



Testimony

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U.S. Senate

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SMALL BUSINESS

Taxpayers Face Many Layers of Requirements

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Small Business: Taxpayers Face Many Layers of Requirements

Small businesses—a category that includes sole proprietorships, partnerships, S corporations, and corporations with assets less than \$5 million—are an important segment of taxpayers that are subject to substantial federal tax requirements. Not only do they account for nearly half of all taxes the Internal Revenue Service (IRS) collects annually, but they also have extensive interactions with IRS about some very difficult and complex issues.

GAO's preliminary results indicate that

- Small businesses, like large businesses, are subject to multiple layers of filing, reporting, and deposit requirements. GAO identified more than 200 different Internal Revenue Code (IRC) requirements that potentially apply to small businesses. The requirements reflect IRS' administration of a variety of tax and other policies, including income, employment, and excise taxes, as well as pension and other employee benefit programs. GAO also found that it is highly unlikely that any business would need to comply with all or even most of these requirements. Those that apply would depend on how the small business is organized, whether it has employees, and the nature of its business operations. In considering the number of requirements, it is important to note that the requirements did not come about by happenstance. They reflect the many decisions and compromises that have been made by Congress and Administrations to accomplish their policy goals, including those that may benefit small businesses and other taxpayers.
- Limitations in IRS information systems prevented GAO from fully determining the extent to which small businesses filed the various forms and schedules or their involvement in key stages of IRS' enforcement processes. One problem pertained to locating information that GAO needed. IRS has dozens of discrete databases—so many that it is difficult to determine what data are in them, what the data mean, how the files are structured, or even how many files there might be. Also, many of the IRS databases do not allow for a detailed analysis of the information they contain. The limitations currently hinder IRS' ability to effectively manage its activities and serve small businesses and, as IRS has acknowledged, will continue to be a serious impediment until the systems are improved.
- Although IRS does not have a reliable method to measure compliance burden, there is common agreement that the burden is significant for small businesses. Past GAO surveys and case studies illustrate that much of the burden can be traced to the IRC itself. For example, respondents to one survey of small businesses, larger businesses, and tax professionals noted that some of the most difficult problems they faced were due to the tax provisions' ambiguity, frequent changes, and expiration clauses and the

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many layers of complex and confusing regulation that attend such provisions.

- IRS has long tried to reduce small businesses' compliance burden and improve customer service to these taxpayers. For example, IRS has used targeted mailings, expanded toll-free telephone service, experimented with one-stop shopping, and sponsored seminars and other face-to-face educational outreach. IRS also has worked to make filing and reporting easier and to increase IRS employees' expertise and understanding of small business tax issues and practices.
- Most recently, IRS has begun an extensive modernization effort that, among other things, is intended to substantially improve customer service, thereby making it less burdensome for small businesses and other taxpayers to meet their tax obligations. One of the most visible signs of IRS' commitment to improve its services to small businesses is the establishment of a separate operating unit dedicated to this group of taxpayers. However, as IRS has acknowledged, reorganization alone will not change IRS' business practices or the way the agency treats taxpayers. As part of its reform efforts, IRS also will need to consistently follow results-oriented management principles, integrate the principles into its day-to-day activities and culture, and hold managers at every level accountable for doing the same. IRS also must develop and use organizational and individual performance systems that support IRS' new mission statement and implement information systems that support customer service and management in a reorganized environment.

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Mr. Chairman and Members of the Committee:

I want to thank you for inviting me here today to discuss small business tax issues. As the Internal Revenue Service (IRS) is reorganizing into four operating units, one of which is dedicated to small businesses, the agency faces critical challenges in meeting the needs of taxpayers and its managers and employees.

As my testimony underscores, small businesses are an important category of taxpayers. Not only do they account for nearly half the total taxes collected annually, but they also have extensive interactions with IRS about some very difficult and complex tax issues. As you requested, we focused on federal taxes in relation to four types of small businesses (including farmers)—sole proprietorship, partnership, S corporation, and corporation. My remarks today concern (1) the federal filing, reporting, and deposit requirements that apply to small businesses; (2) the actual experience of small businesses in meeting these requirements, including their involvement in IRS' enforcement processes; (3) the burden small businesses can face in complying; and (4) IRS' efforts to reduce small businesses' compliance burden and improve customer service, especially IRS' planned reorganization.

My statement today is based on our ongoing small business tax work for the Committee. To develop the information, we reviewed IRS forms, publications, manuals, and related Internal Revenue Code (IRC) provisions; collected and analyzed relevant data; and interviewed agency officials who were cognizant of small business tax issues and IRS' efforts to improve small business customer service and reduce compliance burden. We also drew from our past reports and testimonies and our current work related to small business tax issues.

We experienced several limitations during the course of our work. As described later in this statement, much of the data we sought to obtain were not collected in IRS information systems or were not sufficiently reliable. To obtain and analyze the available data, we often had to rely upon sampling, matching, and ad hoc techniques. In addition, data were not available for a single year across all variables, so we had to use data from different years as needed.¹ We did not verify the reliability of IRS data used in this testimony, except for some limited checking described in the statement. Lastly, our review did not address IRS activities related to small business nonfilers.

¹We obtained the most recent data available from IRS; some were for 1995 and some for 1997.

Background

Businesses established in the United States (including farmers) are generally structured in one of four forms: sole proprietorship, partnership, S corporation,² or corporation.³ The IRC distinguishes small businesses from larger businesses in a number of ways, and IRS has used different definitions of small business for different internal operating purposes.⁴

Now, as part of its current reorganization effort, IRS is developing an agencywide definition of small business, which we have adopted for this testimony. Small businesses (including farmers) are sole proprietorships, partnerships, S corporations, and corporations that reported less than \$5 million in assets. In this context, a large majority of all businesses are small businesses.⁵

Small Businesses Face Multiple Layers of Tax Requirements

Small businesses, like large businesses, are subject to multiple layers of filing, reporting, and deposit requirements that reflect how the business is organized, whether it has employees, and the nature of its business operations.⁶ By our count, there are more than 200 requirements—which we grouped into four layers—that may apply to small businesses as well as larger businesses and other taxpayers. The requirements are designed to implement a variety of tax policies. Not only do they provide a way to collect taxes from businesses, but also to use businesses to collect taxes owed by third parties (e.g., employees' personal income tax withholding and Social Security and Medicare (FICA) taxes).

²Corporations with no more than 75 shareholders can elect to be treated as S corporations for federal tax purposes if certain requirements are met. The main advantage of this election is avoidance of tax at both the corporate and shareholder level, as the income of S corporations is generally subject to tax only at the shareholder level.

³ Another alternative business form that has emerged is the limited liability company (LLC). The LLC generally is classified as a partnership for tax purposes, but offers the corporate benefit of limited liability for owners.

⁴Tax rates vary by business type, as corporations are taxed at a corporate rate, sole proprietorships are taxed as individuals, and the income earned by partnerships and S corporations is passed through to their owners and taxed at individual rates. Because of this, partnerships and S corporations are often referred to as "pass-through entities."

⁵To illustrate, for tax year 1995 we identified approximately 23.4 million businesses that filed returns. Of this population, 94 percent of partnerships reported total assets of less than \$5 million and 98 percent of S corporations reported total assets of less than \$5 million. Although most large businesses are organized as corporations, even among corporations, 97 percent reported assets of less than \$5 million in 1995. Also included were all sole proprietorships, which accounted for approximately 16.3 million of the nearly 23.4 million small business filers in 1995. According to IRS, though, about half of these taxpayers received the vast majority of their income from wages, not business-related enterprises, and should be considered as "incidental" business filers. Nevertheless, both we and IRS include them in the definition of small business.

⁶For the purpose of this testimony, requirements are the filing of a tax form, schedule, and deposit. Schedules that were embedded in a primary return were not counted as a separate requirement.

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In contemplating the significance of the total number, it is important to know that many of the requirements apply to businesses generally and that it is highly unlikely that any business would need to complete all 200 requirements. This is because the forms, schedules, and other requirements that apply to a particular small business reflect how the business is organized, whether it has employees, and the nature of its business operations. It is also important to note that although a few of the requirements must be submitted more frequently than once a year, the vast majority is submitted annually. Appendix I provides a listing of all the requirements that we identified. Also, as described later in this statement, the requirements reflect the decisions and compromises of Congress and Administrations in keeping with their policy goals and objectives.

Primary Income Tax Returns Represent One Layer of Requirements

The requirements with which a small business must comply depend upon how it is organized—sole proprietorship, partnership, S corporation, and corporation. Each business type has its own primary income tax return, some of which include a set of schedules embedded in the form. For example, the primary corporate income tax return, Form 1120, U.S. Corporation Income Tax Return, contains eight embedded schedules. To further support their primary income tax return, certain types of businesses and individuals with business income must also attach a mandatory schedule to their return. (See table 1.) For example, sole proprietorships must file Form 1040, U.S. Individual Income Tax Return and Schedule C, Profit or Loss from Business.⁷ As pass-through entities, partnerships and S corporations each have two separate sets of returns—one for the entity and one for its owners. In addition to the primary income tax return filed by the entity, each owner must file a Form 1040 and a Schedule E, Supplemental Income and Loss.⁸

⁷Related to income tax, estimated tax is another important requirement that applies to many small businesses. Many sole proprietorships, partners, and S corporation shareholders must pay estimated taxes quarterly for income and self-employment tax. In making these payments, they must estimate their income for the coming year and the amount of income, Social Security, and Medicare taxes that will be owed on this income. Corporations must also make installment payments of estimated tax on their income, while S corporations must pay estimated tax only on certain tax liabilities.

⁸ Form 1040 and Schedule E are not generally considered to be business returns.

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Table 1: Primary Income Tax Returns and Mandatory Schedules

Business category	Primary income tax return	Mandatory schedule ^a
Sole proprietorship	Form 1040, U.S. Individual Income Tax Return	Schedule C, Profit or Loss From Business
Farmer	Form 1040, U.S. Individual Income Tax Return	Schedule F, Profit or Loss From Farming
Partnership	Form 1065, U.S. Partnership Return of Income	Schedule K-1, Partner's Share of Income
Partner	Form 1040, U.S. Individual Income Tax Return	Schedule E, Supplemental Income and Loss
S corporation	Form 1120S, Income Tax Return for an S corporation	Schedule K-1, Shareholders Share of Income
Shareholder	Form 1040, U.S. Individual Income Tax Return	Schedule E, Supplemental Income and Loss
Corporation	Form 1120, U.S. Corporation Income Tax Return	None

^aSchedules that are required with the primary return.

Source: IRS.

Employment Tax Adds a Second Layer of Requirements

A small business' decision to hire employees adds a second layer of tax requirements. We identified more than 10 different federal employment tax requirements that potentially apply to small businesses. The number of employment tax filings and deposits depends on the number of employees and the resulting employment tax liability owed at a particular time. (See table 2.) For each employee, a small business is generally responsible for collecting and remitting several federal taxes with varying frequency stipulations—withholdings for employees' personal income tax along with the employer's matching amount, FICA, and federal unemployment tax (FUTA).

Table 2: Key Employment Tax Requirements

Type of employment tax	Primary return	Deposit
Personal income and FICA tax withheld	Form 941, Employer's Quarterly Federal Tax Return	Quarterly if liability is less than \$1,000 per quarter
		Monthly if less than \$50,000 in the lookback period ^a
		Semi-weekly if more than \$50,000 in the lookback period
		Next day if more than \$100,000 accumulated on any day during a deposit period
FUTA	Form 943, Employer's Annual Tax Return for Agricultural Employees	Annually if liability is less than \$1,000 per year
		Monthly if less than \$50,000 in the lookback period ^b
		Semi-weekly if more than \$50,000 in the lookback period
		Next day if more than \$100,000 accumulated on any day during a deposit period
		Deposits made by mail using Form 8109 or electronically using EFTPS ^c
	Form 940, Employer's Annual Unemployment Tax Return (if liability is greater than \$100 in a tax year)	Deposit quarterly by mail using Form 8109 or electronically using EFTPS ^a

^aThe Form 941 lookback period for 1999 covers four quarters, beginning July 1, 1997 and ending June 30, 1998.

^bThe Form 943 lookback period is the second calendar year preceding the current calendar year.

^cElectronic Funds Transfer Payment System

Source: IRS.

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A small business employer must report quarterly the amount of personal income tax withheld and FICA paid for each employee on Form 941, Employer's Quarterly Federal Tax Return. The employer must deposit income tax withheld, including the matching amount, and FICA taxes either by mail or electronically either quarterly, monthly, weekly, or the next business day, depending on the employers' tax liability. If total deposits of withheld income taxes and FICA taxes were more than \$50,000 in the preceding year, the employer must make electronic deposits using the Electronic Federal Tax Payment System (EFTPS).⁹ In addition, a small business employer must annually report and quarterly deposit FUTA taxes separately from FICA and withheld income tax. Lastly, an employer must send a federal Form W-2, Wage and Earnings Statement to each of its employees and file federal Forms W-3, Transmittal of Wage and Tax Statements and W-2 with the Social Security Administration. In sum, hiring employees—even just one employee—is a critical decision for small businesses in terms of their tax liability and the complexities of the tax administration processes that they face.¹⁰

Offering Employee Benefits Adds a Third Layer of Requirements

The decision to offer employee pension, fringe, and welfare benefit plans adds another layer of requirements for a small business. Some benefit plans may substantially increase the number of filing requirements that small businesses face, while others are simplified and entail few if any filing requirements. We counted over 10 filing and reporting requirements pertaining to benefit plans, including requirements like the Form 5500 series and related schedules.

Certain pension plans are tailored to small businesses and self-employed individuals, offering them a tax-favored way to save for retirement. Simplified Employee Pensions (SEP), Savings Incentive Match Plans for Employees (SIMPLE), and Keogh plans offer small employers and self-employed individuals a deduction for contributions to the plan and deferral of tax on income of the plan. Generally, SEP and SIMPLE plans are less complex than Keogh plans and, while businesses must maintain records about the plans, they do not have any separate filing or reporting requirements with IRS. Keogh plans offer certain benefits not offered by SEP and SIMPLE, but they tend to be more complex and entail substantial

⁹IRS has waived penalties for most smaller businesses required to use EFTPS that make timely deposits using paper deposit coupons. The penalty relief applies through January 1, 2000, to all taxpayers currently required to use EFTPS if they did not make aggregate tax deposits of more than \$200,000 during the year.

¹⁰Employment Taxes and Small Business (GAO/T-GGD-97-21, Nov. 8, 1996), p. 7.

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filing and reporting requirements with IRS (Form 5500 series).¹¹ In addition, most fringe and welfare benefit plans entail filing and reporting requirements with IRS (Form 5500 series). (For a complete list see table I.3 in app. I.)

**Other Business Operations
Add a Fourth Layer of
Requirements**

The remaining tax requirements that potentially apply to small businesses depend upon the nature of the business activities. A few of these secondary requirements are specific to a type of business, but most are generally applicable to all businesses. For example, there are requirements that pertain to the depreciation of assets, the sale of business property, and claims for a credit to increase research activities. These requirements, of which there are nearly 140, range across income taxes, excise taxes, and information reporting. (For a complete list see tables I.4, I.5, and I.6 in app. I.) Some of these requirements are used to implement provisions in the IRC (some of which were recently enacted) that can benefit small (and other) businesses. For example, businesses must complete Form 8861, Welfare-to-Work Credit, to receive a tax credit for hiring long-term family assistance recipients. Also, businesses must complete Form 4562 to claim deductions for depreciation and amortization of business assets or to make the election to immediately expense the cost of certain property. The election to expense property allows the taxpayer to take an immediate deduction instead of using the depreciation schedules to recover a portion of the costs annually over the property's useful life. (The total cost that may be expensed is \$18,500 for 1998).

Among excise taxes alone, we identified about 70 requirements that potentially apply to small businesses. (For a complete list see tables I.5 and I.6 in app. I.) Generally, though, most small businesses are not responsible for filing excise taxes. According to IRS, fewer than 800,000 small businesses filed excise tax returns in 1997. IRS and the Bureau of Alcohol, Tobacco and Firearms (ATF) administer many of the federal excise taxes. The excise taxes administered by IRS consist of several broad categories, including environmental taxes, communications taxes, fuel taxes, retail sale of heavy trucks and trailers, luxury taxes on passenger cars, and manufacturers' taxes on a variety of different products. ATF administers excise taxes on the production, sale, or import of guns, tobacco, or alcohol products or the manufacture of equipment for their production.

¹¹IRS, Department of Labor, and Pension Benefit Guaranty Corporation have consolidated their returns and report forms to minimize the filing burden for plan administrators and employers.

Small Businesses' Experience in Filing and Enforcement Processes Could Not Be Fully Determined

Limitations in IRS' information systems prevented us from fully determining the extent to which small businesses actually filed various required forms and schedules and which businesses made deposits, or determine the extent of small businesses' involvement in IRS' enforcement processes. We were, however, able to obtain and analyze limited data on small business filings of income tax forms in 1995. As we discuss in detail in the final section of this statement, the data limitations currently hinder IRS' ability to effectively manage its activities and serve small businesses and, as IRS has acknowledged, will continue to be a serious impediment until the systems are improved.

Information Systems Significantly Limit Access to Data

The first problem we encountered pertained to locating information that we needed. IRS has dozens of discrete databases – so many that it is difficult to determine what data are in them, what the data mean, how the files are structured, or even how many files there might be. The databases are function-specific (e.g., Examination) and designed to reflect transactions at different points in the life of a return or information report—from its receipt to its disposition. As a consequence, IRS does not have any easy means to access comprehensive information about taxpayers or their accounts in order to provide high quality customer service.

Second, many of the IRS datasets do not allow for a detailed analysis of the information they contain. We were unable to separate out the four types of small businesses in some the datasets. For example, the Form 941 that employers are to use to file their employment taxes does not have information on business assets or gross receipts that would have allowed us to categorize employers by size. Without this information, our alternative was to use information from the Business Master File. Accessing the appropriate tax module in that file might have made it possible to capture information on assets.

However, extracting Master File data is a time- and resource-intensive undertaking that is prone to errors and data reliability problems. It involves requesting IRS' Information Services to provide an extract from various Master Files, working with the File to validate it, and then melding the data from two Files into one that would be suitable for analysis. IRS receives many internal and external requests for data, and each request must await its turn in the queue. IRS' resources are limited, and the request

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could have taken many months for the agency to complete. Thus, we decided not to request IRS to make the extractions.¹²

Filing Experience of Small Businesses

Income Tax

Although we weren't able to obtain data on most types of requirements, we were able to obtain information pertaining to small business income tax requirements. Our analysis of 1995 IRS data for approximately 44 forms and 46 related schedules that IRS believes are those most commonly filed showed that small businesses, on average, filed one secondary form in addition to their primary income tax return, with little variation among the different types of business. The most commonly filed secondary income tax form among the 44 was Form 4562, Depreciation and Amortization. Approximately 74 percent of farmers, 62 percent of partnerships, 69 percent of S corporations, and 73 percent of corporations filed the depreciation and amortization form in 1995. The returns for sole proprietorships were lower, with slightly less than 40 percent filing the depreciation and amortization form in 1995.

The number of schedules small businesses submitted varied, depending on the type of business. This includes the mandatory schedules filed with the primary return by certain business types and individuals with business income as well as secondary schedules and other schedules embedded in the primary tax return. On average, sole proprietorships and corporations filed approximately three schedules, while farmers filed slightly less than three.¹³ Partnerships and S corporations filed more schedules than other types of business. Partnerships filed approximately 11 schedules and S corporations filed approximately six schedules, on average, in 1995. The filing results are higher for partnerships and S corporations because of their unique structure as pass-through entities. Partnerships and S

¹² IRS has information about each taxpayer's filing and compliance history in a Master File account, currently maintained in Martinsburg, West Virginia. Business Master File accounts are especially complicated due to multiple reporting requirements and are more difficult for IRS to maintain without error or have data from them accessed and used. Also, the information on the Master Files is not complete because other databases may have other related information (e.g., income received about the business from a bank or other payer that has been reported to IRS on an information return). Further, IRS updates Master Files on a weekly basis, after the transactions have taken place. Most of IRS' compliance systems (e.g., Collection) operate off of uploads and downloads of selected taxpayer account information on the Master Files. These systems are used online by IRS employees to assist taxpayers or assess their compliance. But, the account information on the systems is limited to the intended purpose and updates are not reflected until the Master Files are updated on weekends.

¹³ The results for sole proprietorships and farmers include schedules pertaining to nonbusiness income (e.g., wages).

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corporations must file a Schedule K-1, Partner's or Shareholder's Share of Income, with IRS for each partner or shareholder. As a result, Schedule K-1 filings accounted for a significant proportion of the multiple schedules filed by partnerships and S corporations in that year.

Employment Tax and Pensions

IRS does have information on federal employment taxes, but it could not be broken out by small businesses. Further, IRS did not have sufficient and reliable data on the number of small businesses that filed pension forms in 1995.¹⁴

Enforcement Experience of Small Businesses

IRS also did not have the data we needed on the extent to which small businesses are involved in both Examination and Collection activities. We did obtain limited data on audit rates and some aspects of how the audits concluded (i.e., with refunds, no change, or recommended changes).¹⁵

When IRS has indications that a small business may have failed to meet one or more of the aforementioned requirements, the business can become involved in IRS' enforcement processes. These processes are basically the same for small businesses as for other taxpayers. They involve examining returns for potential errors or compliance problems, notifying taxpayers of suspected discrepancies, settling disputes over additional taxes recommended, and collecting taxes assessed.¹⁶ (App. 2 provides a simplified picture of IRS' audit and dispute resolution process.)

¹⁴We were able to obtain very limited disaggregated data on the number of pension forms filed in 1995. However, the results cannot be projected to the larger population of small businesses. We worked with IRS' Employee Plans/Exempt Organizations Division to obtain a sample of the number of small businesses that filed Form 5500 using an Employer Identification Number (EIN) match. From a sample of 65,701 small business EINs, we matched 11,585 that filed Form 5500. The data indicated that 1,090 sole proprietorships, 824 partnerships, and 9,671 corporations filed forms from the Form 5500 series in 1995.

¹⁵Some of the information we sought was not readily available from IRS' Examination and Collection databases. For example, no single IRS database contains the data needed to determine the proportion of amounts owed that were ultimately collected (the collection rate) or whether a small business is undergoing a specific collection action. Second, as was true for other databases we used, IRS' Audit Information Management System (AIMS) database does not identify some small business taxpayers or adequately distinguish small businesses from other businesses. AIMS does not include the asset size of partnerships or S corporations; it cannot distinguish between small and other partnerships or S corporations. AIMS does include asset data for sole proprietorships and corporations.

¹⁶See [Tax Administration: IRS' Return Selection Process](#) (GAO/GGD-99-30, Feb. 22, 1999) and [Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs](#) (GAO/GGD-98-128, June 23, 1998).

Audits

IRS' primary technique for assessing compliance with tax laws is to examine the accuracy of the tax reported on filed tax returns.¹⁷

In selecting returns to be audited, IRS attempts to focus on those it believes are most likely to have compliance problems. IRS data showed that about 2.3 percent of the small business income tax returns filed by small businesses in 1997 were audited, generally through audits conducted by IRS' district offices.¹⁸ By contrast, IRS audited 1.3 percent of all returns filed in 1997. The audit rate for sole proprietors (individuals filing Schedule C) was 3.2 percent compared to 1.2 percent for individuals not filing Schedule C.¹⁹

According to IRS officials, the audit rate for small business taxpayers is higher than the overall rate because small businesses tend to have more compliance problems than other taxpayers. For example, in the area of employment tax audits, a small business could fall short of operating capital. As a consequence, it might divert some or all of its estimated tax deposits or employment tax withholdings to make up the shortfall, hoping to pay IRS at a later date. According to IRS officials, the amount of these unpaid taxes, penalties, and interest can pyramid quickly. The danger is that a business, which must rely on these funds for working capital, is likely to have other liabilities and delinquencies that reflect financial problems so severe that it cannot recover.

Table 3 provides detailed information on the audit rates for the four types of small businesses.

¹⁷ IRS' audits do not include all taxpayer contacts that can result in recommended assessments of additional tax. In particular, notices resulting from IRS' information matching math-error programs are generally not counted as audits, according to IRS officials. In 1997, IRS' information matching program generated about 2.8 million notices, resulting in assessments totaling about \$1.5 billion. We could not identify any readily available data on the proportion of these assessments directed at small businesses.

¹⁸ IRS data on audits of schedule C filers is limited to filers who derive most of their income from their business activities rather than from wages. These audits, when conducted by IRS' service centers, generally involve aspects of the Form 1040 or self-employment tax return, rather than Schedule C. Also, the data do not take into account audits of Schedule E filers, particularly the individual owners of partnerships or S corporations.

¹⁹ The data showed audit rates of 4.1 percent and 3.6 percent for Schedule C filers in 1995 and 1996 respectively, compared to 1.5 percent in both years for individuals not filing Schedule C.

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Table 3: Audit Rates Across Small Business Types (1997)

Business category	Size	Audit rate
Sole proprietorship	Total	3.2%
	Gross receipts < \$25,000	3.2
	Gross receipts \$25,000 < 100,000	2.6
	Gross receipts \$100,000 and over	4.1
Farmer	Total	1.8
	Gross receipts < \$100,000	1.3
	Gross receipts \$100,000 and over	2.8
Partnership ^a	Total	0.6
S corporation ^a	Total	1.0
Corporation	Total	2.1
	Assets < \$250,000	1.2
	Assets \$ 250,000 < \$1 million	3.5
	Assets \$1 million < \$5 million	7.8

^aAbout 98 percent of S corporations and 94 percent of partnerships were small businesses in 1995 (i.e., they had less than \$5 million in assets, based on GAO's analysis of IRS' Statistics of Income data).

Source: IRS Data Book (Publication 55B), 1997.

Recommended Additional Taxes and Penalties

Small business audits often result in recommendations for the assessment of additional tax and penalties. For the small business audits closed in 1995, 67 percent resulted in some recommended change to the reported tax liability or refundable credits, while about 33 percent resulted in no such changes. Some audits resulting in no change to the reported tax liability did result in changes to other return items deemed significant by IRS examiners. For example, net loss, which can be carried forward and claimed in future years, may have been overstated on the return and adjusted by IRS. Table 4 provides more detailed information on small business audit results. In considering the information presented, it is important to note that the audit recommendations do not equate to final audit outcomes. For example, recommendations may be partially or fully overturned in IRS appeals or in court decisions.

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Table 4: Audit Recommendations for Small Business Audits Closed in 1995

Business category ^a	Total audits	Audits recommending change		Audits recommending no change	
		Additional taxes/penalties %	Refund %	Adjustment ^b %	No adjustment %
Sole proprietorship	298,609	63.8	4.4	15.7	16.1
Farmer	13,381	59.0	6.7	10.3	23.9
Corporation	35,011	52.4	5.8	17.0	24.8
Total	347,001	62.4	4.6	15.6	17.3

^aPartnerships and S corporations were excluded because audit results generally pass through to the individual business owners.

^bIncludes audits that resulted in adjustments not affecting the taxpayers liability for the current year, such as adjustments to reported net losses. Also includes delinquent returns secured by IRS auditors where reported tax liability was considered accurate.

Source: GAO analysis of IRS' AIMS Data.

Collections

IRS' Collection process starts at the point IRS identifies a taxpayer as not having paid the amount of tax due as determined by the tax assessment.²⁰ First, IRS is to send a notice (or series of notices) to the taxpayers informing them of the amount owed.²¹ If the amount is not paid, IRS is authorized to employ enforcement powers to collect what is owed.

IRS can refer the delinquency to an automated collection system call site where an employee calls the taxpayer by telephone, asking for payment. The payment arrangements may include installment agreements or an offer-in-compromise from the taxpayers if the full amount owed cannot be paid.

Information about large and chronic tax delinquencies can be referred directly to one of IRS' 33 district offices where IRS revenue officers may contact the taxpayer in person. According to IRS officials, small businesses' audits involving employment taxes are often referred directly to district offices. In addition to liens and levies, IRS Collection officials have authority to seize and sell taxpayers' property, such as cars or real estate. Seizure is generally a last resort to get payment of the amount owed and the IRS Restructuring and Reform Act (RRA) now requires a district director's approval. We were unable to obtain information on the number of small businesses undergoing enforced collection actions (i.e., liens, levies, or seizures).

²⁰As we have reported, IRS has had difficulty collecting assessments from many taxpayers, including small businesses. See [Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs](#) (GAO/GGD-98-128, June 23, 1998).

²¹Collectively, these notices are to provide the taxpayer with statutory notification of the tax liability, IRS' intent to levy assets if necessary, and information on the taxpayer's rights.

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Compliance Burden Is Hard to Measure, but Significant

Although IRS does not have a reliable way to measure tax compliance burden or the portion attributable to small business tax requirements, there is common agreement that the burden is significant. Employment taxes present a microcosm of these requirements, the tax provisions that underlie them, and an illustration of how burdensome the requirements can be.

IRS Does Not Have a Reliable Measure of Compliance Burden

IRS has acknowledged that the measure of burden that it now uses to meet requirements of the Paperwork Reduction Act is inadequate, and IRS is beginning work to change it. Until IRS develops such a measure, it will be difficult for IRS or others to assess the extent to which the compliance burdens of small businesses are being reduced or increased.

Developing such a measure, including that portion that IRS can influence, will not be easy. A key problem involves defining the set of activities that contributes to burden and figuring what portion of the resources expended are the result of federal tax regulations, state and local regulations, or are part of business operations that would have been done in the absence of the requirement. Although business officials and tax experts we have interviewed for past work identified considerable anecdotal examples of such compliance costs, the businesses told us that they did not routinely need, nor did they keep, information on these costs. A reason may be that business tax compliance strategies are usually not done in isolation of other business operations. Some business activities serve multiple purposes, and it is difficult to separate out the activities conducted primarily for tax reasons. For example, businesses told us that it would be difficult to take payroll expenditures and isolate those associated with tax compliance.

To be comprehensive, any measure of compliance burden would need to include more than the resources expended to fill in the returns, forms, and schedules that we identified as being required of small business. In addition to the time and resources that small businesses expend to complete a return or schedule are the resources they expend to learn of the form and determine whether and how it might apply to their facts and circumstances. They also expend resources to collect the information necessary to complete the form and store any supporting documentation that IRS later might ask to see in connection with an inquiry or audit.

There is common agreement that tax burden, while hard to measure, is significant. Tax experts, small businesses, and larger businesses that responded to a survey we conducted to identify aspects of the business tax compliance burden and options for reducing it identified the following

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characteristics of especially troublesome tax provisions—ambiguity, frequent changes, expiration clauses, and layers of regulation.²² That survey underscored the role of the IRC as a major factor in compliance burden. Business officials and tax experts we interviewed regarded the code as complex, difficult to understand, and in some cases, indecipherable. They reported that businesses have difficulty with the code because of numerous and unwieldy cross-references and overly broad, imprecise, and ambiguous language

Employment Tax Requirements Illustrate the Complexity and Burden Small Businesses Can Face

Employment taxes are a case in point. As discussed earlier, when a business hires an employee, the business generally becomes responsible for collecting and paying personal income taxes withheld, FICA, and FUTA. To meet these requirements, employers must answer four questions: (1) Is the worker an employee covered by the tax? (2) Are the compensation payments made to the employee to be considered wages for employment tax purposes? (3) What is the employer's employment tax liability related to these wages? (4) What are the associated deposit and filing requirements?

The answers to these questions are not always clear-cut. For example, we have identified perennial problems and inconsistencies in IRS' administration of common law rules governing whether a worker is an employee for employment tax purposes or is an independent contractor, who is responsible for payment of such taxes. Our reviews also have pointed out the complexities in determining whether the compensation paid to the employee fits the category of nontaxable compensation for such payments as fringe benefits.

Making proper calculations of the periodic tax liability of compensation payments and meeting filing and depositing requirements also can be difficult. For the federal income tax, wages are to be withheld for each payroll period; and the amount is to be based on the amount of wages and number of allowances claimed by the employee on his or her federal Form W-4, Employee's Withholding Allowance Certificate. For FICA, the employer is to deduct a certain percentage of the employee's wages up to a dollar limit and a lesser percentage of wages above that amount. FUTA is paid at a different rate, but the amount paid can be reduced with credit for payments to state unemployment tax. Added to all of this, in many cases, employers will also need to make an additional set of calculations and remittances for state employment taxes.

²² The survey is discussed in *Tax System Issues in Compliance Burden* (GAO/T-GGD-90-100, Apr. 3, 1996).

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The complexities of employment taxes were not created by happenstance. They, like other tax requirements, reflect the compromises that have been made to address assorted tax policy issues.

IRS Has Tried Many Approaches to Reduce Compliance Burden

With tax laws and the ensuing regulations, forms, and instructions so complicated, it is not surprising that over the years IRS has tried many different approaches to reduce the compliance burden and make it less difficult for small businesses to meet their tax obligations. IRS has used targeted mailings, expanded toll-free telephone service, experimented with one-stop service facilities dedicated to small business clients, expanded its Web site, and sponsored seminars and other face-to-face educational programs in partnership with the Small Business Administration as means to educate small business taxpayers. IRS also has sought to make filing easier by encouraging electronic filing of information returns and by establishing a nationwide telephone service that these businesses can use to file their quarterly federal employment tax returns. Through programs such as the Market Segment Specialization Program, IRS has worked to improve its employees' capacity to deal effectively and efficiently with business tax issues affecting specific industries or market segments, including small business issues, in its enforcement processes.

Other IRS programs, including the Simplified Tax and Wage Reporting System, have been intended to reduce burden by increasing opportunities to file tax and wage forms electronically and improving coordination among federal and state tax administrators. Still other IRS programs have focused on effective and timely identification of small businesses that have not paid their proper tax so that compliance problems are resolved before they become overwhelming.

While the benefits of such programs may not yet have been realized, the Commissioner of Internal Revenue has recognized the importance of IRS' working with taxpayers in a more proactive manner to ease these compliance burdens. He also recognizes the importance of modernizing IRS' information systems to allow for better informed, proactive interactions with taxpayers.

Reorganization and Other Reforms Show Promise

Most recently, IRS has begun an extensive modernization effort that, among other things, is intended to substantially improve customer service. IRS' has characterized its plan as the most significant reform of the agency in more than 50 years. In part, it is to reorganize IRS into four major operating units, each one serving a taxpayer group with similar needs and tax issues. One will be the Small Business and Self-Employed operating unit, serving the small businesses discussed in this statement. The

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organizational blueprints for the small business unit are nearly complete, and implementation blueprints are in process.

The vision of a modernized IRS is compelling, but IRS' agenda is formidable. As IRS has acknowledged, reorganization will not, in itself, change IRS' business processes, its culture, or the way in which the agency deals with taxpayers. Management, performance, and information systems improvements will also be critical.

Managing for Results Is as Important as Organizational Structure

As our past work on the Government Performance and Results Act demonstrates, IRS should follow results-oriented management principles in addition to reorganizing its structure.²³ Our case studies of leading organizations using performance and accountability principles found that the organizations had varied structures, but similar results-oriented management strategies. These organizations placed great emphasis on clearly defined missions and desired outcomes and measuring and using information on performance. Their leaders devolved decision making and accountability, developed incentives to achieve organizational objectives, built expertise, and used an integrated approach to manage reform. They made clear their commitment to the fundamental principles of this type of management and to steps to ensure that managers and staff at all levels of the organization recognized that they must do the same.

Driving a results orientation down through all levels of the organization can be particularly important because, traditionally, the danger to such reforms is that they become hollow, paper-filled exercises. By integrating results-oriented management into the day-to-day activities and culture of the organization and holding managers accountable for doing the same, leaders can help to avoid that danger.

As noted above, IRS has recently revised its mission statement to reflect the need for better balance between customer service and compliance enforcement. This is an important first step for IRS to define its mission and articulate corresponding objectives.²⁴ It is too early to know whether IRS will successfully continue this initiative and consistently apply the results-oriented principles. We have recently begun to monitor how IRS is managing reorganization and the other challenges that accompany so

²³ Numerous reports by GAO in recent years have discussed the implementation of the Results Act by federal agencies. A major report addressing these issues was, Effectively Implementing the Government Performance and Results Act (GAO/GGD-96-118, June 1996).

²⁴ IRS' mission statement is to "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

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significant a reform effort. Some of our work is being done at the request of this committee. Because we believe that a results orientation will be critical to IRS' success, we expect to pay close attention to how IRS is progressing in this area.

Organizational and Individual Performance Measurement Systems Could Change Incentives and Help Reinforce IRS' New Mission

Performance measures can create powerful incentives to influence organizational and individual behavior. In this regard, IRS recently announced a new set of organizational performance measures that it believes reflect the agency's new customer service emphasis, while also striking a balance between customer satisfaction, employee satisfaction, and business results. IRS is now in the process of further defining and implementing the measures for organizational performance, using a phased approach.²⁵

IRS has not yet announced its approach for applying the measures to individual performance. IRS does, however, list the establishment of a new employee evaluation system as one of more than 150 short-term customer service improvements it hopes to complete by mid-2000. Doing so will be important. Unless the performance of IRS employees is based on incentives that are in accord with the agency's new mission statement and aligned with its organizational measures, managers and front-line workers might find it easy to fall back on measures such as enforcement results and other productivity statistics—measures that have created problems for IRS in the past. Alternately, if employees come to believe that they should place disproportionate value on customer satisfaction, they might not take enforcement actions, even where appropriate, because the perceived risks of taking action might be seen to outweigh the risks of not taking action. The potential for such a pendulum swing is an additional reason for putting the systems in place expeditiously.

How effectively IRS addresses the issue of balance in its measures of performance could be especially significant for the small business unit. Although the unit is also expected to have new resources to expand IRS' education, outreach, and account services to small businesses, a large majority of its employees will be engaged in post-filing and enforcement activities. We are currently reviewing the relationship between IRS' employee evaluation system and its new mission statement. Preliminary results raise a question as to the extent to which evaluations have tended to emphasize efficiency and revenue over customer service considerations

²⁵For example, IRS has not yet determined how it will measure all aspects of business results, most notably compliance. Also, IRS expects the new units to make refinements to the performance measures consistent with their own objectives to achieve IRS new mission statement.

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and whether the tone of some evaluative statements discourages customer service. If this concern were borne out, IRS would need to modify the system to achieve the types of cultural change to which Congress and IRS' leadership are committed.

Success Will Also Depend on Implementation of Information Systems to Support Customer Service and Management Needs

As IRS has recognized, the information systems that it uses to keep records on taxpayers' accounts are fundamentally deficient and thwart IRS' ability to provide high-quality customer service. For years, IRS has struggled with this problem, and we have made numerous recommendations for actions that IRS could take. As IRS begins to implement aspects of its reorganization plans, in the near term, IRS also plans to modify its existing systems so that it can better identify taxpayers' needs in each of the four operating units. In the long term, as part of its modernization blueprint, IRS is to develop new systems and databases. This long-term effort will take several years, and even near-term efforts will pose serious challenges. In the interim, the limitations will make it more difficult to manage and improve customer service, even in a reorganized environment.

Many of IRS' current systems reflect the agency's stovepipe structure and transaction-based business approach.²⁶ Now that IRS is to be structured along taxpayer lines, its information systems need to reflect the new environment. They should provide managers and employees with convenient access to reliable up-to-date information on all relevant transactions between taxpayers and IRS. For example, the type of information we sought presumably would be the type that managers would need to know about small business taxpayers and understand their problems—including the source of the problems. If this kind of information about small businesses is not readily available or in a form suitable for analysis, it will be more difficult for unit managers to devise effective strategies to target resources and improve service.

The implications of these system limitations extend to customer service as well as management. For example, the information system that front-line workers generally use in dealing with employment tax issues stores information on quarterly employment tax deposits. That is, the data are arranged according to each individual required filing—at least four for each year. IRS is to notify the taxpayer about delinquencies in required filings, although the notifications may be received by the taxpayer after

²⁶ As noted, historically IRS has operated through functions like Examination or Collection and information about taxpayers' compliance tended to be developed to service the functions' needs and interactions with taxpayers, rather than IRS' overall needs or those of taxpayers.

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several delinquencies have occurred. Confusion may result over what has been paid and what remains due. Such confusion may be particularly difficult to resolve if IRS and the taxpayer are corresponding over a protracted period. Also, interest on any tax liability due would continue to accrue and could eventually come to equal or exceed the amount owed.²⁷

Employment tax situations like this illustrate how fragmented account information can make it difficult for IRS to work with taxpayers to resolve their problems and can frustrate taxpayers seeking to settle their account by paying the taxes owed. Also, the extra time and energy that the taxpayer might spend due to IRS' systems limitations is time away from income-producing activities that an already struggling business might ill afford to miss.

IRS has said it is taking interim steps to address some of its data problems. IRS expects to develop a way of linking a customer identifier to the case information in 35 of its most important information systems. When this "workaround" is complete, IRS managers and front-line workers should know whether the return or information report data they might be using are for a small sole proprietor, partnership, S corporation, or corporation.

However, the interim solution will not provide real-time information about the full range of transactions currently ongoing for a particular taxpayer. Nor will it be easy or inexpensive to put in place. As with IRS' initiative to make its information systems Year 2000 compliant, the workaround will affect a large number of systems and involve many steps to program, implement, and validate. Nevertheless, IRS may not have a choice as it will remain hamstrung in its efforts to assist taxpayers in complying with tax laws until its systems are replaced.

Depending on the speed and success of this and other interim solutions IRS might devise for its data problems, the small business and other operating units will need to rely on existing systems and human ingenuity. Recent IRS experience shows that such reliance bears careful watching. As we testified in March 1999, IRS' problems in preparing financial statements illustrate what can happen when human ingenuity is substituted in lieu of adequate information technology.²⁸ Our work showed that in the past,

²⁷The IRS Restructuring and Reform Act of 1998 (RRA) includes provisions that suspend the accrual of interest and some penalties if IRS fails to notify the taxpayer of additional tax liabilities within 18 months after a return is filed.

²⁸ Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit (GAO/T-AIMD-99-103, March 1, 1999).

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without adequate systems, IRS was forced to use ad hoc programming and substantial manual intervention to overcome pervasive internal control and systems weaknesses. However, these costly and time-consuming efforts could not be duplicated for fiscal year 1998 due to IRS' loss of key Chief Financial Officer staff who were managing the preparation of its administrative financial statements. As a consequence, IRS has received a qualified opinion from us on most of its fiscal year 1998 administrative financial statements.

**Concluding
Observations**

Small businesses, like large businesses, are subject to multiple layers of filing, reporting, and deposit requirements. Together, the requirements are intended to implement a complicated mix of fiscal and other policies—some of which benefit as well as burden businesses. Although IRS does not have a reliable way to measure the full extent of the compliance burden associated with the policies, the burden is significant.

The reforms underway at IRS hold promise for small businesses and all taxpayers. One of the most visible signs that IRS may be changing is its establishment of four new operating units. However, reorganization will not be enough. As my statement underscores, management, performance, and information systems improvements will also be critical.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee might have.

Tax Requirements that Potentially Apply to Small Businesses

Table I.1: Layer One - Primary Income Tax Returns and Related Schedules

	Title^a	Frequency (annually unless otherwise noted)	Explanation
Sole Proprietorship	Form 1040 - U.S. Individual Income Tax Return		If reporting income from a sole proprietorship (or other individual income)
	Schedule C - Profit or Loss from a Business (Sole Proprietor)		If incurred profit or loss as owner of a sole proprietorship
	Schedule C-EZ - Net Profit from Business		If expenses are \$2,500 or less, may use Schedule C-EZ as alternative to Schedule C
	Form 1040 ES – Estimated Tax for Individuals	Quarterly	If income and self-employment taxes expected to be \$1,000 or more and withholding and credits are expected to be less than the smaller of 90 percent of the tax on the current year return or 100 percent of the tax shown on return for the previous year.
	Form 2210 - Underpayment of Estimated Tax by Individuals, Estates, and Trusts		If estimated tax filer wants to perform their own penalty calculations instead of allowing IRS to make the calculations for them
Farmer	Form 1040 - U.S. Individual Income Tax Return		If reporting income from a farm as an individual taxpayer
	Form 1065 - U.S. Partnership Return of Income		If reporting income from a farm and organized as a partnership
	Schedule F - Profit or Loss from Farming		If incurred farm income or expenses
	Schedule J - Farm Income Averaging		If electing to figure tax liability by averaging income over past 3 years
	Form 990C- Farmers' Cooperative Association Income Tax Return		If a farmers' associations operated on a cooperative basis
	Form 1040 ES – Estimated Tax for Individuals	Quarterly	See explanation above. Qualified farmers pay annually; nonqualified farmers pay quarterly.
	Form 2210F - Underpayment of Estimated Tax by Farmers and Fisherman		If farmers or fishermen want to perform their own penalty calculations for estimated tax instead of allowing IRS to make the calculations for them
Partnership	Form 1065 - U.S. Partnership Return (info return only)		If organized as a partnership, unless received no income and incurred no expenses treated as deductions or credits for federal income tax purposes
	Schedule K1 - (form 1065) Partners Share of Income, Credits, Deductions etc.		If organized as a partnership with income or deductions; copy filed with IRS for each partner
Partner	Form 1040 - U.S. Individual Income Tax Return		See explanation above
	Schedule E - Supplemental Income and Loss (part II)		If a partner in a partnership (even if no income received) to report share of partnership income or loss
	Form 1040 ES – Estimated Tax for Individuals	Quarterly	See explanation above
	Form 2210 - Underpayment of Estimated Tax by Individuals, Estates, and Trusts		See explanation above
S corporation	Form 1120S – U.S. Income Tax Return for an S Corporation		If elected to be an S corporation to report income, gains, losses, etc.
	Schedule K1 - (form 1120S) Shareholder's Share of Income, Credits, Deductions		If an S corporation, copy filed with IRS for each shareholder
	Estimated Tax – Form 8109 – Tax Deposit Coupon or EFTPS	Quarterly	If tax expected to be \$500 or more for certain specified taxes

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Shareholder	Form 1040 - U.S. Individual Income Tax Return		See explanation above
	Schedule E - Supplemental Income and Loss (part II)		If a shareholder in a S corporation (even if no income received) to report share of S corporation income or losses
	Form 1040 ES – Estimated Tax for Individuals	Quarterly	See explanation above
	Form 2210 - Underpayment of Estimated Tax by Individuals, Estates, and Trusts		See explanation above
Corporation	Form 1120 - U.S. Corporation Income Tax Return		If a domestic corporation regardless of taxable income, unless meeting requirements for specialized forms or exempt under section 501
	Form 1120-A - U.S. Corporation Short Form Income Tax Return		If gross receipts, total income, and total assets each under \$500,000 and certain other requirements met
	Estimated Tax - Form 8109 Tax Deposit Coupon or EFTPS	Quarterly	If income tax expected to be \$500 or more
	Form 2220 – Underpayment of Estimated Tax by Corporations		If corporation is using annualized income installment method or adjusted seasonal installment method or a large corporation figuring first required installment based on prior year's tax
Other Corporation Returns	Form 1120-H - Income Tax Return for Homeowners Associations (attach to 1120)		If a qualified homeowners association and form 1120-H yields lower tax than form 1120
	Form 1120-IC-DISC - Interest Charge Domestic International Sales Corporation Return (also must file three additional forms, Schedules K, P, Q Form 1120-IC-DISC)		If at least 95 percent of gross receipts during the tax year are qualified export receipts and certain other requirements met
	Form 1120-L - U.S. Life Insurance Company Income Tax Return		If a domestic LIC (or a foreign corporation that would qualify as a LIC if it were a U.S. corporation)
	Form 1120-PC - U.S. Property and Casualty Insurance Company Income Tax Return		If a domestic nonlife insurance company (or a foreign corporation that would qualify as a nonlife insurance company if it were a U.S. corporation)
	Form 1120-REIT - U.S. Income Tax Return for Real Estate Investment Trusts		If a corporation, trust or association meeting specified conditions and electing to be treated as a REIT
	Form 1120-RIC - U.S. Income Tax Return for Regulated Investment Companies		If a domestic corporation that elects to be treated as an RIC
	Form 1120-SF - U.S. Income Tax Return for Settlement Funds		If structured as a section 468B designated and qualified settlement fund

^aWe did not count schedules that are embedded in a primary return as separate requirements.

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Table I.2: Layer Two - Employment Tax Requirements

	Title	Frequency (annually unless otherwise noted)	Explanation	
Withheld Income Taxes and FICA	Form 941 - Employer's Quarterly Federal Tax Return	Quarterly	If business has employees they are to report withheld taxes	
	Schedule B (form 941) - Employer's Record of Federal Tax Liability (attach to 941)	As required: quarterly, monthly, semi-weekly	If business has employees	
	Form 941C - Supporting Statement to Correct Information	As needed to correct withholding errors from prior quarters	If business has employees	
	Form 941-M - Employer's Monthly Federal Tax Return	Monthly	If business has employees	
	Deposit (Form 941 payments) – By mail using Form 8109 - Federal Tax Deposit Coupon or by EFTPS	Quarterly if liability < \$1,000 per quarter monthly if ≤ \$50,000 in lookback period ^a semi-weekly if > \$50,000 in lookback period next day if > \$100,000 undeposited	If business has employees and withholds taxes. Electronic deposit if annual liability greater than \$50,000	
	Form 943 – Employer's Annual Tax Return for Agricultural Employees		If withheld income and employment taxes on wages paid to agricultural employees.	
	Deposit (Form 943 payments) - By mail using Form 8109 - Federal Tax Deposit Coupon or by EFTPS	Annually if liability < \$1000 for the year monthly if ≤ \$50,000 in lookback period ^b semi-weekly if > \$50,000 in lookback period next day if > \$100,000 undeposited	Same as above	
	Form 945 - Annual Return of Withheld Federal Income Tax		If income tax withheld from nonpayroll payments	
	FUTA	Form 940 - employer's annual federal unemployment tax return		If business has employees and liability is greater than \$100 in tax year
		Form 940EZ		If business has employees and if certain conditions are met for state unemployment taxes
	Deposit (Form 940 payments) Form 8109 - Federal Tax Deposit Coupon or EFTPS	Quarterly	If liability greater than \$100 in tax year	
Information Returns	Form W-2 - Wages and Compensation Paid to Employees		If business has employees (must file on magnetic media if 250 or more Form W-2s)	

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	Form W-2G – Certain Gambling Winnings	If business paid out reportable gambling winnings
	Form W3 - transmittal of W2s	If business has employees (shows totals from Form W2s, same filing as W2)
Self Employment Tax	Schedule SE – Self Employment Tax	If received net earnings of \$400 or more from self employment

^aThe Form 941 lookback period for 1999 covers four quarters, beginning July 1, 1997 and ending June 30, 1998.

^bThe Form 943 lookback period is the second calendar year preceding the current calendar year.

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Table I.3: Layer Three - Employee Benefit Plan Requirements

Title	Frequency	Explanation
Form 5500, Annual Return/Report of Employee Benefit Plan	Annually	If plan has 100 or more participants
Form 5500-EZ, Annual Return/Report of One-Participant Retirement Plan	Annually	If only participant and certain other conditions met
Form 5500-C/R, Annual Return/Report of Employee Benefit Plan	Annually	If fewer than 100 participants
Schedule A (Form 5500), Insurance Information	Annually	If any plan benefits provided by insurance company
Schedule B (Form 5500), Actuarial Information	Annually	If plan set up as "defined benefit" rather than "defined contribution" and subject to minimum funding standard
Schedule C (Form 5500), Service Provider and Trustee Information	Annually	If compensation paid to any trustee or others providing services to the plan exceeds a certain threshold, generally \$5,000 per year
Schedule E (Form 5500) - Employee Stock Ownership Plan (ESOP) Annual Information	Annually	If an employer with a pension benefit plan that contains ESOP benefits
Schedule F (Form 5500) - Fringe Benefit Plan Annual Information Return	Annually	If an employer with a cafeteria plan, educational assistance program, or adoption assistance program
Schedule G (Form 5500) - Financial Schedules	Annually	If filing Form 5500
Schedule P (Form 5500) - Annual Return of Fiduciary of Employee Benefit Trust	Annually	If a trustee of a trust created as part of an employee benefit plan or a custodian of a custodial account
Schedule SSA (Form 5500) - Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits	Annually	If filing Form 5500, to report participants with vested benefits who were separated from the company during the year

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Table I.4: Layer Four - Requirements That Depend on Business Operations

	Title	Frequency (annually unless otherwise noted)	Explanation
Potentially applicable to any business form	Schedule D - Capital Gains and Losses		If business sold or exchanged capital assets
	Form 1116 - Foreign Tax Credit		If filing as an individual, estate or trust and paid certain foreign taxes to a foreign country or U.S. possession
	Form 3468 - Investment Credit		If claiming investment in building rehabilitation, alternative energy or reforestation
	Form 3800 - General Business Credit		If more than one type business credit claimed
	Form 4255 - Recapture of Investment Credit		If required to refigure investment credit, e.g., when investment credit property sold
	Form 4562 - Depreciation and Amortization		If depreciating, amortizing, or expensing certain business property
	Form 4684 - Casualties and Thefts		If deducting losses due to fire, storm, theft or other casualty
	Form 4797 - Sales of Business Property		If sold or exchanged business property
	Form 4952 - Investment Interest Expense Deduction		If filing as an individual, estate or trust and claiming deduction for investment interest expense
	Form 5884 - Work Opportunity Credit		If claiming the work opportunity credit for wages paid to targeted groups of employees
	Form 6198 - At-Risk Limitations		If incurred loss from specified "at risk activities" e.g., farming, exploring for oil, others
	Form 6251 - AMT Individuals		If tax on alternative minimum tax income is greater than tax reported on 1040
	Form 6252 - Installment Sale Income		If reporting income from casual sales (other than inventory) where payments received in a tax year after the year of sale
	Form 6478 - Alcohol Used as Fuel Credit		If claiming the credit for alcohol used as fuel
	Form 6765 - Increasing Research Credit		If claiming the credit for increasing research activities
	6781 - Gains and Losses from Section 1256 Contracts and Straddles		If claiming gains or losses from (1) section 1256 contracts under the marked-to-market rules (such as regulated futures contracts) or (2) straddles (offsetting positions that decrease the risk of loss)
	Form 8275 - Disclosure Statement		If disclosing items that are otherwise not adequately disclosed for the purpose of avoiding penalties
	Form 8275-R - Regulation Disclosure Statement		If disclosing positions taken on a tax return that are contrary to Treasury regulations
	Form 8404 - Interest Charge on DISC-Related Deferred Tax Liability		If a shareholder in a Interest Charge Domestic International Sales Corporation and receiving deferred DISC income that increases taxable income
	Form 8582 - Passive Activity Loss Limitations		If reporting a net loss from "passive activities" (e.g., most real estate investments)
Form 8586 - Low Income Housing Credit		If an owner of certain low-income housing projects and claiming credit	
Form 8594 - Asset Acquisition Statement		If bought or sold a trade or business and goodwill or going-concern value attaches or could attach to assets	
Form 8609 - Low-Income Housing Credit Allocation Certification		If obtaining a housing credit allocation in order to claim low-income housing credit	

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Form 8697 - Interest Computation under the Look-Back Method for Completed Long-term Contracts		If required to figure interest on certain long-term contracts under the "look-back" method of section 460(b)(2)
Form 8801 - Credit for Prior Year Minimum Tax		If filing as individual, estate, or trust and claiming the minimum tax credit for alternative minimum tax incurred in a prior year
Form 8816 - Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies		If an insurance company and electing an additional deduction under section 847
Form 8817 - Allocation of Patronage and Nonpatronage Income and Deductions		If organized as a cooperative and reporting income or deductions from patronage or nonpatronage sources.
Form 8820 - Orphan Drug Credit		If claiming an orphan drug credit
Form 8824 - Like-kind Exchanges		If exchanged of business or investment property for property that is of a like kind
Form 8826 - Disabled Access Credit		If an eligible small business (with not more than \$1 million in gross receipts or 30 employees) and claiming the Disabled Access Credit
Form 8830 - Enhanced Oil Recovery Credit		If claiming the enhanced oil recovery credit
Form 8834 - Qualified Electric Vehicle Credit		If claiming the credit for a qualified electric vehicle placed in service during the tax year
Form 8835 - Renewable Electricity Production Credit		If claiming the renewable electricity production credit
Form 8844 - Empowerment Zone Employment Credit		If claiming the empowerment zone employment credit for qualified wages and other expenses paid or incurred on behalf of any qualified zone employee
Form 8845 - Indian Employment Credit		If employed American Indian(s) meeting certain criteria
Form 8846 - Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips		If claiming credit for Social Security and Medicare taxes incurred on employees' tip income
Form 8847 - Credit for Contributions to Selected Community Development Corps		If claiming the credit for contributions to a selected Community Development Corporation
Form 8850 - Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits	No later than 21 days after job applicant begins working	If an employer and claiming the Work Opportunity Credit or the Welfare-to-Work Credit
Form 8861 - Welfare-to-work Credit		If an employer and claiming the welfare-to-work credit for wages paid or incurred to long-term family assistance recipients
Form 1096 - Annual Summary and Transmittal of Information Returns		If certain information returns filed, including paper forms 1099
Form 1098 - Mortgage Interest Statement		If business receives \$600 or more in mortgage interest from any person(s)
Form 1099-A - Acquisition or Abandonment of Secured Property		If acquired property as security for loan
Form 1099-B - Proceeds from Broker or Barter Exchange Transactions		If business operates as a broker or barter exchange, it must report proceeds from transactions
Form 1099-C - Cancellation of Debt		If certain financial institutions cancel debt of \$600 or more
Form 1099-DIV - Dividends and Distributions		If paid dividends or made certain other distributions of stock
Form 1099-INT - Interest Income		If paid interest income exceeding specified amounts; also shows backup withholding
Form 1099-LTC - Long-Term Care and Accelerated Death Benefits		If an insurance company or other payer of long-term care benefits

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	Form 1099-MISC - Miscellaneous Income		If made certain payments in the course of a trade or business, e.g., payments to independent contractors
	Form 1099-MSA - Distributions From Medical Savings Accounts		If made distributions from employees medical savings accounts
	Form 1099-OID - Original Issue Discount		If issued debt instrument with \$10 or more of original issue discount
	Form 1099-PATR - Taxable Distributions Received From Cooperatives		If a consumer cooperative and issued patronage dividends of \$10 or more
	Form 1099-R - Distributions From Pensions, Annuities, Profit Sharing and Retirement Plans, etc.		If business distributed \$10 or more from retirement or profit sharing plan
	Form 1099-S - Proceeds From Real Estate Transactions		If received proceeds from the sale or exchange of real estate
	Form 4789 - Currency Transaction Report	No later than 15 days after transaction	If customer of financial institution enters transaction of \$10,000 or more in currency
	Form 5498 - IRA Contribution Information		If maintained IRAs for any person(s)
	Form 5498 - MSA Information		If maintained a medical savings account for any person(s)
	Form 8027 - Employer's Annual Information Return of Tip Income and Allocated Tips		If a food and beverage establishment with more than 10 employees who work a total of more than 80 business hours on a typical business day (and tipping is a customary practice)
	Form 8281 - Information Return for Publicly Offered Original Issue Discount Instruments	Within 30 days of issuance of OID instrument	If issued publicly offered debt instrument having original issue discount
	Form 8282 - Donee Information Return	125 days after disposition of charitable property	If a donee organization that sells or otherwise disposes of certain charitable deduction property within 2 years after the date of receipt
	Form 8271 - Investor Reporting of Tax Shelter Registration Number		If claiming a tax benefit or reporting income from a "registration-required" tax shelter
	Form 8300 - Report of Cash Payments Over \$10,000 Received in a Trade or Business	No later than 15 days after transaction	If business received cash payment of \$10,000 or more received in one transaction
	Form 8329 - Lender's Information Return for Mortgage Credit Certificates (MCCs)		If made a loan that is a certified indebtedness amount on any mortgage credit certificate
	Form 8362 - Currency Transaction Report by Casinos	Daily	If a casino in the U.S. with gross gaming revenues in excess of \$1 million, to report currency transactions of \$10,000 or more
	Form 8703 - Annual Certification of a Residential Rental Project		If operating a qualified residential rental project
	Form 8852 - Currency Transaction Report by Casinos-Nevada	15th day after the transaction	If a Nevada casino with annual gross gaming revenue of more than \$10 million to report currency transactions of \$10,000 or more
	Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation	Day of transfer	If transferred property to a foreign corporation, estate, trust, or partnership
Specific to Farmers	Form 4835 - Farm Rental Income and Expenses		If a landowning farmer reporting farm rental income based on crops or livestock produced by tenant
Partnership and/or S corporation	Schedule D (Form 1065), Capital Gains and Losses		If sale of capital assets allocated to partnership, not partners
	Schedule D (Form 1120S) - Capital Gains and Losses and Built-in Gain		If sold or exchanged capital assets and to report gains on distributions to shareholders of appreciated capital assets; also used to report any built in gains tax

Appendix I
Tax Requirements That Potentially Apply to Small Businesses

	Form 8308 - Report of a Sale or Exchange of Certain Partnership Interests	If sold or exchanged a partner's interest in a section 751a exchange
	Form 8621 - Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund	If an owner/shareholder of a PFIC
	Form 8752 - Required Payment or Refund Under Section 7519	If elected to have an alternate tax year
	Form 8825 - Rental Real Estate Income and Expenses of a Partnership or an S Corporation	If business had income or deductible expenses from rental real estate activities
Partner and/or Shareholder	Form 4952, Investment Interest Expense Deduction	If a partner or other individual, estate or trust claiming a deduction for investment interest expense, unless certain conditions apply
	Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request	If items treated differently on schedule E and Form 1065 or Form 1120S
Corporation	Schedule D (Form 1120) - Capital Gains and Losses	If sold or exchanged capital assets and have gains on distributions to shareholders of appreciated capital assets
	Schedule H (Form 1120) - Section 280H Limitations for a Personal Service Corporation (PSC)	If a PSC did not meet certain distribution requirements
	Schedule PH (Form 1120) - U.S. Personal Holding Company (PHC) Tax	If a PHC
	Form 1118 - Foreign Tax Credit (form 1120); (attached to Form 1118 are schedule I - Reduction of Oil and Gas Extraction Taxes and Schedule J - Separate Limitation Loss Allocations)	If electing to claim the foreign tax credit; separate forms 1118 must be filed for each of nine limitation categories that apply
	Form 2438 - Undistributed Capital Gains (attach to 1120-RIC or 1120-REIT)	If a RIC or REIT and had undistributed capital gains
	Form 4626 - Alternative Minimum Tax--Corporations (file with Form 1120)	If taxable income or loss before the net operating loss deduction, plus adjustments and preferences, totals more than \$40,000
	Form 5735 - Possessions Corporation Tax Credit	If a domestic corporation engaged in a trade or business within a U.S. possession on Oct. 13, 1995 and elected the benefits of the possessions credit
	Form 8810 - Corporate Passive Activity Loss and Credit Limitations	If a personal service corporation or closely held corporation with losses or credits from passive activities
	Form 8827 - Credit for Prior Minimum Tax (file with 1120)	If incurred an AMT liability in previous year and meet certain criteria
	Form 8860 - Qualified Zone Academy Bond Credit	If a bank, insurance company or other corporation that lends money and an eligible holder of qualified zone academy bonds
	Form 5452 - Corporate Report of Nondividend Distributions	If made nondividend distributions to shareholders
	Form 5472 - Information Return of a 25% Foreign-Owned U.S. Corporation or a foreign corporation engaged in a U.S. trade or business	If had a reportable transaction with a foreign or domestic related party
	Form 8842 - Election to Use Different Annualization Periods for Corporate Estimated Tax	If electing to use an annualization option under the annualized income installment method to figure estimated tax payments

Appendix I
Tax Requirements That Potentially Apply to Small Businesses

Table I.5: Layer Four (continued) - Excise Tax Requirements Administered by IRS

Title	Frequency (annually unless otherwise noted)	Explanation
Form 637 - Application for Registration	As needed	If engaging in activities with excise taxes entity must register
Form 720 - Quarterly Federal Excise Tax Return	Quarterly: April 30, July 31, Oct. 31, Jan. 31	If engaging in activities with excise taxes; Form 720 covers most excise taxes - environmental, communications, air transport, fuel, retail, luxury, manufacturing, foreign insurance
Form 11-C - Occupational Tax and Registration Return for Wagering		If principle operator or employee-agent of businesses that accept wagers
Form 730 - Tax on Wagering	Monthly for the periods reporting taxable wagers	If involved in the business of accepting wagers or conducting wagering pools or lotteries
Form 1363 - Export Exemption Certificate	As needed	If exporting property by continuous movement must file to claim exemption from the tax on transportation of property by air
Form 2290 - Heavy Vehicle Use Tax Return	Annually (unless used for a partial year)	Any entity with a taxable highway motor vehicle - vehicles greater than 55,000 pounds
Form 4136 - Credit for Federal Tax Paid on Fuels		If claiming the credit for federal excise tax paid on fuels; generally partnerships cannot file this form
Form 5330 - Return of Excise Taxes Related to Employee Benefit Plans		If there were nondeductible contributions or prohibited transactions
Form 6197 - Gas Guzzler Tax (attach to Form 720)	Quarterly as needed	If manufacturer and importers (including individuals) that sell or use automobiles that do not meet fuel economy standards
Form 6627 - Environmental Taxes (attach to Form 720)	Quarterly as needed	If manufacturers or importer of ozone-depleting chemicals (ODCs) and entities that hold for sale or sell those products
Form 8849 - Claim for Refund of Excise Taxes	As needed	If business paid excise taxes

Appendix I
Tax Requirements That Potentially Apply to Small Businesses

Table I.6: Layer Four (continued) - Excise Taxes Administered by ATF

Form Number	Title^a
F 5000.19	Tax Information Authorization
F 5000.24	Excise Tax Return
F 5000.25	Excise Tax Return – Alcohol and Tobacco (Puerto Rico)
F 5000.25A	Excise Tax Return – Alcohol and Tobacco (Puerto Rico)
F 5100.12	Specific Transportation Bond-Distilled Spirits Or Wines Withdrawn for Transportation to Manufacturing Bonded Warehouse – Class Six
F 5100.25	Specific Export Bond – Distilled Spirits or Wine
F 5110.31	Application and Permit to Ship Puerto Rico Spirits to the United States Without Payment of Tax
F 5120.20	Certification of Tax Determination - Wine
F 5120.24	Drawback on Wine Exported
F 5130.6	Drawback on Beer Exported
F 5130.12	Beer for Exportation
F 5170.7	Application and Permit to Ship Liquors and Articles of Puerto Rico Manufacture Tax paid to the United States
F 5200.17	Bond - Drawback of Tax on Tobacco Products, Cigarette Papers or Tubes
F 5210.5	Monthly Report – Manufacturer of Tobacco Products
F 5210.8	Computation of Tax Agreement to Pay Tax on Puerto Rican Cigars or Cigarettes
F 5210.9	Inventory – Manufacturer of Tobacco Products
F 5300.27	Federal Firearms and Ammunition Excise Tax Deposit
F 5620.7	Claim for Drawback of Tax on Tobacco Products, Cigarette Papers, or Cigarette Tubes
F 5620.8	Claim – Alcohol, Tobacco, and Firearms Taxes
F 5630.5	Special Tax Registration and Return (Alcohol and Tobacco)
F 5320.4	Application for Tax Paid transfer and Registration of a Firearm
F 5320.5	Application for Tax-Exempt Transfer and Registration of a Firearm
F 1610.2	Special Occupational Tax Printing Request
F 5100.30	Continuing Export Bond- Distilled Spirits and Wine
F 5110.67	Continuing Transportation Bond Distilled Spirits Or Wines Withdrawn for Transportation to Manufacturing Bonded Warehouse – Class Six
F 5110.68	Drawback Bind – Distilled Spirits and Wine
F 5130.16	Tax Deferral Bond – Beer (Puerto Rico)
F 5200.9	Certification of Prepayment of Tax on Puerto Rico Cigars, Cigarettes, Cigarette Papers, or Cigarette Tubes
	Report of Multiple Sales or Other Disposition of Pistols and Revolvers
F 5300.9	Firearms Transaction Record Part I Over-the-Counter
F 5300.24	Firearms Transaction Record Part I – Low Volume – Over-the-Counter
F 5300.9	Firearms Transaction Record Part I - Intra-State Over-the-Counter (English-Spanish)
F 5300.9	Firearms Transaction Record Part II – Non-Over-the-Counter
F 5300.9	Firearms Transaction Record Part II – Low Volumne – Intra-State Non-Over-the-Counter
F 5000.28	Floor Stocks Tax Return
F 5000.28T	1993 Floor Stocks Tax Return (Cigarettes)
F 5100.4	Certificate of Taxpaid Alcohol
F 5110.3	Drawback on Distilled Spirits Exported
F 5110.5	Tax Deferred Bond – Distilled Spirits
F 5200.23	Floor Stocks Tax Return – Pipe Tobacco
F 5300.26	Federal Firearms and Ammunition Excise tax Return
F 5300.28	Application for Registration for Tax Free Transactions Under 26 USC 4221 (Firearms and Ammunition)
F 55600.8	Statement of Adjustment to the Puerto Rico or Virgin Islands Tax Account

Appendix I
Tax Requirements That Potentially Apply to Small Businesses

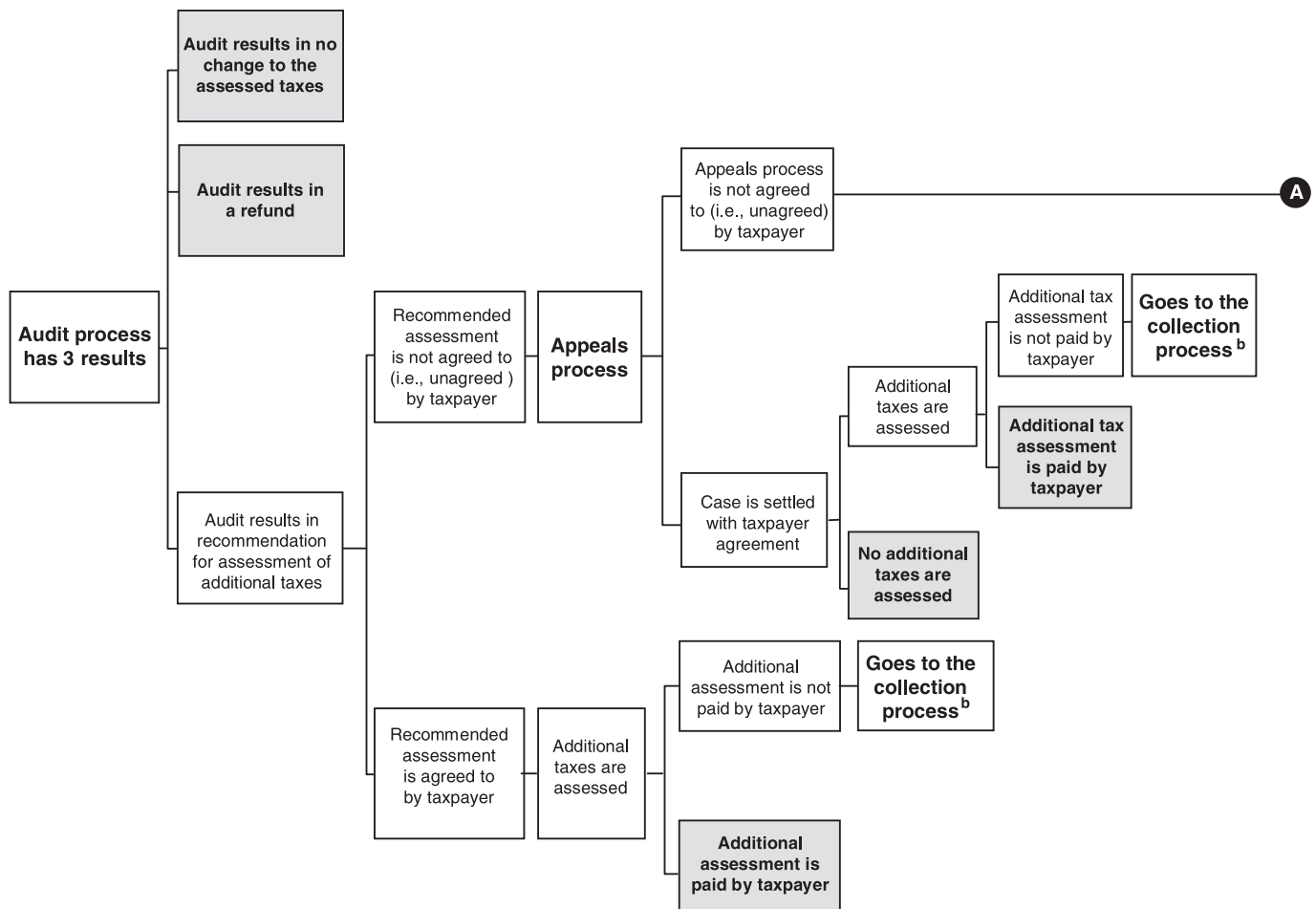
F 5600.26	Tax Collection Waiver
F5600.33	Certification of Ultimate Vendor for Use in Tax Refund Claim Under Section 6416 (b) (2) of the Internal Revenue Code (27 CFR 53.179 (b) (iii))
F 5600.34	Purchaser's Certificate of Tax Free Purchase for use as Supplies for Vessels and Aircraft (27 CFR 53.134 (d) (2))
F 5600.35	Purchaser's Certificate of Tax Free Purchase for State or Local Government Use (27 CFR 53.135 (c) (1))
F 5600.36	Vendor's Certificate of Tax-Free Purchase for Resale for Export (27 CFR 53.133 (d) (2))
F 5600.37	Vendor's Certificate of Tax-Free Purchase for Resale for Further Manufacture (27 CFR 53.132 (c) (2))
F 5600.38	Application for Extension of Time for Payment of Excise Tax
F 5610.6	Consent to Extend the Time to Assess ATF Excise Tax
F 5630.5R	Special Tax "Renewal" Registration and Return
F 5630.5RC	Special Tax Location Registration Listing
F 5630.6A	Special Tax Stamp
F 5630.7	Special Tax Registration and Return National Firearms Act (NFA)
F 5632.1	Special Occupational Tax Inquiry Letter
F 5640.5	IRC Guideline/Worksheet for Late Excise Payment/Deposit or Tax Return
F 5150.35	Bond for Spirits or Distilled Spirits or Rum Brought into the US Free of Tax (Used by Virgin Islands)
F 5150.36	Bond for Articles Brought into the US Free of Tax (Used by Virgin Islands)


^aWe did not compile information regarding the applicability or frequency of ATF excise tax requirements.

Simplified Audit and Dispute Resolution Processes

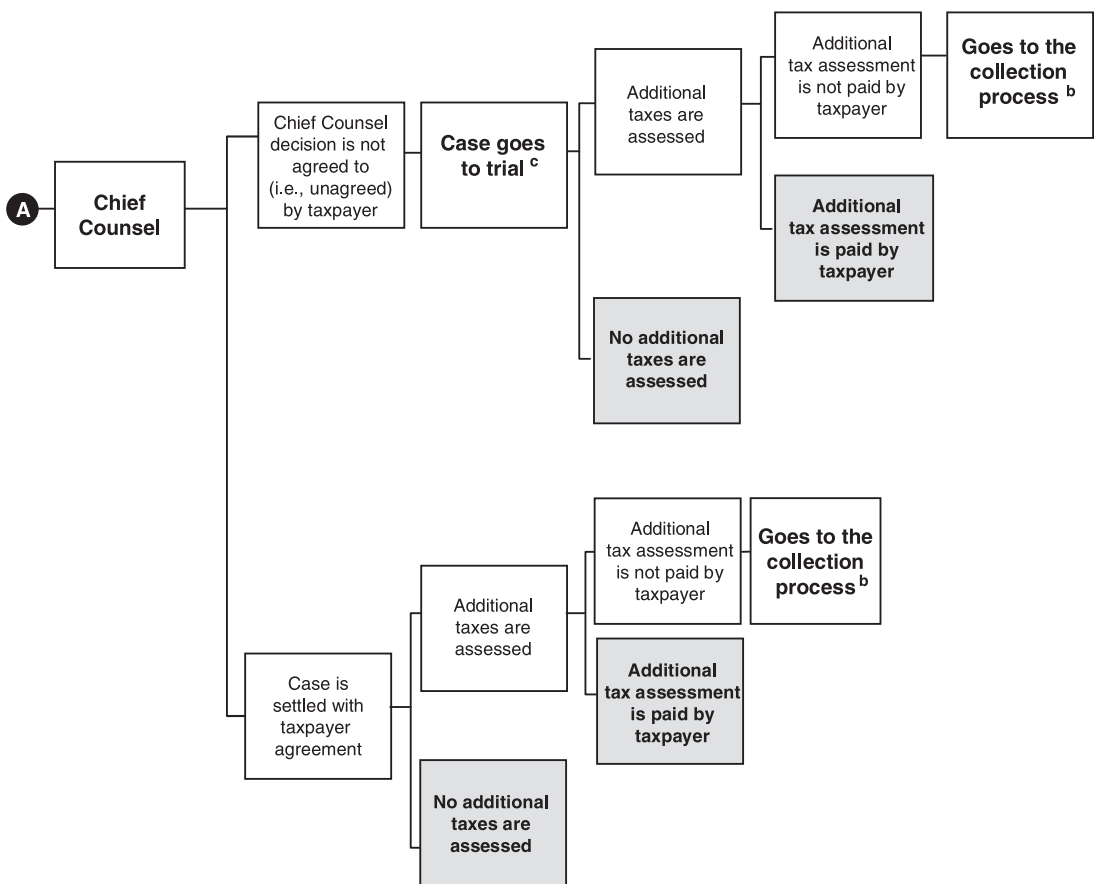
This appendix illustrates a simplified process for auditing tax returns, resolving disputed taxes, and collecting taxes owed. For the small percentage of returns that are audited, most tax issues are resolved during the audit process. However, some audited taxpayers dispute their additional taxes to Appeals, and a few seek to resolve their disputes with IRS in the courts.

Figure II.1: Simplified Audit and Dispute Resolution Processes^a



 Shaded boxes indicate the end of the tax process as a result of payment, refund, no change (to assessed taxes), or no additional taxes being assessed.

Appendix II
Simplified Audit and Dispute Resolution Processes



^a Taxpayers can receive notices from IRS apart from the audit process, including notices from IRS' math-error and information matching programs. When audited, taxpayers can receive up to two notices from IRS to notify them of audit results. The number of notices a taxpayer receives depends on when or if they respond.

^b Taxpayers can receive up to four notices from IRS' Collection Division. The number of notices a taxpayer receives depends on when or if the taxpayer responds.

^c Most cases are docketed in the U.S. Tax Court, but cases can also be docketed in Federal District Courts, the U.S. Court of Federal Claims, or the Federal Courts of Appeals.

Source: Prepared by GAO based on IRS data.

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