

August 1999

**TAX
ADMINISTRATION**

**Tax Requirements of
Small Businesses**





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United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-281009

August 24, 1999

The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

Small businesses—a category that includes all farmers and sole proprietorships and partnerships, S corporations,¹ and corporations with assets of 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 as they attempt to comply with their tax obligations.

Because of your interest in alleviating any unnecessary burden that the federal tax system places on small businesses, you asked us to assess the magnitude of the burden that complying with tax obligations imposes for these businesses. This report is the first of a series of reports to address your concerns. As agreed with your office, our objectives for this report were to determine (1) the federal filing, reporting, and deposit requirements that apply to small businesses and (2) the actual experience of small businesses in meeting these requirements, including their involvement in IRS' enforcement processes.

Results in Brief

Small businesses, like large businesses, are subject to multiple layers of filing, reporting, and deposit requirements. We identified more than 200 different IRS requirements that potentially apply to small businesses. Through such requirements, IRS administers a variety of tax policies—notably those associated with income, employment, and excise taxes. In considering the implications of the number of requirements, it is important to recognize that the requirements reflect the many decisions that have been made by Congress and the executive branch to accomplish their policy goals, including those that might benefit small businesses and other taxpayers. It is equally important to recognize that most businesses do not need to comply with all or even most of these requirements. The ones that

¹Corporations 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.

apply to a particular small business would depend on how the business is organized, whether it has employees, and the nature of its business operations.

Limitations in IRS' information systems prevented us 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. IRS has acknowledged that these limitations hinder its ability to effectively manage small business activities and will continue to be a serious impediment until the systems are improved. We were able to obtain and analyze limited data on small business filings of income tax forms and on some aspects of their involvement in IRS' enforcement processes. Our analysis of IRS' 1995 data on the most commonly filed income tax forms and schedules showed that small businesses, on average, filed one secondary form in addition to their primary income tax return, with little variation among types of businesses. Our analysis of small business audits showed that the audit rate for small businesses is higher than the rate for all taxpayers and that about two-thirds of the audits of small businesses result in recommendations for assessment of additional taxes and penalties.

Background

Businesses in the United States (including farmers) are generally structured in one of four forms: sole proprietorship, partnership, S corporation, and corporation.² Each form of business has distinctive legal characteristics and different tax consequences. Corporations are taxed as corporations, with dividends included in the owner's income; sole proprietors are taxed as individuals; and the income earned by S corporations and partnerships is passed through to their owners and taxed at the owners' rates.

The Internal Revenue Code (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. As part of its current reorganization effort, IRS has developed an agencywide definition of small business, which we used in our work. Based on that definition, small businesses include (1) all farmers and sole proprietorships and (2) partnerships, S corporations, and corporations that annually reported less than \$5 million in assets.

²Another alternative business form that has emerged is the limited liability company, which generally is classified as a partnership for tax purposes, but offers the corporate benefit of limited liability for owners.

A large majority of all businesses are small businesses. To illustrate, for tax year 1995, we used IRS data to identify 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. About 97 percent of U.S. corporations reported assets of less than \$5 million in 1995. Sole proprietorships accounted for approximately 16.3 million of the nearly 23.4 million business filers in 1995.³

Scope and Methodology

To identify the federal filing, reporting, and deposit requirements that apply to small businesses, we examined information such as IRS forms, publications, manuals, and related IRC provisions. We also interviewed IRS officials who were cognizant of small business tax issues, including officials in IRS' Office of Public Liaison and Small Business Affairs, Compliance Research Division, Appeals Division, and the Small Business/Self-Employed/Supplemental Income Team.⁴

To help ensure completeness, we had knowledgeable IRS officials review our listing of IRS requirements. To develop a more comprehensive list of federal tax requirements that apply to small businesses, we contacted the Bureau of Alcohol, Tobacco, and Firearms (ATF) in the Department of the Treasury for information on requirements pertaining to the excise taxes that it administers. The ATF requirements apply generally to any business.

To determine the actual experience of small businesses in meeting their filing, reporting, and deposit requirements, including their involvement in IRS' enforcement processes, we (1) interviewed IRS compliance officials specializing in examination, appeals, and collection issues to ascertain how small businesses are affected by the enforcement processes and (2) obtained some computerized information from IRS databases on the filing and enforcement experience of small businesses. This included data from IRS' Statistics of Income Division, Audit Information Management System (AIMS), and Accounts Receivable databases. Throughout this review, we drew on our previous work at IRS and on tax administration issues in general.

³According to IRS, 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.

⁴The Small Business/Self-Employed/Supplemental Income Team is one of several IRS teams developing plans and blueprints to, among other things, restructure IRS into four principal operating units to better serve taxpayers.

Our work did not address IRS activities related to small businesses that had not filed returns. Also, we experienced several limitations during the course of our work because much of the data we sought were not collected in IRS' information systems and databases 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.⁵ We did not verify the reliability of the IRS data we used except for some limited checking. Appendix I describes the data limitations we experienced in more detail.

We requested comments on a draft of this report from IRS. Their comments are reprinted in appendix IV. Our work was performed in accordance with generally accepted government auditing standards between September 1998 and May 1999 at IRS headquarters in Washington, D.C.

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. They provide a way not only to collect taxes from businesses, but also to use businesses to collect taxes owed by third parties (e.g., withholding employees' personal income tax and Social Security and Medicare (FICA) taxes).

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. Although a few of the requirements must be submitted more frequently than once a year, the vast majority are submitted annually. Appendix II provides a listing of all the requirements that we identified. They reflect the decisions of Congress and the executive branch in keeping with their policy goals and objectives.

⁵We obtained the most recent data available from IRS; some were for 1995 and some for 1997.

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

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 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

Table 1: Primary Income Tax Returns and Mandatory Schedules

Business category	Primary income tax return	Mandatory schedule^a
Sole proprietorship	Form 1040	Schedule C
Farmer	Form 1040	Schedule F
Partnership	Form 1065	Schedule K-1
Partner	Form 1040	Schedule E
S corporation	Form 1120S	Schedule K-1
Shareholder	Form 1040	Schedule E
Corporation	Form 1120	None

Legend

Form 1040, U.S. Individual Income Tax Return
 Form 1065, U.S. Partnership Return of Income
 Form 1120, U.S. Corporation Income Tax Return
 Form 1120S, U.S. Income Tax Return for an S Corporation
 Schedule C, Profit or Loss From Business
 Schedule E, Supplemental Income and Loss
 Schedule F, Profit or Loss From Farming
 Schedule K-1, (form 1065) Partner's Share of Income
 Schedule K-1, (form 1120S) Shareholder's Share of Income

^aSchedules that are required to be filed with the primary return.

Source: IRS.

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.

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

Employment Tax Adds Another Layer of Tax Requirements

A small business' decision to hire employees adds a second layer of tax requirements. We identified 10 different federal employment tax deposit 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 and table II.2 in app. II.) For each employee, a small business is generally responsible for collecting and remitting several federal taxes with varying frequency stipulations— withholding for employees' personal income tax and the employee's share of FICA, the employer's share of FICA, and federal unemployment tax (FUTA).

Table 2: Key Employment Tax Requirements

Type of employment tax	Primary return	Deposit requirements
Personal income and FICA tax withheld and employer's share of FICA	Form 941, Employer's Quarterly Federal Tax Return	Quarterly if liability is less than \$1,000 per quarter Monthly if \$50,000 or less in the lookback period ^a Semiweekly if more than \$50,000 in the lookback period Next day if \$100,000 or more accumulated on any day during a deposit period
	Form 943, Employer's Annual Tax Return for Agricultural Employees	Annually if liability is less than \$1,000 per year Monthly if \$50,000 or less in the lookback period ^b Semiweekly if more than \$50,000 in the lookback period Next day if \$100,000 or more accumulated on any day during a deposit period Deposits made by mail using Form 8109 or electronically using Electronic Federal Tax Payment System
FUTA tax	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 Electronic Federal Tax Payment System

^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.

Source: IRS.

A small business employer must report quarterly the amount of personal income tax withheld and FICA taxes paid for employees on Form 941, Employer's Quarterly Federal Tax Return. The employer must deposit

employee income tax and FICA taxes withheld and the employer's share of FICA taxes by mail or electronically either quarterly, monthly, semiweekly, or the next business day, depending on the employers' tax liability. If total deposits of withheld income and FICA taxes were more than \$50,000 in the second year preceding the current 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 filing and reporting requirements with IRS using Form 5500 and related schedules.¹¹ In addition, most fringe and welfare benefit plans entail filing

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 December 31, 1999, to all taxpayers currently required to use EFTPS if they did not make aggregate tax deposits of more than \$200,000 during the year. In addition, new regulations increase the threshold amount from \$50,000 (withheld income and FICA taxes) to \$200,000 (aggregated of the federal tax deposits).

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

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.

and reporting requirements with IRS using the Form 5500 series. (For a complete list, see table II.3 in app. II.)

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 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 II.4, II.5, and II.6 in app. II.)

Some of these requirements are used to implement provisions in the Internal Revenue Code 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 II.5 and II.6 in app. II.) 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 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.

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 the extent of small businesses' involvement in IRS' enforcement processes. We were, however, able to obtain and analyze limited data on small businesses' filing of income tax forms and on some aspects of small businesses' involvement in IRS' enforcement processes.

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. (For a more detailed discussion of IRS' data limitations, see app. I.)

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.¹² Partnerships and S corporations filed more schedules than other types of businesses. Partnerships filed approximately 11 schedules, and S

¹²The results for sole proprietorships and farmers include schedules pertaining to nonbusiness income (e.g., wages).

corporations filed approximately 6 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 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 did have information on federal employment taxes, but it could not be broken out by small businesses. Further, IRS did not have sufficient, reliable data on the number of small businesses that filed pension forms in 1995. We were able to obtain very limited disaggregated data on the number of pension forms filed in 1995. However, the results could not 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 match. From a sample of 65,701 small business employer identification numbers, 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.

Enforcement Experience of Small Businesses

IRS had limited data on the extent to which small businesses are involved in both examination and collection activities. We obtained limited data on audit rates; duration; recommendations, such as refunds, no change, or changes recommended by IRS examiners; and appeals and petitions.

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.¹³ (App. III provides a simplified picture of IRS' audit and dispute resolution process.)

¹³See 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.¹⁴ 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 income tax returns filed by small businesses in 1997 were audited, generally through audits conducted by IRS' district offices.¹⁵ 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.¹⁶

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. A common kind of problem that small businesses can face is in the area of employment tax compliance. A small business can fall short of operating capital, and as a consequence, it may 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 that 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.¹⁷

Table 3 provides detailed information on the audit rates in 1997 for the four types of small businesses and farmers.

¹⁴IRS 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 how much was assessed to small businesses.

¹⁵IRS data on audits of Schedule C filers is limited to those 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 AIMS data do not take into account audits of Schedule E filers, particularly the individual owners of partnerships or S corporations.

¹⁶The 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.

¹⁷See Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed (GAO/AIMD/GGD-99-211, Aug. 2, 1999), which discusses employment tax compliance.

Table 3: Audit Rates Across Small Business Types

Type of business	Size	Audit rate
Sole proprietorship	Gross receipts < \$25,000	3.2%
	Gross receipts \$25,000 < 100,000	2.6
	Gross receipts \$100,000 and more	4.1
All sole proprietorships		3.2
Farmer	Gross receipts < \$100,000	1.3
	Gross receipts \$100,000 and more	2.8
	All farmers	1.8
Partnership ^a	All partnerships	0.6
S corporation ^a	All S corporations	1.0
Corporation	Assets < \$250,000	1.2
	Assets \$ 250,000 < \$1 million	3.5
	Assets \$1 million < \$5 million	7.8
	All corporations	2.1

^aAbout 94 percent of partnerships and 98 percent of S corporations 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.

IRS has little data on the burden imposed by its audits of small businesses and other taxpayers.¹⁸ IRS' AIMS database does include information on the length of audits from an administrative perspective—that is, the number of days from when IRS' auditors first begin working on a case until the case is closed.¹⁹ This information, although not a complete indicator of the burden that IRS audits imposed on small businesses, does provide some insight on the time it takes to go through the audit process.

During an audit, a taxpayer is likely to spend some time searching for documentation, responding to IRS' inquiries, and meeting with IRS examiners. However, over the course of the audit, there are also periods of time when the taxpayer is not actively involved, such as while IRS is evaluating records and researching issues, or when IRS examiners are temporarily reassigned to other cases or activities. Table 4 provides data on the average length of small business IRS audits that were closed in 1995.

¹⁸As of May 1999, IRS was working with a consultant on a multiyear project to develop better estimates of tax compliance burden, including the burdens associated with audits.

¹⁹Audit cases are closed in various circumstances, such as when the case results in no changes, the taxpayer appeals the case, or IRS officials refer the case to the collection unit to collect the outstanding tax liability. Thus, when audit cases are referred to either the appeals or collection unit, IRS considers that the audit has concluded, and the case is closed in its Examination Division. However, as IRS opens a new case in either its appeals or collection unit, a taxpayer may perceive this as simply a continuation of the audit.

Table 4: Average Length of Small Business Audits

Type of business	Average length (in days)	Duration ^a		
		Less than 6 months	6-12 months	More than 12 months
Sole proprietorship	273	45.7%	32.5%	21.7%
Farm	221	69.1	17.1	13.8
Partnership ^b	754 ^d	30.1	16.9	52.9
S corporation ^c	308 ^d	44.2	28.7	27.1
Corporation	335	45.8	27.2	27.0
Average for all businesses	288	46.2	31.0	22.8

Note: Excludes audits recorded in IRS' database merely because a business was partially or totally owned by a large business subject to IRS' Coordinated Examination Program, in which IRS conducts lengthy audits of the very largest corporations.

^aTotal percent for some business categories does not equal 100 due to rounding.

^bIncludes all partnerships because IRS' AIMS database does not differentiate partnerships with less than \$5 million in assets.

^cIncludes S corporations with less than \$10 million in assets because IRS' AIMS database does not differentiate S corporations with less than \$5 million in assets.

^dAccording to IRS, partnership and S corporation audits assigned to service centers remain open in the AIMS database even after they are appealed. Excluding service center audits reduces the average length of partnership audits to 472 days, with 41.8 percent lasting more than 12 months, and S corporation audits to 289 days, with 25.5 percent lasting more than 12 months.

Source: GAO analysis of IRS' AIMS data.

As shown in the table, on average, the audits lasted less than 1 year, and nearly half closed in less than 6 months. Still, some audits—especially those of partnerships—lasted much longer. For example, more than half of the audits of partnerships lasted more than 1 year, as did nearly 30 percent of those for S corporations and corporations. Also, although not shown in the table, 16 percent of partnership audits and from 1 to 3 percent of the audits for other types of small businesses continued beyond 4 years.²⁰

According to IRS' Examination Division officials, a variety of factors can lengthen the time it takes to complete a business audit. Examples cited included (1) difficulties in scheduling appointments with taxpayers, (2) the time required for a taxpayer to assemble needed information, and (3) the fact that some audits involve highly complex business tax issues requiring extensive research and investigation. With respect to audits of partnerships in particular, the officials said that the audits tend to take longer because IRS must secure and examine each partner's return in addition to the partnership return. An audit of a partnership's return remains open as long as any partner is in disagreement with any audit issue.²¹ Also, audits of partnerships often require special procedures and

²⁰With certain exceptions, an assessment must be made within 3 years after a return has been filed.

²¹Under IRC section 6229, special rules apply to the period of limitations on the assessment of partnership items.

analyses, such as reviewing the linkages between the returns filed by the partnership and each of the partners and checking the application of complex tax laws affecting partnerships in some circumstances.

Recommended Additional Taxes and Penalties

Small business audits often result in recommendations for the assessment of additional taxes and penalties. For the small business audits closed in 1995, 67 percent resulted in a 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 5 provides more detailed information on IRS examiners' recommendations on audits closed in 1995. 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.

Table 5: Audit Recommendations for Small Business Audits

Type of business ^a	Total audits	Audits recommending change		Audits recommending no change	
		Additional taxes and 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
All businesses	347,001	62.4	4.6	15.6	17.3

Note: For audits closed in 1995.

^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 taxpayer's 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.

IRS' 1995 data show that small businesses appealed to IRS or filed court petitions in 8 percent of the audits where it recommended additional tax and penalties. Table 6 provides more detailed information on audits that were appealed and petitioned by each small business category.

According to IRS Appeals officials, the lower appeals rates for sole proprietorships and farms may reflect the fact that their returns generally involve less complex tax issues, which leads to fewer potential tax

disagreements. Similarly, the officials attribute the much higher appeals rate for partnerships to the complexity of the tax laws affecting partnerships and their returns.

Table 6: Number of Small Business Audits Appealed or Petitioned to the Courts

Type of business	Number ^a	Audit appeals and petitions	
		As percent of total audits	As percent of audits recommending additional taxes and penalties
Sole proprietorship	11,739	3.9	6.2
Farm	557	4.2	7.1
Partnership ^b	1,031	14.6	31.7
S Corporation ^c	1249	7.2	15.7
Corporation	3,615	10.3	19.9
All businesses	18,216	4.9	8.0

Note: For audits closed in 1995.

^aLimited to appeals of audits that recommended additional taxes and penalties.

^bIncludes all partnerships because IRS' AIMS database does not differentiate partnerships with less than \$5 million in assets.

^cIncludes S corporations with less than \$10 million in assets because IRS' AIMS database does not differentiate S corporations with less than \$5 million in assets.

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.²² First, IRS is to send a notice (or series of notices) to the taxpayers informing them of the amount owed.²³ 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 and asks 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 business audits that involve employment taxes are often referred directly to district offices. In addition to liens and levies, IRS collection officials have

²²As we have reported, IRS has had difficulty collecting assessments from many taxpayers, including small businesses. (See GAO/GGD-98-128, June 23, 1998.)

²³Collectively, 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.

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 now requires a district director's approval.

IRS could not provide information on the number of small businesses undergoing enforced collection actions (i.e., liens, levies, or seizures). However, recent IRS information shows that enforced collections, in general, have declined dramatically since 1997. For example, in fiscal year 1997, IRS made about 10,000 seizures compared to about 2,300 in fiscal year 1998, and fewer than 200 in fiscal year 1999.

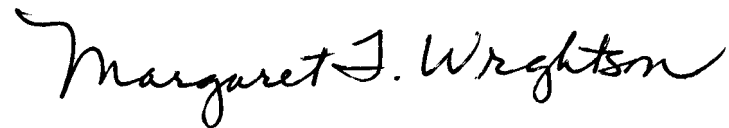
Agency Comments

We requested comments on a draft of this report from the Commissioner of Internal Revenue. On July 23, 1999, we received IRS' written comments, which discuss IRS' plans and actions to assist small businesses with their filing and reporting burdens. The comments are reprinted in appendix IV. We also met with IRS officials, including the Deputy National Director of the Public Liaison and Small Business Affairs Office and the Assistant Commissioner for Forms and Submission Processing, to discuss their technical comments, which we incorporated where appropriate.

We are sending copies of this report to Senator John Kerry, Ranking Minority Member of your Committee; Senator William V. Roth, Jr., Chairman, and Senator Daniel P. Moynihan, Ranking Minority Member, Senate Committee on Finance, and Representative Bill Archer, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means. Copies will also be sent to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and the Honorable Jacob Lew, Director, Office of Management and Budget. Copies will be made available to others upon request.

If you or your staff have any questions concerning this report, please contact me or Charlie W. Daniel on (202) 512-9110. Key contributors to this report were Robert Floren and Daniel Lynch.

Sincerely yours,

A handwritten signature in black ink that reads "Margaret T. Wrightson". The signature is written in a cursive style with a large, looping initial "M".

Margaret T. Wrightson
Associate Director, Tax Policy and
Administration Issues

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Abbreviations

AIMS	Audit Information Management System
ATF	Bureau of Alcohol, Tobacco, and Firearms
EFTPS	Electronic Federal Tax Payment System
FICA	Federal Insurance Compensation Act
FUTA	Federal Unemployment Tax Act
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SEP	simplified employee pensions
SIMPLE	savings incentive match plans for employees

IRS' Information Systems Limit Availability of Data on Small Businesses

In general, the Internal Revenue Service's (IRS) numerous information systems do not collect or store information by taxpayer groups, such as small businesses. Rather, IRS' current data systems reflect the agency's stovepipe structure and transaction-based business approach. Even if IRS' information systems maintained data by taxpayer groups, obtaining complete account information for a taxpayer would not be easy because IRS' systems are not linked together.

Historically, IRS has operated through functions, such as Examination or Collection, and information about taxpayers tended to be developed to serve each function's specific needs and its specific interactions with taxpayers rather than IRS' overall needs or taxpayers' needs. As a result, IRS' various and discrete databases provide information pertaining to certain transactions, such as seizures or the filing of income tax returns. The structure of IRS' information systems does not easily allow for a complete assessment of a small business taxpayer's interactions—from filing to postfiling—with IRS.

IRS maintains information about taxpayers' filing and compliance histories in masterfile accounts, currently housed in Martinsburg, WV. The majority of the information about taxpayers' filing and compliance histories is stored in two masterfiles—the individual masterfile and the business masterfile. Neither of these files is coded to distinguish small businesses from other taxpayers. To further complicate matters, data on filings and payments by small businesses may be divided between the individual and business masterfile. Data from Schedule C (sole proprietorship), Schedule E (partnership and S corporation shareholder), and Schedule F (farmer) are posted to the individual masterfile. Data from Schedule 1120 for corporations, including S corporations, are posted to the business masterfile. In addition, all employment and excise tax data are posted to the business masterfile. As a result, certain small businesses may have data on both masterfiles. A similar situation exists with postfiling data, such as that pertaining to examination and collection activities. The data are scattered across numerous information systems and are not coded to distinguish small businesses from other taxpayers.

The business masterfile accounts are especially complicated, having multiple reporting requirements and being more difficult for IRS to maintain without error or to use to access data. Also, the information on the masterfiles is not complete because other databases may have other related information. For example, income received about the business from a bank or other payer that has been reported to IRS on an information return is not included in the masterfiles.

Further, IRS updates the masterfiles weekly, after the transactions have taken place. Most of IRS' compliance systems (e.g., Collection) operate off uploads and downloads of selected taxpayer account information on the masterfiles. These systems are used on-line 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 masterfiles are updated on weekends.

The limitations in IRS' information systems prevented us from fully determining the extent to which small businesses actually filed various required forms and schedules and made deposits. The limitations also prevented us from fully determining the extent of small businesses' involvement in IRS' enforcement processes.

Many of the IRS databases 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 of the databases. 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 masterfile. Accessing the appropriate tax module in that file might have made it possible to capture information on assets.

However, extracting masterfile 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 masterfiles, working with the files to validate them, and then merging the data 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 could have taken many months for the agency to complete. Thus, we decided not to ask IRS to make the extractions for us.

Some of the information we sought was not readily available from IRS' compliance databases. For example, IRS' Audit Information Management System (AIMS) database does not identify some small business taxpayers or adequately distinguish small businesses from other businesses. Because 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, however, include asset data for sole proprietorships and corporations.

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.

IRS 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 frontline 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. Neither will the interim solution link IRS' systems to provide comprehensive information about taxpayers' interactions with the agency. IRS has acknowledged that its systems limitations hinder its ability to effectively manage its activities and serve small businesses and plans to continue making information systems improvements as part of its ongoing modernization and restructuring efforts.

Tax Requirements That Potentially Apply to Small Businesses

Table II.1: Layer One—Primary Income Tax Returns and Related Schedules

Type of business	Tax form ^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 E, 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 (information return)		If organized as a partnership, unless received no income and incurred no expenses treated as deductions or credits for federal income tax purposes
	Schedule K-1, (form 1065) Partner's 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.

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Type of business	Tax form^a	Frequency (annually unless otherwise noted)	Explanation
S corporation	Schedule K-1 (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
Shareholder	Form 1040, U.S. Individual Income Tax Return		See explanation above
	Schedule E, Supplemental Income and Loss (part II)		If a shareholder in an 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
	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
Other corporation returns	Form 1120-IC-DISC, Interest Charge Domestic International Sales Corporation Return (also must file three Schedules—K, P, and 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 life insurance company (or a foreign corporation that would qualify as a life insurance company 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 Real Estate Investment Trust
	Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies		If a domestic corporation that elects to be treated as an Regulated Investment Company
	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.

Source: GAO compilation of IRS information.

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Table II.2: Layer Two—Employment Tax Requirements

Type of tax	Tax form	Frequency	Explanation
Withheld income 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, semiweekly	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 semiweekly if > \$50,000 in lookback period; or 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	Annually	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 semiweekly if > \$50,000 in lookback period; next day if ≥ \$100,000 undeposited	Same as above
FUTA	Form 945, Annual Return of Withheld Federal Income Tax	Annually	If income tax withheld from nonpayroll payments
	Form 940, Employer's Annual Federal Unemployment Tax Return	Annually	If business has employees and liability is greater than \$100 in tax year
	Form 940EZ	Annually	If business has employees and if certain conditions are met for state unemployment taxes
Information returns	Deposit (Form 940 payments) Form 8109, Federal Tax Deposit Coupon or EFTPS	Quarterly	If liability greater than \$100 in tax year
	Form W-2, Wages and Compensation Paid to Employees	Annually	If business has employees (must file on magnetic media if 250 or more Form W-2s)
Self-employment	Form W-3, transmittal of W-2s	Annually	If business has employees (shows totals from Form W2s, same filing as W2)
	Schedule SE, Self-Employment Tax	Annually	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.

Source: GAO compilation of IRS information.

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Table II.3: Layer Three—Employee Benefit Plan Requirements

Tax form	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 one 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

Source: GAO compilation of IRS information.

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Table II.4: Layer Four—Requirements That Depend on Business Operations

Form applicability	Tax form	Frequency (annually unless otherwise noted)	Explanation
Potentially any business	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 form 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
	Form 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	

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Form applicability	Tax form	Frequency (annually unless otherwise noted)	Explanation
Potentially any business	Form 8609, Low-Income Housing Credit Allocation Certification		If obtaining a housing credit allocation in order to claim low-income housing credit
	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 "lookback" 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 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	

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Form applicability	Tax form	Frequency (annually unless otherwise noted)	Explanation
Potentially any business	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
	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 8 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 in one transaction
	Form 8329, Lender's Information Return for Mortgage Credit Certificates		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 annual gross gaming revenues in excess of \$1 million, to report currency transactions of \$10,000 or more	

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Form applicability	Tax form	Frequency (annually unless otherwise noted)	Explanation
Potentially any business	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
Farmers	Form 4835, Farm Rental Income and Expenses		If a landowning farmer reporting farm rental income based on crops or livestock produced by tenant
Partnerships and S corporations	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
	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 or shareholder of a passive foreign investment company
	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
Partners and shareholders	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
Corporations	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		If a personal service corporation did not meet certain distribution requirements
	Schedule PH (form 1120), U.S. Personal Holding Company Tax		If a personal holding company
	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 form 1120-RIC or 1120-REIT)		If a Regulated Investment Company or Real Estate Investment Trust and had undistributed capital gains

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Form applicability	Tax form	Frequency (annually unless otherwise noted)	Explanation
Corporations	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 form 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
	Form W-2G, Certain Gambling Winnings		If business paid out reportable gambling winnings

Source: GAO compilation of IRS information.

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Table II.5: Layer Four—Excise Tax Requirements Administered by IRS

Tax form	Frequency	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	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	Annually	If principal 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	Annually	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	Annually	If there were nondeductible contributions or prohibited transactions or failure to meet certain other employee benefit plan requirements
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

Source: GAO compilation of IRS information.

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Table II.6: Layer Four—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 Bond—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 Volume—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

(continued)

Appendix II
Tax Requirements That Potentially Apply to Small Businesses

Form number	Title^a
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 U.S. Free of Tax (used by Virgin Islands)

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

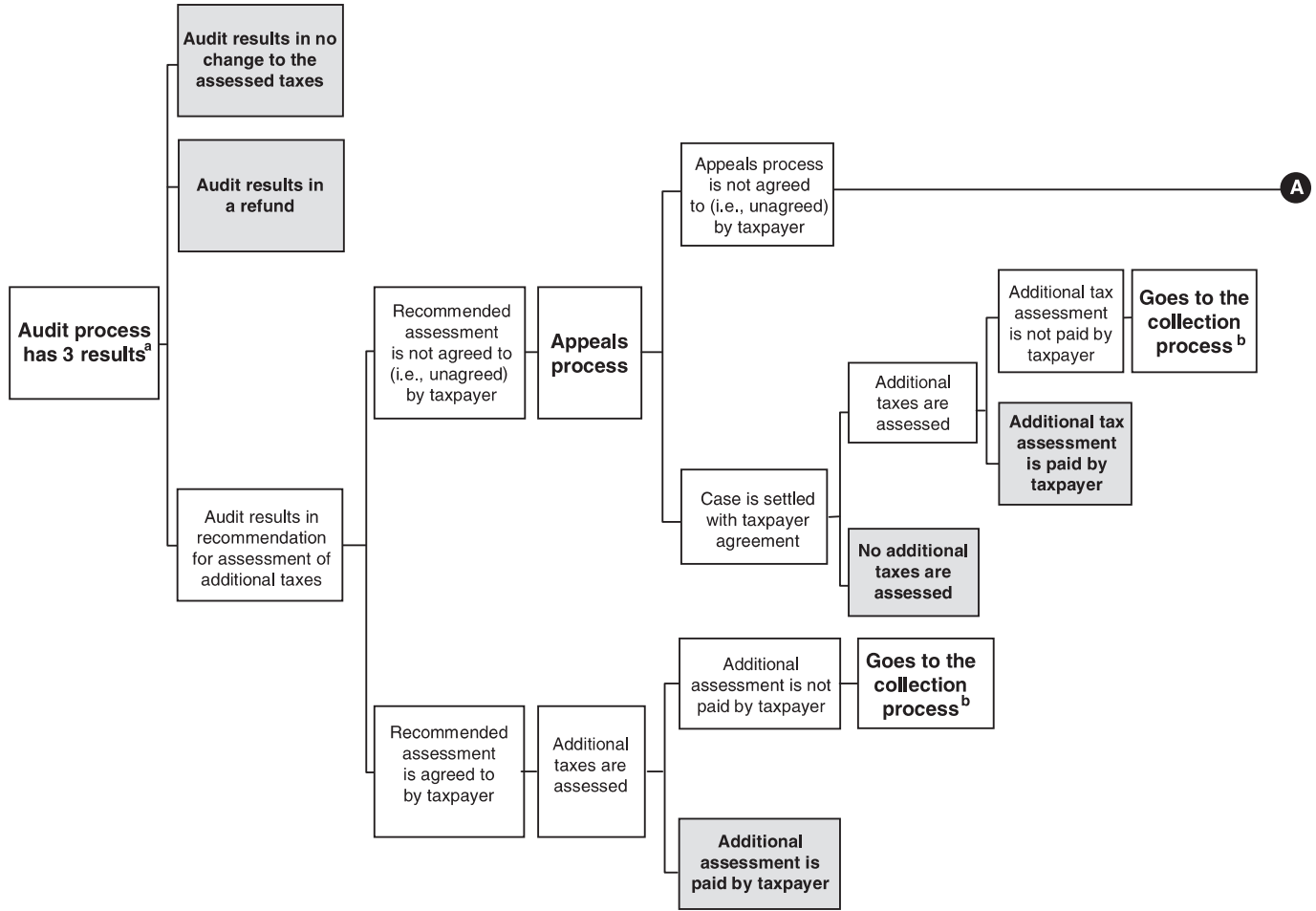
Source: GAO compilation of IRS information.

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.

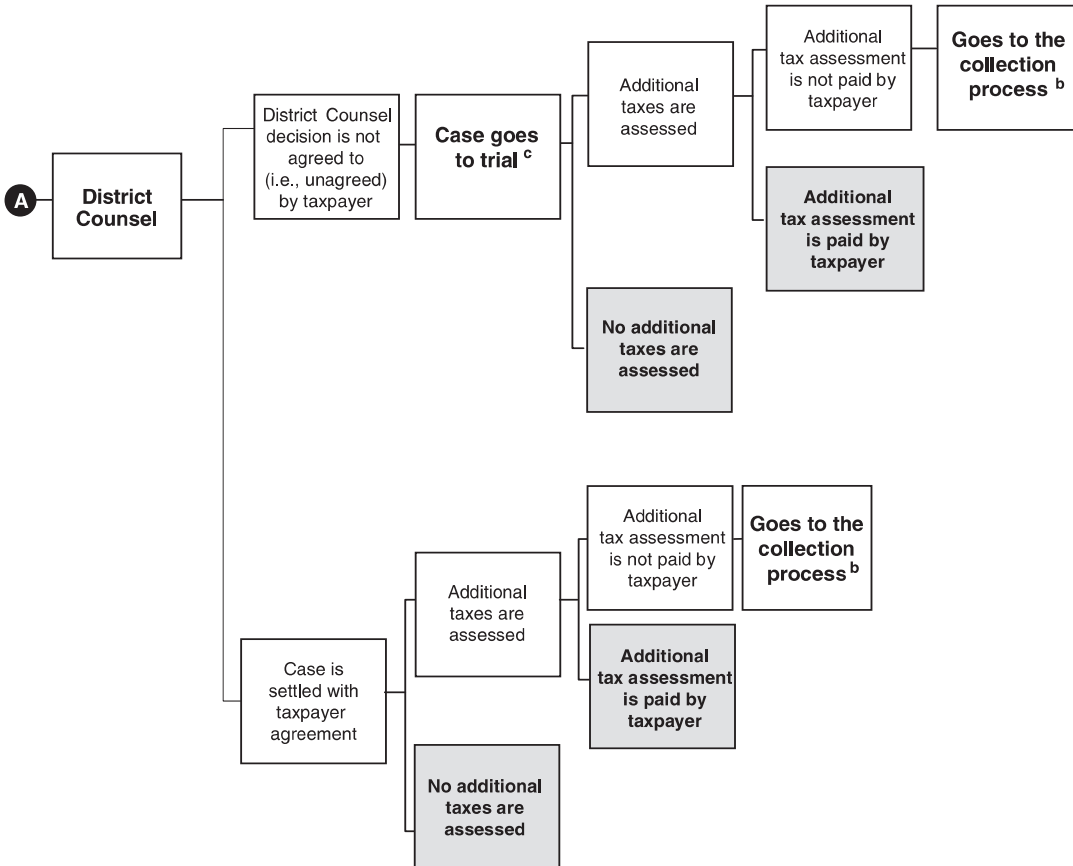
Appendix III
Simplified Audit and Dispute Resolution Processes

Figure III.1: Simplified Audit and Dispute Resolution Processes



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 III
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 or the U.S. Court of Federal Claims.

Source: Prepared by GAO based on IRS data.

Comments From the Internal Revenue Service



COMMISSIONER

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

July 22, 1999

Ms. Margaret T. Wrightson
Associate Director, Tax Policy and Administration
United States General Accounting Office
Washington, D.C 20548

Dear Ms. Wrightson:

Thank you for the opportunity to review and comment on your recent draft report entitled "Tax Administration: Tax Requirements of Small Businesses." We have provided technical comments that we believe will improve your draft report directly to your staff. Additionally, I do want to highlight some of our long-term plans and changes we have recently implemented to reduce and/or assist small businesses with their filing and reporting burdens.

We must make fundamental changes in the way the IRS operates to improve tax administration, to provide better quality service, to be less burdensome and to be fairer to small businesses. That is why we are planning to organize the IRS with a division dedicated to serving nearly 40 million small businesses and self-employed taxpayers. This new approach will provide small businesses with a clearer voice and a helping hand within the IRS. It will be designed to put in place a structure that will enable a management team to work with and understand small business issues. This new operating division will have the responsibility for improving the way the tax administration works for small business. In the short-term we are working as quickly as possible to make incremental improvements. Some of our recent improvements are as follows:

First, rather than continue to require mandatory participation of smaller businesses in the Electronic Federal Tax Payment System (EFTPS), the Internal Revenue Service (IRS) has raised the threshold requiring the use of EFTPS to more than \$200,000 beginning January 1, 2000, and has offered penalty relief to small businesses because of concerns that the requirement may have created a hardship for some businesses. While we encourage businesses to use EFTPS, we hope to increase their voluntary participation through education and outreach on the business benefits of enrolling in EFTPS rather than with mandates and penalties.

Second, last year the IRS increased the threshold amount when quarterly tax deposits are required from \$500 to \$1,000. This change means that almost one-

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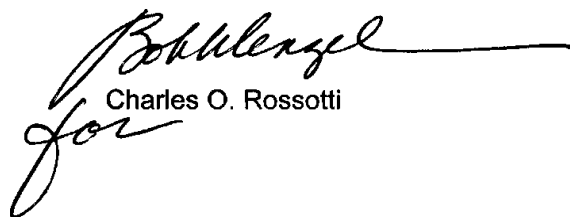
third of the nation's 6.2 million small business employers will not have to deposit employment taxes.

Third, we are always exploring new ways to communicate with small businesses, including CD-ROM technology and Internet sites to provide one-stop information, education, and registration services to the small business community. Our new IRS/Small Business Administration CD-ROM "Small Business Resource Guide: What You Need To Know About Taxes and Other Topics" provides easy-to-access guidance that is organized by the stages of a business' life cycle. In addition, all of the IRS small business tax forms and publications are included in the CD-ROM and a majority are in fill-in-the-blank and/or searchable format. The Small Business Corner on the IRS Web site debuted this January, and provides small business taxpayers with the information necessary to comply with their tax requirements. Most recently, IRS provided a direct link to the Senate Committee on Small Business Internet site's initiative to reduce burden by seeking feedback from small business. The feedback from small business owners will help to identify which IRS forms, schedules, publications, letters and notices are most in need of revision.

Finally, IRS recently hosted the "1999 Business and Professional Roundtable: Tax Forms Forum" in an effort to give small business trade associations and tax practitioner organizations an opportunity to discuss directly with IRS executives their concerns about tax form complexity and burden. We believe working cooperatively with small businesses and their representatives will better allow us to help them understand their tax obligations and pay their taxes with the least burden and least chance of error.

Thank you for the opportunity to discuss our work designed to ease the filing and reporting burdens placed upon small businesses. We look forward to working with you and your staff in the future to identify additional ways to help small business taxpayers.

Sincerely,



Charles O. Rossotti

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