleum and banking cases accounted for $2.5 billion.

-- 52 food/beverage, utilities, and insurance cases accounted for $2.0 billion.

-- 116 cases in another 18 industries accounted for the remaining $2.0 billion.

For 38 of the 307 corporations, the examinations did not result in any recommended taxes. Of the 38 corporations, the industry was not reported for 13. Manufacturing, forest products, conglomerates, and chemical industries accounted for 14 of the other 25 corporations.

CEP covers many, but not all, of the largest corporations. In 1988, CEP's national caseload included 276 corporations that were ranked among the top 500 corporations in assets. Most of the other 224 corporations came from banking and finance industries. IRS officials explained that CEP does not always include large corporations that are regulated by other federal agencies. CEP also does not include those not meeting the selection criteria, which focus on the amount of assets and profits, high complexity, and the likelihood for additional tax liabilities. They added that not all CEP corporations are examined annually, such as those with no tax liability. Even so, they said IRS examiners should survey these corporations' books to track their tax liability.

LARGE CORPORATIONS--AREAS OF NONCOMPLIANCE

IRS has little specific data available on the issues of noncompliance that caused the 1987 corporate tax gap. However, IRS' data suggest that the noncompliance generally involved

-- improper accounting of reported income and deductions and

-- vagueness in tax laws or faulty tax records.

LARGE CORPORATIONS--AREAS OF NONCOMPLIANCE

IRS has few details available on the issues of noncompliance that caused the 1987 corporate tax gap. IRS only tracks, through a quarterly report, the main issue in each examination. The report does not include the tax impacts of the main issue being tracked or the other issues being examined. As a result, IRS does not know which issues occur most often or account for most tax losses. IRS officials said that tracking has been limited because of the issues' complexities and the lack of computer capability to maintain extensive data on all issues.

Although IRS does not have details, IRS officials said that large corporate examinations rarely identify unreported income. They believe that financial controls and oversight by stockholders and federal agencies deter hiding income. Noncompliance more often comes from improperly accounting for the sources and timing of income and expenses. For example, a corporation may treat an asset as an expense in the year of purchase when it should be capitalized and depreciated over its useful life.

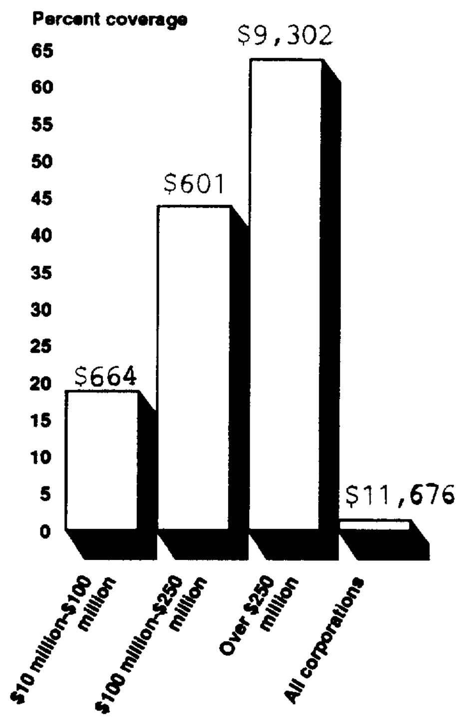
Our analysis of the main CEP issues in June 1989 showed that the sources or timing of income and expenses often involve issues such as depreciation, the proper tax year for income or deductions, disallowed deductions for capital expenditures, and income and deduction allocations among related businesses. To deal with such issues, IRS instructs examiners to check whether receipts should be capital gains or ordinary income, whether inventory has been properly carried over from past years, and whether foreign-source income has been properly allocated. For example, multinational corporations--such as those in real estate, finance, or insurance--that create legal entities in foreign nations with lower taxes may improperly channel profits earned in the United States to foreign entities.

According to IRS, large corporations, such as those with diverse subsidiaries, have aggressively used vagueness in the tax law. For example, they have claimed questionable research tax credits because of unclear documentation requirements for the credits. IRS has uncovered improper deductions due to faulty tax records. Thrift institutions have taken deductions for losses in one year but did not adjust their records, leading to duplicate deductions in the future. IRS has had to contend with some issues year after year as companies repeat practices that have previously been raised in examinations. As a result, IRS is working with the industries to create a uniform examination approach on such issues. For example, should spare parts for equipment such as computers be treated as capital assets and depreciated over the useful life or as inventory and expensed in the year of the purchase?

LARGE CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

Figure III.13:

Large Corporations--IRS' Examination Coverage by Large Corporations and All Corporations, 1988
(Dollars in millions)



All corporations includes large corporations plus small corporations (i.e.,those with assets under $10 million).

Dollars represent recommended tax and penalties.

Source: IRS' 1988 Annual Report.

LARGE CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

IRS' major way to pursue noncompliance among large corporations is the examination program. In 1988, large corporations were examined much more frequently as asset size increased. For example, IRS examined about 64 percent of those with assets exceeding $250 million and less than 20 percent of those with assets of $10 million to $100 million.

Large corporations also were examined much more frequently than all corporations, as shown in figure III.13. Further, they accounted for almost all recommended taxes and penalties from examinations of all corporations, particularly from those with assets over $250 million where the examinations generated $9.3 billion of the total $11.7 billion.

IRS' examination coverage decreased from about 78 percent and 71 percent for the largest two classes of corporations in 1986, to 64 percent and 44 percent, respectively, in 1988. IRS officials attributed the decrease in these examinations to a greater focus on tax shelters. However, the 1988 examinations generated almost $1 billion more in recommended taxes and penalties, with the greatest portion coming from those with assets over $250 million.

LARGE CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

-- Coordinated Examination Program (CEP) and Industry Specialization Program (ISP).

-- IRS district projects on large corporations' noncompliance.

-- Service center compliance teams.

LARGE CORPORATIONS--HOW IRS PURSUES NONCOMPLIANCE

To examine the largest, most complex corporations, IRS uses CEP. IRS officials said CEP largely includes corporations with assets exceeding $250 million, but also includes some corporations with assets ranging between $100 million and $250 million because of the complexity of their tax returns.

For those with assets over $100 million, CEP accounted for most of the recommended tax and penalty--$9.6 billion of the $9.9 billion in 1988 and $8 billion of the $8.7 billion in 1986. The rest of these revenues came from other types of examinations. IRS officials view CEP as essential to coordinate large corporate examinations. Also, IRS uses ISP to develop and coordinate uniform policies on industries with major tax issues, which generally involve corporations in CEP. (See app. VIII for a list of issues.)

IRS did not identify those district projects on potential noncompliance that applied to large corporations, as of June 1989. Even so, the issues in certain projects may apply. Some of these issues include amortization of intangible assets at television and radio stations, depletion recapture, investment tax credit, hidden assets, and banks that treat premiums paid to purchase a financial institution as depreciable.

Starting in 1988, teams in IRS' service centers have checked for potential noncompliance as corporate returns were filed. In the first half of 1989, teams identified 13 issues. While results are preliminary, major issues involved overstated deductions for meals and entertainment, depreciation on luxury automobiles, and the carry-over of investment tax credits, along with the improper capitalization of inventory, construction, and development costs.

LARGE CORPORATIONS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

GAO, IRS, and others have identified the following ways for IRS to better pursue large corporation noncompliance:

-- IRS is studying ways to better recover assessments from examinations that are appealed or litigated.

-- IRS proposed tax law changes to increase accountability over the reporting of foreign sources of income.

-- As we recommended, IRS is testing a document-matching program for corporations (GAO-T-GGD-87-4, Mar. 17, 1987).

-- We recommended that IRS act to collect taxes owed by corporations in bankruptcy (GAO/GGD-86-20, Feb. 21, 1986).

-- ABA suggested that IRS tighten controls on taxes owed by corporations in bankruptcy.

-- Citizens for Tax Justice has suggested clarifying the tax law to minimize disputes over compliance.

LARGE CORPORATIONS--HOW IRS COULD BETTER PURSUE NONCOMPLIANCE

GAO, IRS, and others have identified ways to reduce noncompliance by large corporations. The following list is not intended to be all-inclusive but contains ideas brought to our attention during this review. Since we did not evaluate the ideas proposed by IRS or others, we are not endorsing or recommending them, but we are including them to inspire further debate on ways that IRS can better pursue large corporations' noncompliance.

-- IRS has difficulty recovering recommended taxes from CEP examinations because of complex issues and the attrition of experienced examiners. For example, in 1988 tax court cases, IRS recovered 38 percent of $1.1 billion in taxes disputed by all corporations but 30 percent of $513 million disputed by those with assets over $50 million. IRS has, therefore, recently initiated a study of its recovery rate from CEP and other cases that are ultimately resolved in appeals or the courts. IRS expects this study to take as much as 2 years to complete. In its written comments, IRS elaborated on this study, which is developing a way to more accurately measure the amount of recommended taxes conceded through appeals or lost in litigation. The study also will identify reasons for these concessions. Further, IRS is tracking appealed cases in its TCMP survey of 1988 individual returns to develop related information. The results of the study and this tracking could help IRS to identify ways to improve IRS' recovery rate. (See app. IX.)

-- Large corporations do not always properly account for their foreign income. Recognizing this, Congress passed the Revenue Reconciliation Act of 1989, which requires that corporations with 25 percent foreign ownership report financial information to the IRS and provides that shareholders of controlled foreign corporations may be required to furnish information on the corporation and its transactions. Once IRS begins receiving this information, it will be better able to account for all sources of income through future examinations.

-- As we recommended, IRS is testing the feasibility of a corporate information returns program to identify unreported income through document matching. This test is to be completed by December 1990. The test uses information returns IRS already receives voluntarily. Since such returns are not required on payments to corporations, a tax law change would be needed for this matching program to cover all corporations.

-- We have reported that IRS needs to take additional steps to protect taxes owed by corporations that are going through bankruptcy because they do not always pay taxes they owe. IRS could better monitor bankrupt businesses and court referrals to minimize the accumulation of tax delinquencies and improve the accuracy of claims to the bankruptcy court.

-- ABA also has supported protecting tax revenue owed by failing businesses. It pointed out that taxes withheld from employees are often a tempting source of much needed money to support their operations. ABA suggested that IRS take action to collect these withheld taxes before the debt becomes unmanageable for the corporation.

-- In a 1989 report, the Citizens for Tax Justice suggested some areas of the tax law that could be clarified to minimize disputes. One suggestion involved curtailing excessive tax deductions under accelerated depreciation by using a clearer method to compute the actual depreciation deduction. In addition, because this group believed that large corporations have been taking advantage of gray areas in the tax law--such as those for mergers and acquisitions, and the alternative minimum tax--it suggested a number of legislative changes to close off these gray areas and protect the integrity and equity of the income tax system. These areas include the completed contract method and tax-free rollovers.

APPENDIX III

SUMMARY OBSERVATIONS

NONCOMPLIANCE IN THE MAJOR TAX GAP COMPONENTS

Sole Proprietors

-- Underreported taxes by type of sole proprietor.

-- Unreported income by type of income.

-- Overstated business deductions.

Informal Suppliers

-- Goods and services in the informal economy in 1985-86.

-- Reasons that informal suppliers underreport income.

Small Corporations

-- Income tax compliance by type of small corporations.

-- Unreported income.

-- Overstated business deductions.

Large Corporations

-- IRS' examination results by industry.

-- Large corporations not always examined.

-- Incomplete data on types and amounts of noncompliance.

-- Views on the nature of corporate noncompliance.

NONCOMPLIANCE IN THE MAJOR TAX GAP COMPONENTS

Observations on the nature of noncompliance for each of the four components of the 1987 tax gap follow.

Sole Proprietors

In reporting taxes for 1985, those who underreported the most taxes had the highest income and provided services, produced goods, or sold goods at a fixed location. However, those who underreported the greatest percentage of taxes had the lowest income and either sold goods or worked in transportation. In reporting income, compliance was much better for gross receipts than for net income because of overstated deductions. Deductions for vehicles and depreciation were overstated in the highest amounts while those for vehicles, insurance, and repairs were overstated to the greatest percent.

Informal Suppliers

On the basis of estimated gross receipts in 1985-86, large parts of the informal supplier economy come from providing home repairs or child care, or selling food at roadside stands. Informal suppliers can underreport receipts because they operate informally. Their business transactions often occur in cash, seldom are documented, and are not subject to third-party reporting to IRS.

Small Corporations

In 1980, those with the fewest assets and who worked in the service or retail industries were most often noncompliant in paying taxes. The noncompliance was about equally split between unreported income and overreported deductions, such as those for depreciation and repairs.

Large Corporations

In 1988, IRS' team examinations generated the most recommended taxes for those in the petroleum and banking industries. Even so, many banks were not examined, nor were large corporations in finance, because they were regulated by other federal agencies or had little tax liability. IRS does not maintain details on the types and amounts of corporate noncompliance. However, IRS officials believe that noncompliance dealt less with unreported income and more with the timing and sources of stated income and deductions. For example, corporations may misallocate income and deductions among tax years or to activities in a foreign country.

IRS' ENFORCEMENT FOR THE MAJOR TAX GAP COMPONENTS

IRS' Current Enforcement Programs

-- Regular and special examinations.

-- Information return and tax return matching program.

-- District offices' projects.

-- Teams to check compliance on incoming tax returns.

-- Ongoing initiatives:

1. Schedule C initiative.
2. Corporate document matching program.
3. Ways to encourage small business compliance.
4. Compliance strategies in the future.

IRS' ENFORCEMENT FOR THE MAJOR TAX GAP COMPONENTS

IRS' Current Enforcement Programs

-- IRS' annual examinations of income tax returns as a percentage of those filed have been decreasing for all taxpayers, even though tax revenues have increased. Yet, IRS has had some success with special examinations of direct sellers who improperly reduced their taxable income by creating business losses.

-- IRS' information returns program for individuals helps to identify unreported income. However, payments to sole proprietors and informal suppliers are less likely to be identified than income to individuals from wages, which employers are to withhold and deposit in the federal treasury.

-- IRS' district projects cover many types of noncompliance. However, IRS' national office does not have detailed information on these projects for dissemination to other districts. Even if a project works, nationwide implementation is not likely because of other priorities and limited resources.

-- IRS envisions service center compliance teams as an "early warning" system on noncompliance trends. This system is too new to know to what extent it will work.

-- IRS has ongoing initiatives to reduce noncompliance such as expanding its efforts to probe for unreported Schedule C income. As recommended by GAO, IRS also is testing whether information returns can work with corporations. IRS is also exploring ways to help small businesses to comply. For both taxpayer enforcement and service, IRS has created a Service-wide committee to develop compliance strategies into the year 2000.

IRS' ENFORCEMENT FOR THE MAJOR TAX GAP COMPONENTS

IRS could better enforce compliance across four major components of the 1987 tax gap by doing the following:

-- Sole proprietors: Document matching and tax withholding.

-- Informal suppliers: Using information from third parties.

-- Small corporations: Improving examinations, using third-party reports, and increasing controls over taxes owed.

-- Large corporations: Increasing controls over foreign-source income and taxes owed by failing businesses.

IRS' ENFORCEMENT FOR THE MAJOR TAX GAP COMPONENTS

The following ideas to improve enforcement are not intended to be all-inclusive. Since we have not evaluated ideas from IRS or others, we are not endorsing or recommending them but are including them to inspire further debate on ways IRS can improve compliance.

-- Sole proprietors: Enhance document matching with more effective checks during examinations for information reporting on payments to sole proprietors and with better information in IRS' master file. Withhold income taxes to reduce the opportunity to underreport income.

-- Informal suppliers: Use information--both inside and outside IRS--to identify informal suppliers who may not report income. Sources would include information returns and state and local governments' licenses and permits.

-- Small corporations: Improve the quality of IRS examinations and improve controls over those who use tax money they owe to support a failing business. Seek more information from third parties, such as state and local tax authorities and expand document matching to include payments made to corporations.

-- Large corporations: Improve controls over those who improperly attributed income to foreign entities or who use tax money they owe to bolster a failing business.

TABLES ON NONCOMPLIANCE FOR THE FOUR COMPONENTS AND ON IRS' EXAMINATION RESULTS

Table V.1:

Sole Proprietors' Correct and Underreported Tax Liabilities by Schedule C Classes, 1985
(Dollars in billions)

Schedule C classes by gross receipts	Amount of correct tax[a]	Amount of tax underreported	Percent of tax underreported
Under $25,000	$ 2.91	$1.12	39
$25,000 to under $100,000	10.91	3.09	28
$100,000 and over	18.45	3.24	18
Total	$32.27	$7.45	23

[a]Equals the amount of the tax that should have been paid.

Source: IRS' 1985 TCMP data.

Table V.2:

Sole Proprietors' Correct and Underreported Tax Liabilities by Principal Industrial Activity, 1985
(Dollars in billions)

Industrial activity	Amount of correct tax[a]	Amount of tax underreported	Percent of tax underreported
Production[b]	$ 6.42	$1.56	24
Agriculture[c]	1.31	0.24	18
Wholesale	1.42	0.27	19
Retail	0.28	0.09	31
Fixed location sales[d]	3.71	1.43	39
Finance[e]	3.60	0.56	16
Transportation[f]	1.24	0.45	36
Services[g]	14.28	2.86	20
Total	$32.27[h]	$7.45[h]	23

[a]Equals the amount of the tax that should have been paid.

[b]Includes construction and manufacturing, among others.

[c]Includes forestry and fishing.

[d]Includes sales from locations such as stores and restaurants, among others.

[e]Includes real estate and insurance.

[f]Includes communication and utilities.

[g]Includes doctors, lawyers, accountants, and barbers, among others.

[h]Does not add because of rounding.

Source: IRS' 1985 TCMP data.

Table V.3:

Sole Proprietors' Correct and Unreported Income by Type, 1985
(Dollars in billions)

Type of income	Correct amount[a]	Amount unreported	Percent unreported
Gross receipts[b]	$452.1	$10.2	2.3
Total income[c]	258.6	12.6	4.9
Net income[d]	94.8	23.7	25.0

[a]Equals the amount of income that should have been reported.

[b]Equals income generated from providing goods or services.

[c]Equals gross receipts plus other income minus the cost of goods sold and allowances.

[d]Equals total income minus business expense deductions and net operating losses.

Source: IRS' 1985 TCMP data.

Table V.4:

Sole Proprietors' Underreported Net Income by Schedule C Classes, 1985

Amount of reported gross receipts	Percent of net income unreported
Under $25,000	35
$25,000 to under $100,000	27
$100,000 and over	21

Source: IRS' 1985 TCMP data.

Table V.5:

Sole Proprietors' Correct and Overstated Deductions for the Largest Types, 1985
(Dollars in billions)

Largest deductions	Correct amount[a]	Amount overstated	Percent overstated[b]
All[c]	$163.8	$11.1	6.8
Cars and trucks	9.8	1.5	15.5
Depreciation	17.7	1.1	6.4
Insurance	6.7	0.9	13.4
Other interest	5.3	0.4	7.0
Rent	10.4	0.6	5.4
Repairs	5.1	0.6	11.1
Supplies	5.2	0.4	7.0
Taxes	7.0	0.3	3.6
Utilities	9.0	0.6	6.3
Wages	32.4	0.4	1.2
Other[d]	32.9	2.4	7.1

[a]Equals the amount of expenses that should have been deducted.

[b]Equals the amount of deductions overstated on the tax return divided by the amount of deductions that should have been stated.

[c]Includes the largest deductions plus 15 others--such as those for advertising, bad debts, depletion, employee benefits, and travel--where the correct and overstated amounts were smaller.

[d]The TCMP checksheet did not identify what "other" included.

Source: IRS' 1985 TCMP data.

Table V.6:

IRS' Examination Results by Schedule C and All Individual Filers, 1988
(Dollars in millions)

Type of individual	Examination coverage on filed returns (percent)	Recommended tax and penalties
Schedule C filers		
Under $25,000	1.45	$ 83
$25,000 to under $100,000	2.12	228
$100,000 and over	4.20	996
All individual filers	1.03	$5,343

Source: IRS' 1988 Annual Report.

Table V.7:

Informal Suppliers' Estimated Gross Receipts for Goods and Services, 1985 and 1986 (Dollars in billions)

Goods	Estimated receipts
Food	$10.3
Other goods	8.9
Flea market goods	4.6
Sidewalk goods	3.5
Fuel	1.3
Total goods	28.6
Services	
Home repairs	21.4
Personal care	8.1
Housekeeping	8.0
Vehicle repairs	4.9
Lawn/garden work	4.7
Other services	2.4
Lessons	2.0
Cosmetic services	1.6
Clothing repairs	1.0
Appliance repairs	0.5
Catering	0.5
Total services	55.1
Total goods and services	$83.7

Source: "The Measurement of Selected Income Flows in Formal Markets, 1981 and 1985-86," the University of Michigan.

Table V.8:

Small Corporations' Voluntary Compliance Levels in Paying Taxes by Type of Industry, 1980

Industry	Voluntary compliance level (percent)
All small corporations	80.5
Manufacturing[a]	86.1
Wholesale trade	85.6
Agriculture[b]	83.8
Construction	80.0
Transportation[c]	79.9
Mining[d]	79.7
Finance[e]	77.0
Retail trade	75.2
Services[f]	67.9

Note: Voluntary compliance level equals the amount of tax voluntarily reported divided by the sum of the tax voluntarily reported plus additional taxes owed, as identified through TCMP examinations.

[a]Includes industries such as food, apparel, and glass.

[b]Includes forestry and fishing.

[c]Includes communication and utilities.

[d]Includes industries such as metal, coal, and oil.

[e]Includes insurance and real estate.

[f]Includes hotels, doctors, and lawyers, among others.

Source: IRS' 1980 TCMP data.

Table V.9:

Small Corporations' Voluntary Compliance Levels in Paying Taxes by Asset Size, 1980

Asset size	Voluntary compliance level (percent)
All small corporations	80.5
Under $10 million to $5 million in assets	89.5
Under $5 million to $1 million in assets	84.2
Under $1 million to $500,000 in assets	80.7
Under $500,000 to $250,000 in assets	74.5
Under $250,000 to $100,000 in assets	66.1
Under $100,000 to $50,000 in assets	50.7
Under $50,000 to $1 in assets	48.4

Note: Voluntary compliance level equals the amount of tax voluntarily reported divided by the sum of the tax voluntarily reported plus additional taxes owed, as identified through TCMP examinations.

Source: IRS' 1980 TCMP data.

Table V.10:

Small Corporations' Correct and Unreported Income by Type, 1980
(Dollars in billions)

Type of income	Correct amount[a]	Amount unreported	Percent unreported
Gross receipts[b]	$1,305.7	$ 3.8	0.3
Total income[c]	447.0	5.1	1.1
Net income[d]	23.6	11.1	47.2

[a]Equals the amount of income that should have been reported.

[b]Equals income generated from providing goods or services.

[c]Equals the gross receipts plus other income minus the cost of goods sold and allowances.

[d]Equals the total income minus various business expense deductions and net operating losses.

Source: IRS' 1980 TCMP data.

Table V.11:

Small Corporations' Correct and Overstated Deductions for Largest Types, 1980
(Dollars in billions)

Largest deductions	Correct amount[a]	Amount overstated	Percent overstated
All[b]	$406.4	$5.5	1.4
Advertising	9.0	0.1	0.9
Depreciation	20.7	0.4	2.1
Interest	21.6	0.2	1.1
Officers' pay	64.3	0.2	0.4
Pension plans	10.3	0.1	1.1
Repairs	7.0	0.4	5.5
Rent	19.6	0.2	1.0
Taxes	23.5	0.2	0.6
Wages/salary	99.9	0.2	0.2
Other deductions[c]	123.2	2.9	2.4

[a]Equals the amount of expenses that should have been deducted.

[b]Includes the largest deductions plus five not listed here--amortization, bad debts, contributions, depletion, and employee benefits--because the correct and overstated amounts were smaller.

[c]The TCMP checksheet did not identify what "other" included.

Source: IRS' 1980 TCMP data.

Table V.12:

IRS' Examination Results on Small Corporations and All Corporations, 1988 (Dollars in millions)

Type of corporation	Examination coverage on filed returns (percent)	Recommended tax and penalties
Small (by assets)		
Under $1 million	0.73	$ 382
$1 million-$5 million	2.58	320
$5 million-$10 million	7.59	217
All corporations[a]	1.33	$11,676

[a]Includes small corporations plus large corporations (i.e., those with assets of $10 million and over).

Source: IRS' 1980 TCMP data.

Table V.13:

Coordinated Examination Program: Cases in June 1988 and Examination Results on Large Corporations by Industry During 1988
(Dollars in billions)

Industry	Cases in June 1988	Closed corporate examinations in 1988	Recommended tax in 1988[a]
Aerospace	22	8	$0.30
Automotive	24	7	0.31
Banking	34	8	1.13
Chemicals	21	6	0.03
Conglomerates	20	9	0.04
Data processing	24	8	0.17
Electronics	32	5	0.17
Food/beverage	49	17	0.73
Forest products	17	10	0.02
Health	14	6	0.11
Insurance	45	17	0.61
Manufacturing	77	18	0.19
Petroleum	49	13	1.34
Retail	18	6	0.04
Service	27	8	0.19
Transportation	12	8	0.29
Utilities	45	18	0.63
Other[b]	96	17	0.25
Unknown	0[c]	118[d]	2.37[d]
Total	626	307	$8.92

[a]Equals the additional tax the large corporation is determined to owe by the Examination Division.

[b]Includes those with fewer than five closed cases, such as mining, communication, construction, pharmaceutical, publishing, and other, and those with no closed cases such as finance, housing, and savings and loan.

[c]IRS' CEP data showed all industries for corporations in which the examination cases under national control were open as of June 1988.

[d]IRS' CEP data did not show all industries for corporations in which examination cases under national control were closed during 1988.

Source: IRS' 1988 CEP data.

Table V.14:

IRS' Examination Results
on Large Corporations
and All Corporations, 1988
(Dollars in millions)

Type of corporation	Examination coverage on filed returns (percent)	Recommended tax and penalties
Large (by assets)		
$10 million-$100 million	18.8	$ 664
$100 million-$250 million	43.8	601
Over $250 million	63.7	9,302
All corporations[a]	1.3	$11,676

[a]Includes large corporations plus small corporations (i.e., those with assets under $10 million).

Source: IRS' 1988 Annual Report.

IDEAS FROM GAO, IRS, AND OTHERS TO IMPROVE COMPLIANCE

In addition to the ideas presented in the four profiles, the following are ideas proposed by GAO, IRS, and others to improve tax enforcement and voluntary tax compliance. These recommendations are listed here because they were not specifically related to the four components in our report. This list is not intended to be all-inclusive. It is limited to ideas we identified in our reports or through our work at IRS. Because we have not evaluated ideas from IRS or others, we are not endorsing or recommending the ideas, but we have listed them to inspire a debate on ways in which IRS could better pursue noncompliance.

General Accounting Office

-- Establish new techniques to detect unreported income (GAO/GGD-86-119, Sept. 30, 1986, GAO/GGD-87-45, July 16, 1987, and GAO/OCG-89-26TR, Nov. 1988).

-- Improve the management of the criminal enforcement programs, which help to detect tax fraud and evasion (GAO/GGD-88-61, Apr. 25, 1988, and GAO/GGD-89-41, Mar. 16, 1989).

-- IRS should take steps to ensure U.S. tax law compliance of nonresident aliens (GAO/GGD-88-54, Apr. 11, 1988).

-- IRS should more actively pursue tax revenue from closed criminal cases (GAO/GGD-89-41, Mar. 16, 1989).

-- Make the process for collecting 100-percent penalties more efficient and effective (GAO/GGD-89-94, Aug. 21, 1989).

-- Congress should reinstate the penalty applied to taxpayers who fail to report income that is disclosed on information returns, and strengthen the penalties applied to taxpayers who understate their tax liabilities (GAO/GGD-89-81, Sept. 6, 1989).

-- IRS should explore ways to better use state tax information (GAO/GGD-86-8, Dec. 13, 1985).

-- IRS should collect and analyze information on exempt organizations to gain insights on the size and nature of unrelated business income tax noncompliance (GAO/GGD-85-64, July 8, 1985).

-- IRS should pursue taxes owed by U.S. citizens living abroad who fail to file tax returns (GAO Testimony, May 8, 1985).

Internal Revenue Service (Strategic Business Plan Fiscal Year 1991-1995)

-- Identify and propose changes to the tax law that promote simplification and fairness and reduce complexity and ambiguity, so that voluntary compliance is more likely.

-- Expand enforcement with increased emphasis on special compliance activities, such as examining known types of noncompliance.

-- Improve the effectiveness, efficiency, and accuracy of automated compliance systems, including those that use information returns and financial information documents--such as Currency Transaction Reports and Combined Annual Wage Reports.

-- Improve the accuracy of telephone responses and provide reasonable telephone assistance service.

-- Analyze the efforts to identify compliance in the nonfiler population and develop new ways to identify nonfilers not covered by information return reporting.

-- Develop new ways to address improper reporting of tax liabilities.

-- Enhance understanding of enforcement coverage through education and information programs.

In addition, IRS' written comments to this report cited initiatives to improve compliance across various types of taxpayers. (See app. IX.) These initiatives include

-- developing automated systems to identify returns with high audit potential and to assist in processing correspondence audits;

-- educating businesses and their employees about their responsibilities in filing Currency Transaction Reports, especially on suspicious currency transactions; and

-- pursuing criminal noncompliance in the legal sector through the Criminal Investigations Division's General Enforcement Program.

American Bar Association Commission on Taxpayer Compliance Report and Recommendations July 1987

-- Improve the effectiveness of audits (emphasis on both quality and quantity).

-- Use more detailed information from prior audits and on taxpayer occupations in selecting returns for audit.

-- Educate taxpayers and assist them in complying.

Citizens for Tax Justice (Study on Tax Reform October 1989)

-- Reduce vagueness in the tax law:

Completed Contract Method

Employee Stock Ownership Plans

Tax-Free Rollovers

-- Do not reduce the capital gains tax.

-- Make the research and development tax credit equitable.

-- Curb the tax advantages of leveraged buy-outs.

-- Do not restore the investment tax credit.

-- Do not allow a corporate tax deduction for dividends paid.

APPENDIX VI

IRS' SUGGESTED LEGISLATIVE PROPOSALS ON TAX COMPLIANCE ISSUES, 1986 TO 1990

Legislative proposal process:

-- IRS package of proposals.

-- Treasury review of the package.

-- Executive Office of the President approval of the package.

-- Congressional action on individual proposals.

IRS' SUGGESTED LEGISLATIVE PROPOSALS ON TAX COMPLIANCE ISSUES

IRS' Legislative Affairs Division annually solicits legislative proposals from each IRS Assistant Commissioner and selects those to submit to the IRS Commissioner. After further review, the Commissioner approves and transmits a package of proposals to the Department of the Treasury. After this stage of review, the package goes through the Executive Office of the President before reaching Congress.

IRS' legislative proposals include some that are administrative in nature. If these are enacted, they could improve the operations of IRS and thereby allow IRS to collect more taxes faster. Even so, generally we did not include these in our listing since we focused on tax policies.

Generally, all of IRS' suggested legislative proposals get included in Treasury's legislative program for review and approval by the Executive Office of the President and are forwarded to Congress.

Only one of the proposals we listed was not approved by the Treasury and forwarded to Congress. That one dealt with the prohibition of amortization of customer-based intangibles, such as core deposits of acquired financial institutions, favorable financing, market share, and other similar intangible items.

Table VII.1 lists proposals that address certain components of the tax gap and have been sent to the Treasury by the IRS Commissioner. As the table shows, several of the IRS proposals are submitted year after year without congressional action. Congress has enacted several of IRS' proposals including those dealing with withholding forms and foreign corporations.

Table VII.1:

Proposals on Tax Compliance Issues

Selected proposals on compliance	Years proposals were made				
	1986	1987	1988	1989	1990
1. Require employers to file withholding forms for employees having excessive withholding allowances or an exemption from withholding.	X				
2. Clarify that corporations must pay estimated taxes on all taxes listed in Title 26.	X	X	X		
3. Require information reporting on the complete redemption value of stock owned by a shareholder.	X				
4. Clarify that rules on deductions and credits apply to domestic as well as foreign partnerships.	X	X	X		
5. Require fiduciaries to report certain information on beneficiaries.	X	X	X	X	
6. Penalize Subchapter S Corporations for failure to file tax returns or information returns on its shareholders.	X	X	X	X	
7. Clarify that an adjustment to correct an overstatement of the earned income tax credit shall be added to the notice of deficiency.	X	X	X		
8. Allow assessments for taxes owed by businesses filing for bankruptcy.	X	X	X	X	X
9. Allow IRS to obtain consumer reports on a taxpayer's assets and income when attempting to collect a tax liability.	X	X			

Selected proposals on compliance	1986	1987	1988	1989	1990
	Years proposals were made				
10. Allow tax assessments on large amounts of cash held by a person who claims to not be the true owner.				X	X
11. Prohibit amortization of customer-based intangibles.				X	
12. Clarify the tax laws that govern use of the percentage depletion allowed for minerals extracted from oil and gas wells.				X	X
13. Limit tax avoidance on dividends paid by a corporation located in a tax haven.				X	
14. Require withholding on payments to certain fishing boat crew members.				X	
15. Require information reporting on foreign-owned corporations.				X	
16. Extend the statute of limitations for asserting penalties when withheld taxes are not paid.				X	
17. Clarify that a trustee in bankruptcy cannot avoid a federal tax lien.				X	X

COORDINATED ISSUES IN THE INDUSTRY SPECIALIZATION PROGRAM OF IRS' EXAMINATION DIVISION, JULY 1989

The following lists the coordinated issues by industry that IRS' Examination Division tracks through its Industry Specialization Program for corporate examinations. In addition to the following industries, ISP includes three other industries--Commodity, Electronic Components, and Health--in which the issues being tracked for examination were not required to be coordinated across IRS.

AEROSPACE

Deductibility of Illegal Bribes, Kickbacks, and Other Illegal Payments: Are illegal bribes, kickbacks, and other illegal payments properly deductible under Internal Revenue Code (IRC) Section 162(c)?

Title of Inventory: Are the tax ramifications of the Defense Acquisition Regulations or the National Aeronautical and Space Administration Regulations fully considered with special emphasis on the title clause?

Loss Contracts and Negative Inventories: To what extent is the deduction of anticipated losses or the establishment of reserve for such losses allowable?

Cost Overruns and Underruns: Is income clearly reflected in cost overrun and underrun situations?

Travel and Entertainment Expense: Are gifts, entertainment, and other payments to government officials and employees ordinary and necessary business expenses?

Full Absorption Costing: Are the aerospace companies in compliance with the full absorption costing principles for determining inventory?

COMMERCIAL BANKING

Accrual of Interest on Nonperforming Loans: Should an accrual-basis bank continue to accrue interest on delinquent loans placed in a nonaccrual status?

Core Deposit Intangibles: Should the excess purchase price paid for a bank over the tangible assets acquired be treated as goodwill/going concern value or as an amortizable intangible asset called core deposit intangible?

Gain or Loss on Foreclosures or Restructuring Debts: Is the gain or loss from disposing of real property through foreclosures, deeds in lieu of foreclosure, or securities as part of restructured debt, ordinary or capital gain or loss?

Gross-up of Net Loans: (1) Must an amount that equals foreign withholding taxes paid by borrowers under "net" loan agreements be included in gross income of the lender in the tax year in which the obligation of the borrower to pay such taxes arose and (2) are creditable foreign withholding taxes that are included in the income of the lender considered documented for the foreign tax credit under IRC 905?

Interest Received in Excess of a Maximum Amount: Should interest income received in excess of a maximum amount be recognized in each year of the loan?

CONSTRUCTION

Advances for Personal Services: Are advances received under an agreement for construction and personal services by the taxpayer, where the agreement is not completed in the same taxable year as the advances, separated into "construction" and "services" components and reported according to IRS regulations?

Income from Services Not Qualifying as Long-Term Contracts: (1) For service contracts such as engineering, management, architectural, and procurement, were these treated as long-term contracts in which income was incorrectly reported under a long-term method of accounting and (2) for combination contracts, which provide for both construction and one or more of these nonqualifying services, were such services "carved out" of the contract?

Income Improperly Deferred on Long-Term Contracts: (1) Under the completed contract method, is gross income from a long-term contract reported for the tax year in which the contract is completed, and was the determination of a contract's completion done properly and (2) under the percentage of completion method, was the computation of the percentage of completion incorrectly adjusted by "risk factors" or reserves for losses and were anticipated losses incorrectly deducted?

Use of IRC 482 and/or Subpart F for Services to Controlled Foreign Corporations (CFCs): Are domestic entities performing services for or providing assets to CFCs properly allocating income under IRC 482 if these are integral parts of the trade or business of the domestic entity or the CFC, and properly reporting in certain conditions Subpart F income under IRC 954(e)?

DATA PROCESSING

Accounting for Spare Parts or Service Parts: Should spare or service parts be expensed or capitalized?

Installation and Other Costs on Rental Equipment: Are these costs deducted as "period" costs when actually these costs apply over the life of the lease?

Investment Tax Credit: Does property, including computer systems and other business equipment, which is leased to the government and/or tax-exempt organizations, qualify for the Investment Tax Credit under IRC 38?

Use of Tax Havens by Data Processing/Computer Manufacturers: Does pricing transactions between U.S. companies and their tax haven affiliates reflect arm's-length standards under IRC 482?

FOOD

Contributions of Food Inventory to Charitable Organization: Have food processors contributing unsalable food to charitable organizations properly calculated the IRC 170 deduction?

Investment Credit on Refrigerated Structures: Is the investment credit claimed on refrigerated structures that can be economically converted to other uses eligible for the credit?

Package Design Costs: (1) Are the costs for developing a new package design for a product, or substantially modifying an existing package design considered capital expenditures under IRC 263, and (2) do the costs for a package registered under the trademark or trade name laws qualify for a 60- month amortization under IRC 177?

Qualified Discount Coupons: Have food processors claiming a deduction under Section 466(c) for accrued discount coupons (1) made the proper election, (2) maintained adequate records as required, (3) met the definition of discount coupons, and (4) set up a suspense account when required?

Recycling Equipment and the Energy Tax Credit: Is the machinery and equipment that is classified as recycling equipment eligible for the energy tax credit under IRC 48, given the equipment's function and end products?

FOREST PRODUCTS

Allowance of Depreciation and Investment Tax Credit on Logging Roads: What portion, if any, of the cost incurred by taxpayers in constructing logging roads on their land should be considered as a nondepreciable cost and therefore not be subject to either a deduction or depreciation under IRC 167(a) or the investment tax credit under IRC 48(a)?

Commission Income Due Under a IRC 631(a) Election: What is the proper basis to be used for the costs of logs in computing combined taxable income when the cutting of timber is treated as a sale or exchange under IRC 631(a)?

Computation of Timber Casualty Losses: When timber is damaged or destroyed in a qualifying casualty loss, what is the "single identifiable property" for purposes of computing the basis limitation?

Energy Credit--Black Liquor Recovery System: What portion of a black liquor recovery system qualifies as alternative energy property under IRC 48(1)(3)?

Expenditures for Forest Re-Planting Losses: Should the costs of re-planting areas where the initial planting was unsuccessful and was not due to a casualty be treated as an ordinary and necessary business expense under IRC 162, as a loss under IRC 165(a), or as a capital expenditure in a manner identical to the original planting costs?

Investment Tax Credit--Paper Machine Structure: Does a structure with a paper machine qualify as "other tangible property" or as a building under IRC 48(a)(1)(b)?

Timber Losses From Severe Drought: What is the proper treatment under IRC 165(a) for losses from severe, prolonged drought?

Losses of Timber Caused by Insects: What is the proper treatment under IRC 165(a), for timber losses caused by insect attack?

LIFE INSURANCE

Allocation of Expenses Between Investment and Underwriting Income: Is the expense between investment and underwriting income properly allocated?

Life Insurance Reserves: (1) Does a reserve for cash surrender values that exceeds the required reserve qualify as a life insurance reserve under IRC 801(b) and (2) where an entire reserve does not qualify under IRC 801(c), what adjustment is necessary to compute gain or loss?

Retrospective Rate Credits: (1) Are refunds made to group policyholders of return premiums deductible under IRC 809(c)(1), or are dividends to policyholders deductible under IRC 811(a) and (2) can taxpayers accrue potential retrospective rate credits attributable to contracts expiring after the close of the taxable year?

Revaluation of Preliminary Term Reserves: (1) When a preliminary term reserve equals the net-level reserve values, can it continue to be revalued under IRC 818(c)(2) and (2) should the benefits under certain combination life insurance contracts be separated into term insurance and nonterm insurance for purposes of the approximate revaluation of life insurance reserves under IRC 818(c)(2)?

Section 334(b)(2) 338: What is the amount of insurance in force to amortize?

MEDIA COMMUNICATIONS

Customer Subscription Lists: Is a customer subscription list acquired in the acquisition of a cable television company, newspaper, magazine, or other business, and to which a portion of the purchase price is allocated, an asset separate from goodwill and subject to amortization?

Converter Deposits: Are customer deposits for converter boxes includible in income in the year received?

Start-Up Expenses: Are these expenses for obtaining a cable television franchise deductible under IRC 195?

PETROLEUM

Crude Oil and Products Trading Operations in Tax-Haven Countries: Which corporated entity is the proper recipient of income when crude oil and trading operations are conducted in a tax-haven country corporation?

Estimated Dismantling and Removal Cost: Are dismantling or removal costs treated as being incurred before the actual dismantling or removal occurs?

Interest-Free Loans to Procedures: Are such loans properly treated as the sale of an overriding royalty and an option, as an advance payment for gas, or as a true loan when gas is not discovered, depending on the factual situation?

Interstate Fixed Gas Contracts: Has the allowance for the sale of natural gas been properly computed under IRC 613A?

Line Pack Gas: Is the cost of the natural gas required to be in a pipeline to maintain pressure part of inventory or subject to depreciation and the investment credit?

Precious Metals: Are the costs for metals used as catalysts in refineries subject to the depreciation allowance and the investment credit when a portion of the catalyst is recovered with the metal?

PROPERTY AND CASUALTY INSURANCE

Captive Insurance Companies: Are insurance premiums paid directly to foreign or domestic captive insurance companies deductible by the parents (and related entities) under IRC 162?

Unpaid Loss Adjustment Expenses: Is the deduction for unpaid loss adjustment expenses a fair and reasonable estimate of the amount the company will be required to pay?

Unpaid Loss Reserves: Is the deduction for "losses incurred," which represents unpaid losses at the close of the taxable year, a fair and reasonable estimate of the amount the company will be required to pay?

RAILROAD

Amortization of Track Structure: Have railroads improperly included assets in their bases when using the Retirement-Replacement-Betterment method of depreciating assets as of December 31, 1980, over a 5-year period?

Protective Conditions: Do the costs of defeating a proposed merger or other protective conditions create an intangible asset, and as such are they not an allowable deduction?

Railroad Holding Companies: Are such companies railroad employers, under IRC 3231(a), and subject to the taxes imposed by IRC chapters 22 and 23a, as well as, or instead of, those imposed by chapters 21, 23, and 24?

Side Track Deposits: Are amounts received by railroads to construct spur lines at the request of a shipper included in income when received, and are they claimed as a deduction for any repayment of deposits?

Structured Settlements: To what extent may a deduction be claimed for accrual of personal injury payments to be made under provisions of an agreement covering several years?

RETAIL

Claims for Refund of Work Incentive Training Program Credit: Has the employer met the certification and "substantially full time" requirements of the credit?

Costs of Heating, Ventilating, and Air Conditioning Systems: Do these costs apply to Section 38 property, and are they eligible for the investment tax credit or the accelerated cost recovery system's 3-year and 5-year recovery?

Costs of Mechanical Service Systems: Do these costs apply to Section 38 property, and are they eligible for accelerated cost recovery as 3-year or 5-year property?

Costs of Suspended Acoustical Ceilings: Do these costs apply to Section 1245 property, and are they eligible for the accelerated cost recovery deduction as 3-year or 5-year property or for the investment tax credit?

Treatment of Inventory Shrinkage: Should inventory shortages attributed to shoplifting be included in the cost-of-goods-sold when computing gross profit?

Valuation of In-Transit Inventory: May the cost and estimated retail selling price of inventory in-transit be excluded from the cost complement ratio under the LIFO retail inventory method?

SAVINGS AND LOAN

Accrued Interest on Nonperforming Loans: Should an accrual basis savings and loan continue to accrue interest on delinquent loans placed in a non-accrual status?

Core Deposit Intangibles: Should the excess purchase price paid for a savings and loan over the tangible assets be treated as goodwill/going concern value or as a amortizable intangible asset called core deposit intangibles?

Deferred Loan Fees--Composite Method: May an accrual basis savings and loan defer loan fees charged to a borrower when originating a mortgage?

Deferred Loan Fees--Loan Liquidation: May a cash basis savings and loan defer loan fees charged to a borrower when originating a mortgage?

Interest Income on the Sale of Foreclosed Property: Does a cash basis savings and loan have to include in gross income the sale of foreclosed property to the extent it represents accrued but unpaid interest?

Mortgage Buy-Downs: Should buy-down fees received at loan origination be considered current income by a savings and loan or be deferred over the period of the buy-down?

Premature Withdrawal Penalties: Is the penalty for the premature withdrawal of a savings certificate considered income from the discharge of indebtedness and thus excludable from income pursuant to IRC 108?

Validity of Regulations Section 1.593-6A(b)(5)(vi): Is this Treasury regulation section valid?

UTILITIES

Budget Billing: When is income reportable by an accrual basis utility company, which bills customers under the budget billing method?

Contributions in Aid of Construction and Related Connection Fees: What is the proper tax treatment for refundable and nonrefundable advances received by utilities from customers, real estate developers, and government agencies?

Customer Deposits: Are deposits received by a utility company considered advance payments and part of gross income?

APPENDIX VIII

COMMENTS FROM THE INTERNAL REVENUE SERVICE

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

COMMISSIONER

FEB 28 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: Profiles of Major Components of the Tax Gap".

See pp. 7-8.

We have enclosed detailed comments on the report which provide clarification on the tax gap estimates and further explanation of initiatives under consideration or underway to address the tax gap.

We believe that a balanced approach between customer service activities and direct enforcement programs is needed to improve compliance with the tax laws. Our FY 1991 budget request reflects this philosophy. With this budget, we will continue our commitment to reducing taxpayer burden by funding Taxpayer Service at levels which will allow IRS to increase access to assistance and continue efforts to improve the quality of assistance. We will also improve our tax enforcement capabilities and increase revenue from our enforcement programs. We will do this in two ways; using existing IRS resources in a more targeted fashion and deploying additional permanent staffing.

See p. 8.

Finally, we would like to point out that later this year we will be issuing a new report which will present IRS' estimates of the "net income tax gap" which is the gross income tax gap less the amount of income taxes paid or collected as a direct result of IRS enforcement activity. The report will also include estimates on the portion of the net tax gap that would be cost effective to recover through expansion of IRS enforcement programs.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Fred T. Goldberg, Jr.

Enclosure

IRS Comments on GAO's Draft Report
"Tax Administration: Profiles of Major
Components of the Tax Gap"

TAX GAP ESTIMATES

See p. 7.

For individual taxpayers with proprietorship income, GAO's figures do not agree with IRS tax gap estimates. IRS estimates the 1987 tax gap for this category of income as $16.6 billion. This estimate is based on analysis of 1982 TCMP data extrapolated to 1987. The GAO figure of $7.4 billion is based on 1985 TCMP data.

See p. 7.

Two factors probably account for the majority of the discrepancy. First, IRS adjusts the estimates for most types of unreported income to allow for the fact that not all unreported income is detected in the TCMP examinations. For business income, this adjustment requires a record-by-record analysis of TCMP cases, taking separate account of misreporting gross receipts, cost of goods sold, and expenses. The GAO figures do not reflect any such adjustments. The second factor which may account for part of the discrepancy is that the GAO figure is based on the total understatement of tax on returns for which proprietorship income is the principal type of income, while the IRS estimate is based on the underreporting of proprietorship income on all returns.

See p. 7.

These differences cause the GAO figure for the level of the proprietorship income tax gap to be too low; they may cause the GAO estimates of distribution by income levels and type of business to be incorrect as well.

See p. 27.

The GAO report states that the percentage of underreporting of tax liabilities is greater for lower Schedule C income categories than for the higher categories. This conclusion may be erroneous because the income-level categorization is based on the income reported on the tax returns. Such analysis should categorize taxpayers by their corrected income, not by their reported income. An analysis of 1979 TCMP data showed that taxpayers in the lowest income categories and in the highest income categories had lower compliance percentages than taxpayers in the middle income categories.

See pp. 7-8.

The GAO report does not mention that IRS' 1988 tax gap report contains alternate estimates of the tax gap. This is especially relevant for large corporations. The tax gap estimate for corporations with more than $10 million in assets is based on the tax deficiencies "recommended" by IRS revenue agents in operational audits of companies tax returns. About 80 percent of these recommendations are appealed by the taxpayers, and about

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See pp. 7-8 and 77.

70 percent of the appealed recommendations are conceded in the administrative appeals process or lost in litigation. It is arguable that some substantial fraction of the amount conceded or lost should not properly be construed as part of the tax gap. On the other hand, revenue agents may not find all instances of tax deficiency on the tax returns they examine. An effort is currently underway to develop a method of more accurately measuring sustention rates in appealed and litigated cases, and to identify reasons for concession from examination recommendations. In a TCMP survey of 1988 individual returns just getting underway, we also plan to track appealed TCMP cases to determine the sustention rates on those cases. With this additional information we should be able to more accurately determine the effect that such cases have on TCMP estimates.

ADDRESSING THE TAX GAP

The IRS believes that a balanced approach between customer service activities and enforcement programs is needed to address the tax gap. Although the GAO report generally describes our efforts in these areas, several other programs and initiatives are worth noting.

Customer Service

See p. 41.

IRS' Research Division is engaged in a multi-functional effort to identify and implement less labor-intensive, non-enforcement methods for dealing with noncompliance among small business taxpayers. Current estimates show that small businesses are responsible for a substantial portion of the tax gap, and because new small businesses are part of the fastest growing section of the economy this influence is expected to increase. Given that in individual cases, a single taxpayer may represent only a very small share of the total underpayment, traditional enforcement methods can prove to be ineffective and cost prohibitive. With the Research Division as coordinator, a variety of non-enforcement education and information techniques are being tested to further assist small business owners in meeting their tax obligations.

See p. 41.

The Research Division also will coordinate the efforts of a District Office working with the State tax authority and State licensing agency to provide a self-help program for small business taxpayers. Taxpayers will be invited to bring in all their business and tax records to receive hands-on assistance in preparing record-keeping systems and in completing their tax forms in a classroom environment. This is being implemented in the St. Louis District. Classes are scheduled for four cities around the state through July 1990.

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See p. 41.

Other customer service initiatives being tested include:

- Requesting that taxpayers confirm information derived from their EIN application in order to validate filing requirements and emphasize the need to file timely. More precise development of filing requirements for business taxpayers is expected to result in a reduction of the number of forms and publications erroneously mailed to taxpayers and in the number of notices erroneously issued by Collection.

- Developing a software package that will produce an individualized calendar for each taxpayer. Filing dates, tax deposits and payments will be included for income tax, payroll tax, excise tax, etc. A notice of availability for the calendar will be issued to applicants for EIN's.

- Determining the influence of IRS educational materials on compliance behavior. Twelve issues of a monthly newsletter will be distributed to new business owners for a full year after they are selected for the test. Information will cover basic issues, including a monthly tax calendar, and will be appropriate for subsequent years with a minimum of updating.

- Testing the effectiveness of educational materials on record-keeping and tax responsibilities provided to new business taxpayers with their EIN's. Testing the effectiveness of alternative methods of advising taxpayers of the availability of Small Business Workshops and other small business tax education programs developed by Taxpayer Service.

See p. 41.

Over the longer term, we are engaging in a five-year survey to determine the most beneficial use of resources in addressing the needs of small business owners and the value of IRS assistance to business taxpayers. It will provide information on the longevity of new small businesses operated by first time owners, the number of small businesses relying on professional tax assistance, and help determine if a correlation exists between the use of such help and the survival rates of new businesses.

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Direct Enforcement

See p. 101.

On a more direct enforcement oriented level, we are developing an Automated Issue Identification Expert System that can identify issues with good audit potential from 1040, 1040A, and 1040EZ income tax returns. Currently, this step in identifying returns is done manually by IRS auditors in the Service Centers after returns have received a high Discriminant Function score indicating a strong audit potential. The goal of the automated system is to replace the manual review process, create a more consistent approach free of individual bias, and relieve auditors from manual classification of returns thus freeing them for other duties.

See p. 101.

Other automation initiatives are addressing expert systems in the estate tax area as well as exploring the feasibility of developing an Automated Correspondence Examination system to assist in processing correspondence examination cases. While this latter initiative is not expected to significantly reduce the time involved in verifying taxpayer receipts or analyzing taxpayer responses, it should achieve a substantial increase in productivity by eliminating most physical handling of a case file. Automating the process would increase the capacity to conduct correspondence audits.

See p. 42.

Collection is continuing to use information returns to identify employees misclassified as independent contractors. Collection examines employment tax returns to identify situations where employers treat workers as independent contractors instead of employees as defined by the 20 common law practices. IRS assesses employment tax against the employers and secures delinquent information documents. By reclassifying the employees, they are added to the withholding rolls in the future, thus preventing future unreported income by these individuals and unreported Federal Insurance Compensation Act (FICA) taxes by their employers.

See p. 65.

Another Collection enforcement program not mentioned in the report involves filing delinquent returns for taxpayers who have stopped filing or for whom information returns indicate potential tax liability. IRS issues delinquency investigations on taxpayers who have stopped filing employment tax, corporate, and partnership income tax returns, and on taxpayers for whom information returns indicate a potential individual income tax liability. For taxpayers who do not respond to notices of tax returns due, IRS makes assessments on certain cases using deficiency procedures and Internal Revenue Code 6020(b).

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See pp. 42 and 65.

To facilitate our document matching programs and to avoid unproductive non-filer investigations, the Returns Processing and Accounting function has instituted corrective actions regarding the erroneous issuance of multiple employer identification numbers (EINs), including:

- The research procedures tax examiners must follow before assigning an EIN have been expanded.
- The letter sent to taxpayers after they have applied for an EIN has been changed telling them to always use the name and number as shown on the letter.
- The name control and number match criteria have also been expanded.

See p. 101.

Finally, it is important to recognize the role of IRS Criminal Investigation programs in ensuring compliance with the tax laws. The Criminal Investigation function's general enforcement program investigates criminal violations of the Internal Revenue Code to combat noncompliance in the legal sector. It initiates these investigations primarily from referrals from the Examination and Collection Division of the IRS, other government agencies and the public. Criminal Investigation also has begun a program to send employees to local financial institutions and businesses to educate them about reporting the currency transactions that occur at their establishments, as required by law. In addition, they are also enlisting these firms to report "suspicious" currency transactions, when it appears the customer is attempting to circumvent the currency transaction reporting laws. By increasing the filing of these forms, the IRS improves the opportunity of detecting noncompliance.

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