United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

September 2009

TAX GAP

Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses

GAO-09-815

September 2009

GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-09-815, a report to the Committee on Finance, U.S. Senate

TAX GAP

Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses

Why GAO Did This Study

Sole proprietors, who own unincorporated businesses by themselves, underreported their net income by 57 percent or $68 billion for 2001, according to the Internal Revenue Service's (IRS) most recent estimate. The underreporting includes both understated receipts and overstated expenses and may result in losses that can be deducted against income from other sources, such as wages.

GAO was asked to (1) describe sole proprietor losses and the extent to which the losses are noncompliant, (2) assess how well IRS addresses the noncompliance, and (3) identify any options to better limit noncompliant losses.

To meet its objectives, GAO analyzed IRS research databases, case files, and examination results data and met with IRS officials.

What GAO Recommends

GAO recommends that IRS estimate the extent of sole proprietor not-for-profit (hobby) activity noncompliance using its research data. GAO is not recommending a loss limitation rule because the trade-off between reducing noncompliant losses and allowing legitimate losses requires a policy judgment.

In commenting on a draft of this report, IRS agreed to implement both GAO recommendations.

View GAO-09-815 or key components.
For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

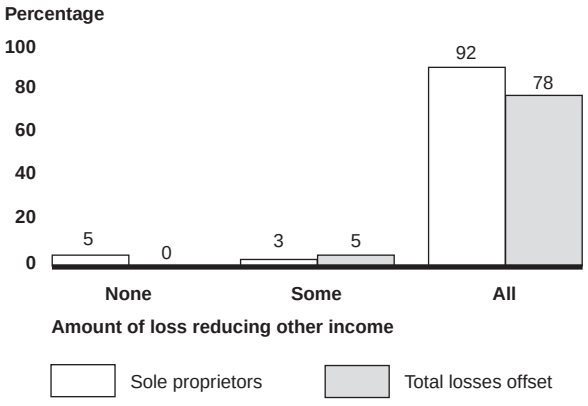
What GAO Found

About 5.4 million or 25 percent of all sole proprietors reported losses in 2006. Ninety-five percent of these loss filers deducted some or all of their losses against other income, deducting a total of $40 billion. According to IRS estimates last made for 2001, 70 percent of the sole proprietor tax returns reporting losses had losses that were either fully or partially noncompliant. About 53 percent of aggregate dollar losses reported in 2001 were noncompliant. This noncompliance would correspond to billions of dollars of lost tax revenue.

IRS's compliance programs address only a small portion of sole proprietor expense noncompliance. Despite investing nearly a quarter of all revenue agent time in 2008, IRS was able to examine (audit) about 1 percent of estimated noncompliant sole proprietors. These exams are costly and yielded less revenue than exams of other categories of taxpayers, in part because sole proprietorships are small in terms of receipts. Another enforcement program that primarily uses third-party information to electronically verify compliance is not effective because little expense information is reported by third parties.

One approach for limiting sole proprietor loss noncompliance would impose a rule that limits losses that could be deducted from other income. The tax code has a number of such limitations. A loss limitation could reduce noncompliant losses but would also limit the ability of sole proprietors to claim legitimate losses. Another approach would improve IRS's estimates of the extent to which activities not engaged in for profit, such as hobbies, are contributing to noncompliant sole proprietor losses. Expenses associated with these activities are not deductible, but IRS's research on the causes of sole proprietor noncompliance has not used available data to estimate the extent of this type of noncompliance. Without such an estimate, IRS could be missing an opportunity to reduce noncompliant sole proprietor losses.

Percentage of Sole Proprietor Loss Returns Where Losses Were Used to Offset Other Income and Percentage of Net Losses Used to Offset Other Income, 2006



Source: GAO analysis of 2006 cross-sectional SOI data.

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Abbreviations

AGI	adjusted gross income
AUR	Automated Underreporter Program
CDW	Compliance Data Warehouse
EITC	Earned Income Tax Credit
IMF	Individual Master File
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NRP	National Research Program
RGS	Report Generation Software
SOI	Statistics of Income
TIN	taxpayer identification number

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

September 10, 2009

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The Internal Revenue Service's (IRS) most recent estimate of the federal tax gap, for tax year 2001, is $345 billion. The gap is the difference between what taxpayers should have paid and what they actually paid on time. IRS also estimated that it would eventually collect, through various enforcement efforts, about $55 billion of the gap, leaving a net tax gap of $290 billion.

According to IRS, sole proprietors—persons who own unincorporated businesses by themselves—are responsible for a large portion of the tax gap. For 2001, IRS estimated that sole proprietors misreported 57 percent of their net business income and accounted for $68 billion of the tax gap. A key reason for this misreporting is well known. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is subject to information reporting to IRS by third parties.

We recently reported that sole proprietor tax returns included substantial misreporting of both gross income and expenses. In that report, we discussed the pros and cons of numerous options for reducing the sole proprietor tax gap, including changes to record keeping, third-party information reporting, relevant IRS compliance programs, and IRS's use of resources.[1]

Expressing your concern about the tax gap and business expense misreporting, you asked us for additional information about sole proprietors' expense noncompliance. Following up on our previous report, we agreed to focus in this report on those sole proprietors whose expenses were large enough to cause a net loss. Our objectives were to

[1] GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

(1) describe the population of sole proprietors who file losses, their patterns of losses over time, and their level of noncompliance; (2) assess whether IRS compliance programs are able to correct a significant portion of sole proprietor expense and loss noncompliance; and (3) identify what additional options are available for IRS to close the tax gap for sole proprietor expenses and losses.

We used several approaches to analyze sole proprietor expense noncompliance and to identify options for reducing this noncompliance. Principally, we analyzed data from IRS's 2001 National Research Program (NRP) to identify the extent of sole proprietor loss and expense noncompliance. We also used IRS Statistics of Income (SOI) program data to profile profits and losses for sole proprietors in 2006 and combined these data with other IRS data to form panels of sole proprietor tax returns from 1998 to 2006 in order to describe patterns of losses over time. For estimates based on samples of taxpayers in this report, we are 95 percent confident that the estimates are within 10 percent of the population values for dollar amounts and counts and 3 percent of population values for percentages, unless otherwise noted. We also interviewed IRS officials on the operations and results of its Examination and Automated Underreporter programs and reviewed case files for a sample of examinations of sole proprietors filing losses from the 2001 NRP, selected to reflect a range of income and compliance.

We conducted this performance audit from July 2008 through September 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. A more detailed description of our methodology is in appendix I.

Background

Sole proprietors are relatively numerous in terms of tax filers but small as measured by receipts. In 2003, the most recent year for which IRS data were available, sole proprietors constituted about 72 percent of all businesses in the United States, while earning about 5 percent of all business receipts. Sole proprietors engaged in a wide range of businesses, including legal and consulting services, manufacturing, and retail sales. A sole proprietor may engage in these activities full- or part-time and the sole proprietorship may account for all or part of an individual's income.

Sole proprietors report their business-related profit or loss on their individual income tax returns—IRS Form 1040—through Schedule C, Profit or Loss from Business. Schedule C requires sole proprietors to report receipts and expenses to determine profits or losses. These business profits or losses are combined with income, deductions, and credits from other sources that are reported elsewhere on Form 1040 to compute a taxpayer's overall individual tax liability. Thus, sole proprietors who report losses on Schedule C can use their losses to offset other categories of income on their returns, such as wages and interest, in the year that they incur the loss.

Identifying which of a sole proprietor's payments qualify as business expenses and the amount to be deducted can be complex. Deductible business expenses must be "ordinary and necessary" and paid or incurred during the tax year in carrying on a trade or business.[2] Two types of payments—costs of goods sold and capital improvements—must be distinguished from other types of payments because they are treated differently under tax rules. To identify the cost of goods sold, businesses that manufacture or resell merchandise must follow tax rules that require valuing their inventory at the beginning and end of the tax year. Payments for capital improvements, such as start-up costs, business assets, and improvements, usually are not fully deducted in the current tax year but instead must be depreciated over a multiyear period. Expenses that are used partly for business and personal purposes can be deducted only to the extent they are used for business. For example, business use of the taxpayer's home or car requires allocating the costs between business and personal use.

The general standard for measuring taxable income is to match receipts and expenses as they occur, that is, their recognition should not be limited or postponed. However, under certain conditions, the tax code limits the extent to which losses can be deducted from other categories of income. One of these limits is that an individual may not deduct losses from activities that are not engaged in for profit against other income. There are also limits when an individual did not materially participate in the activity or for funds that the individual did not put at risk.

[2] Ordinary means that the expense is common and accepted in the sole proprietor's industry. Necessary means that the expense is helpful and appropriate for the sole proprietor's industry. Generally, to be a trade or business the sole proprietor has to demonstrate that he or she has a profit motive and the scope of the business's activities is considerable, regular, and continuous.

Regulations specify a nine-factor test to help identify activities that are not engaged in for profit.[3] The losses an individual incurs from activities not engaged in for profit are sometimes called hobby losses. No single factor is determinative, and the regulations state that factors other than the nine cited can be taken into account when identifying a profit objective. However, taxpayers may still deduct these expenses up to the limit of the income earned from an activity not engaged in for profit. Additionally, activity not engaged in for profit rules presume that the activity is engaged in for profit if the activity produced a profit in at least 3 of the last 5 years or for some activities 2 of the last 7 years.

IRS Compliance Programs

IRS has three principal compliance programs covering various types of taxpayers and various types of income and expenses. Two are used to ensure that sole proprietors are properly reporting expenses.

- The Examination Program—examinations are often called audits—is the principal compliance program for sole proprietor expenses and is operated in three forms. Correspondence examinations are conducted through the mail and usually cover one or two narrow issues. Office examinations require taxpayers to go to an IRS office and are broader than correspondence exams but still limited in scope. Field examinations send revenue agents to taxpayers' homes or businesses and cover all compliance issues regardless of complexity or scope. The field examinations staff have the highest skill levels among staff in IRS's compliance programs. In 2008, simple correspondence examinations for sole proprietor returns required an average of 2 hours, while field examinations, which may require more sophisticated analysis and judgment, averaged 21 hours.
- The Automated Underreporter Program (AUR) matches an information return with a related item on the tax return as reported by the taxpayer. Information returns are prepared for certain types of transactions, such as payment of interest on a bank account. If AUR identifies a discrepancy between the information return and the taxpayer's reporting for that item,

[3] Treasury Regulation 1.183-1 and 2. The regulations' nine factors consider (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayers or his or her advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, that are earned; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation associated with the activity.

AUR may send a notice to the taxpayer, after the discrepancy is verified by an IRS examiner, requesting payment of additional tax, interest, and penalties. If the taxpayer disagrees with the notice, the taxpayer is asked to explain the difference and may provide any other information, such as supporting documents. The taxpayer's response is reviewed by an examiner who determines whether the tax should be assessed. AUR staff use some judgment and skill in their reviews, which require about half an hour to complete.

- The Math Error Program verifies the accuracy of tax returns during processing. It uses IRS computers to identify and generate notices to contact taxpayers about obvious errors, such as mathematical errors, omitted or inconsistent data, or other inconsistencies on the basis of other data reported on their returns or to IRS. This compliance program is not currently used to ensure that sole proprietors are properly reporting expenses. IRS may use this program in specific instances as authorized by Congress through the Internal Revenue Code. The errors must be corrected to process the returns and ensure that all taxpayers comply with tax rules. For example, during return processing, the Math Error Program identifies whether all taxpayers have complied with mathematical limits in the tax law, such as the $3,000 net capital loss limitation. Since math errors are obvious, there is little review of the error by IRS staff before adjustment notices are sent to the taxpayers. The Math Error Program and its possible use in ensuring sole proprietor expense noncompliance is discussed in more detail in later sections of this report.[4]

Compliance Measurement and the Tax Gap

IRS estimates that a large portion of the gross tax gap, $197 billion, is caused by the underreporting of income on individual tax returns. Of this amount, IRS estimates that $68 billion is caused by sole proprietors underreporting their net business income, which can stem from either understated receipts or overstated expenses. The precise proportion of the overall tax gap caused by sole proprietors is uncertain because of sampling error and the exclusion from the estimate of factors affecting the tax gap, such as sole proprietors' not paying because of failing to file tax returns, underpaying the tax due on income that was correctly reported, and underpaying employment taxes.

[4] For more information on the Math Error Program, see GAO, *Tax Administration: IRS's 2008 Filing Season Generally Successful Despite Challenges, although IRS Could Expand Enforcement during Returns Processing*, GAO-09-146 (Washington, D.C.: Dec. 12, 2008), and *Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, GAO-03-378 (Washington, D.C.: Jan. 31, 2003).

IRS estimates the tax gap caused by underreporting of individual income from the NRP, IRS's compliance research program. For tax year 2001, the NRP study used a detailed review and examination of a representative sample of about 45,000 individual tax returns to compute estimates of underreporting of income and taxes for all individual tax returns. The NRP individual sample was designed to include a disproportionately large number of sole proprietors because of their known compliance issues.[5] This allowed more detailed data to be collected about the nature of sole proprietor compliance issues. However, the NRP reviews could not detect all noncompliance. As a consequence, IRS adjusted the NRP estimates to develop final estimates of income misreporting and the resulting tax gap.

IRS has started work on an updated NRP study. The study will examine about 13,500 randomly selected returns annually, starting with tax year 2006. According to IRS, after 3 years the combined sample will be comparable to tax year 2001 and will allow for annual updates of noncompliance estimates. IRS plans to issue a preliminary estimate of the 2006 individual reporting tax gap by 2012.

[5] NRP's oversampling is corrected for statistically in order to make valid population estimates.

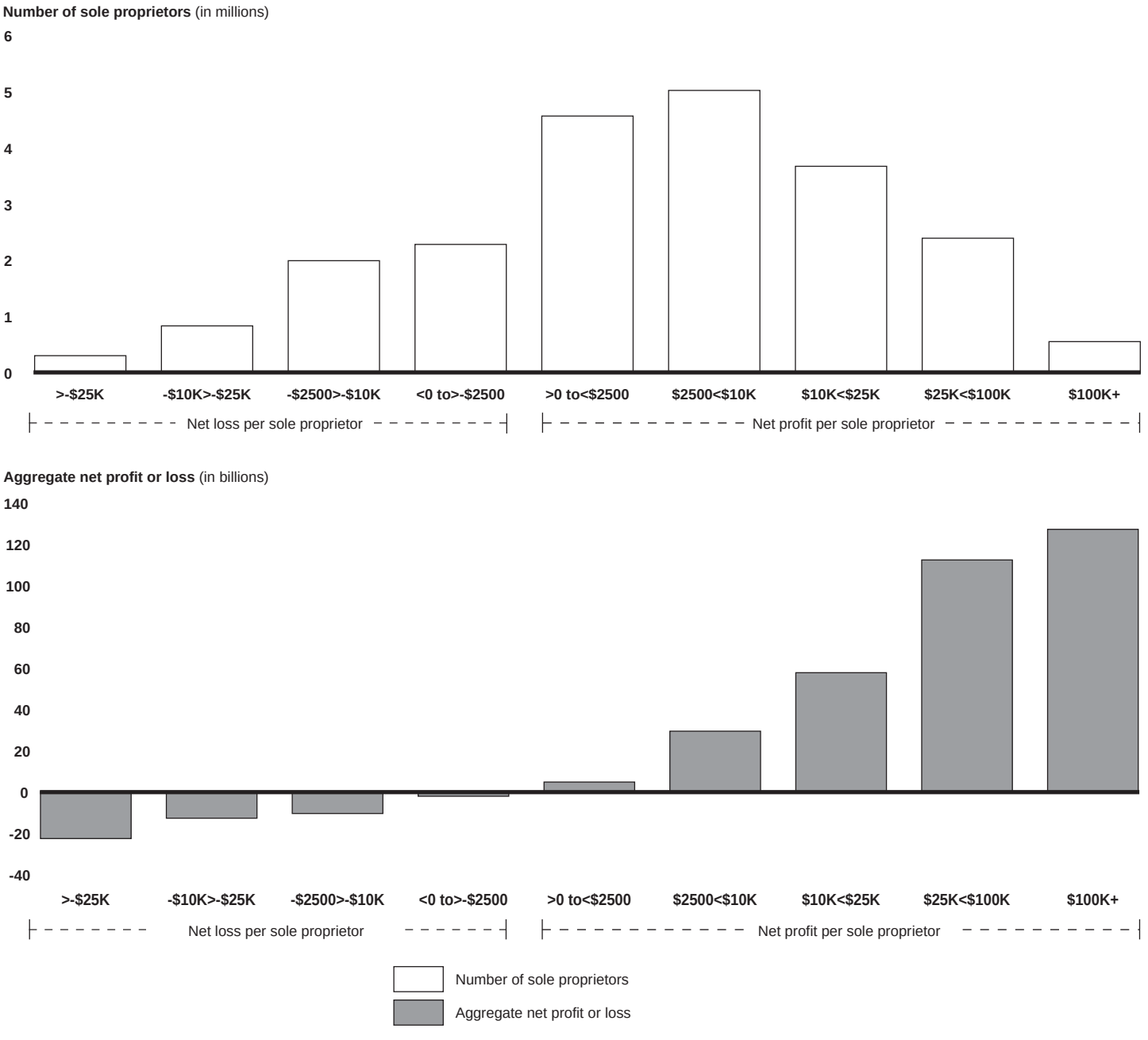
Sole Proprietor Losses Are Substantial and Growing and Are a Compliance Problem

A noticeable proportion of sole proprietors reported a loss in tax year 2006. Of the 21.7 million sole proprietor returns in 2006, an estimated 5.4 million, or 25 percent, reported losses while 16.2 million, or 75 percent, reported profits.[6] Total reported losses were $49 billion and total reported profits were $330 billion.

Most sole proprietors reported small amounts of profit or loss, but a few reported substantial amounts. As figure 1 shows, 85 percent of sole proprietor returns reported net profit or loss of less than $25,000. On the other hand, the 13 percent of sole proprietor returns with at least $25,000 in profits accounted for 72 percent of all reported profits. Similarly, the 1 percent of sole proprietor returns with at least $25,000 in losses accounted for 47 percent of all reported losses.

[6] This estimate of the number of sole proprietors in 2006 includes only those returns reporting a profit or loss. The total above excludes about 400,000 returns reporting no profit or loss. If these were included, the total number of sole proprietors in 2006 would be 22.1 million.

Figure 1: Distribution of Sole Proprietor Returns and Their Net Profit or Loss in 2006

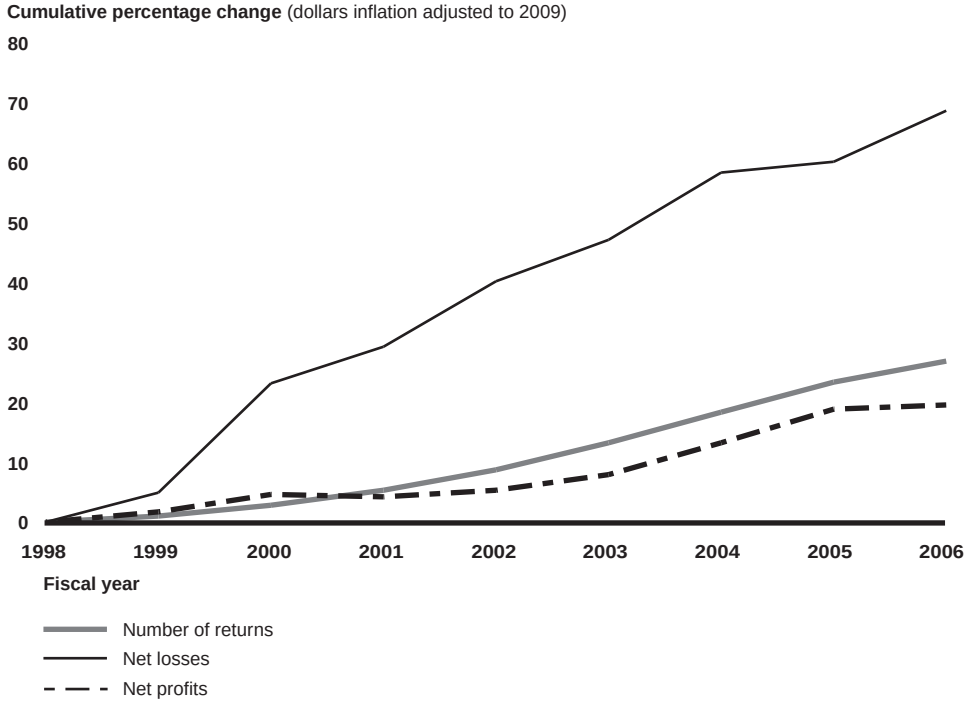


Source: GAO analysis of 2006 cross-sectional SOI data.

Sole Proprietor Losses Are Growing

Total sole proprietors' losses, after adjusting for inflation, grew by 69 percent from 1998 to 2006.[7] As figure 2 shows, losses grew faster than both profits and the number of sole proprietor returns in each year except 2005. Over the same period, expense deductions reported for loss returns grew about four times as fast as expense deductions reported for returns showing a profit.[8]

Figure 2: The Cumulative Percentage Change in Sole Proprietor Returns, Net Profits, and Net Losses from 1998 through 2006



Sources: GAO analysis of SOI studies, tax year 1996 to 2006.

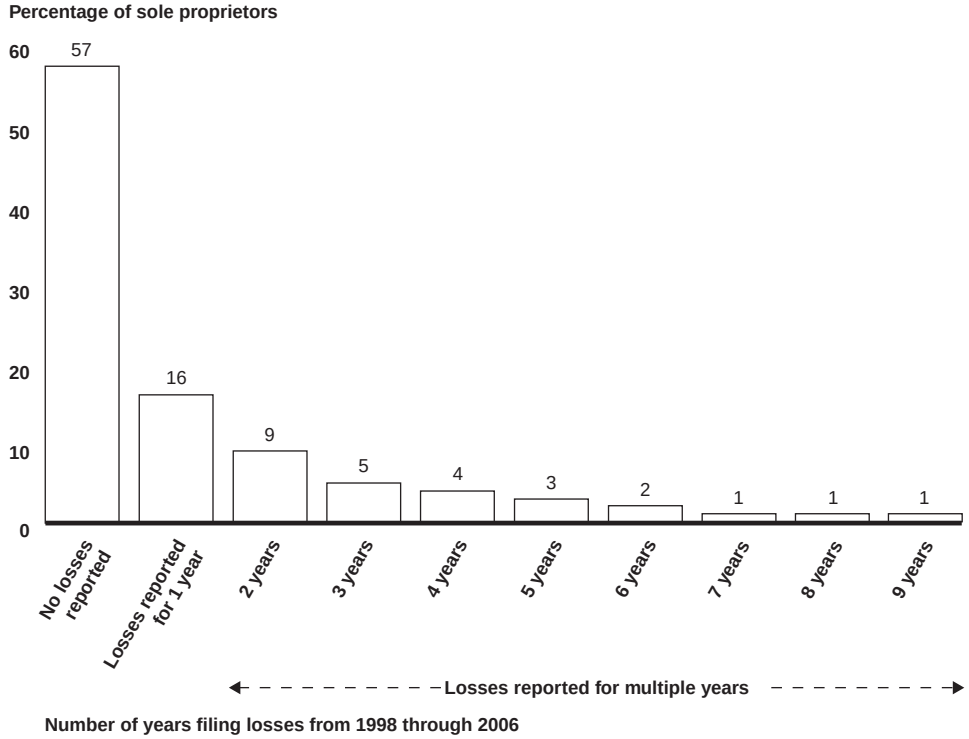
[7] Inflation adjustments were made using the gross domestic product price index because sole proprietors cover a broad group of goods and services.

[8] From 1998 to 2006, after accounting for inflation, business deductions for loss returns increased by about 43 percent as compared to a roughly 9 percent increase for profit filers.

Many Sole Proprietors Reported Losses in Multiple Years

As figure 3 shows, based on data from a panel we constructed, 26 percent of all sole proprietor returns in 2006 reported losses in 2 or more years from 1998 through 2006.[9] However, when only sole proprietors who reported losses in 2006 are considered, the frequency of multiple loss years increases. Seventy percent of these sole proprietor returns reported losses in 2 or more years during this period.[10]

Figure 3: Percentage of Sole Proprietor Returns in 2006 with Reported Losses for Multiple Years from 1998 through 2006



Source: GAO analysis of 2006 SOI cross-sectional data and 1998-2006 Compliance Data Warehouse data.

[9] We dropped from our 2006 sole proprietor panel returns where taxpayers changed marital status and a small number of returns where data were not available. As a result, our panel represents about 17.2 million of the estimated 21.7 million returns with sole proprietorship income in 2006. See app. I for an explanation of the panel data and methodology.

[10] Sole proprietors may not file Schedule C each year and may file multiple years of losses or zero profit out of the 9 years that we reviewed in the panel data. We examined the frequency of filing for 2006 sole proprietor returns. About 83 percent filed Schedule C in at least 1 prior year. Nearly half of 2006 sole proprietors have a filing history of less than 5 years. Another 29 percent filed all 9 years, and 62 percent of 2006 sole proprietors filed for 2 or more consecutive years ending in 2006 with no gaps between filing.

In terms of dollars, a large portion of 2006 losses were reported by sole proprietors with losses in multiple years. Seventy-seven percent of the losses reported in 2006 by the sole proprietors in our panel were reported on sole proprietor returns that also reported 2 or more years of losses from 1998 through 2006. Thirty-five percent of total 2006 losses were reported on sole proprietors' returns that reported 5 or more years of losses.[11]

Losses in multiple years can occur for many reasons. Situations that may result in multiple years of reported losses include starting a business, developing a new product, or facing unfavorable economic conditions. Reported losses may also be due to noncompliance, caused by either understated receipts or overstated expenses. IRS regulations cite examples of compliant businesses that have profit objectives and several years of losses before realizing profits. In one example, a chemist works developing a new product that could have extensive uses and could generate substantial profits if it is successful. In this example, IRS finds that the chemist is engaged in activities for profit, and the losses can be deducted against other categories of income.[12]

Sole proprietors with a history of losses are less likely to recover their losses through sole proprietorship profits in other years. Of sole proprietor returns reporting a loss in 2001 but not in previous years, 45 percent earned an overall profit from 1998 through 2006.[13] However, of the sole proprietor returns reporting a loss in 2001 and 2 previous years of reported losses, 16 percent earned an overall profit. In contrast, 95 percent of sole proprietor returns with profits in 2001 earned an overall profit from 1998 through 2006.

[11] This estimate is based on the 1.2 million 2006 sole proprietor returns with net losses and a total of 5 or more years of reported losses from 1998 through 2006. These sole proprietors may not have filed Schedule C each year and may have filed only 5 years of losses and no profits out of the 9 years reviewed.

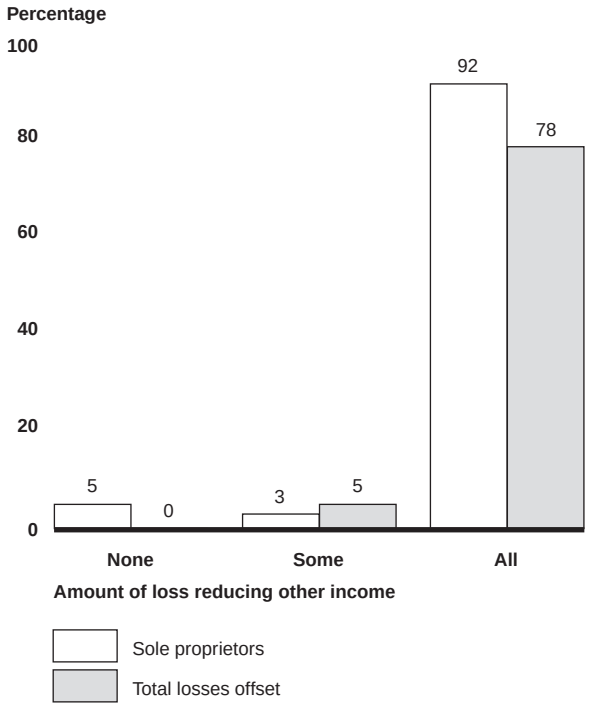
[12] Treasury Regulation 1.183-2.

[13] As in the case of the 2006 panel, we dropped from our 2001 sole proprietor panel returns where taxpayers changed marital status and a small number of returns where data were not available. As a result, our panel represents about 14.9 million of the estimated 18.3 million returns with sole proprietorship income in 2001. We adjusted dollar amounts for inflation using the gross domestic product price index when calculating the percentage of sole proprietor returns that earned an overall profit from 1998 through 2006. The confidence interval for the estimate of the percentage of returns that reported a loss in 2001 but not in previous years that earned an overall profit from 1998 through 2006 is +/- 3.1 percent.

Most Sole Proprietors with Losses Deducted Them against Other Categories of Income

As shown in figure 4, of the 5.4 million sole proprietors with losses in 2006, 92 percent deducted all of their reported losses from other categories of income, while 5 percent were unable to deduct any of the losses.[14] In terms of dollars, of the $49 billion of total losses reported in 2006, 78 percent was fully deducted against other income and another 5 percent was partially deducted. In total, $40 billion was deducted against other categories of income.

Figure 4: Percentage of Sole Proprietor Loss Returns Where Losses Were Used to Offset Other Income and Percentage of Net Losses Used to Offset Other Income, 2006



Source: GAO analysis of 2006 cross-sectional SOI data.

[14] Some sole proprietors could not deduct allowable losses because they did not have enough other income to deduct the losses against. However, these taxpayers may claim a net operating loss if their adjusted gross income net of itemized deductions or the standard deduction is negative. Generally, taxpayers can use their net operating loss from one year to offset income in other years. We could not examine the extent to which this is occurring with the data available from IRS.

Most reported losses were a small proportion of the sole proprietors' other income. Among those sole proprietor returns where losses offset other income, 61 percent had deductions from sole proprietorship losses that were less than 10 percent of their other income, and 92 percent had deductions from sole proprietorship losses that were less than 50 percent of their other income.

Sole Proprietors Reporting Losses Were Likely to Be Noncompliant

A large proportion of sole proprietors reporting losses in 2001, the most recent year data were available, underpaid their taxes and a larger percentage of sole proprietors reporting losses were noncompliant than those reporting profits. As shown in table 1, IRS estimated in its 2001 NRP study that 70 percent of sole proprietor returns with net losses (3 million returns) underreported net income by at least $100 compared to 52 percent of those with profits. Further, of these loss returns that were noncompliant by at least $100, 57 percent were fully noncompliant (i.e., the entire loss was disallowed) and the remaining 43 percent were partially noncompliant (i.e., some of the loss was disallowed).

Table 1: Estimated Percentage of Sole Proprietor Loss and Profit Returns That Were Noncompliant, 2001

Sole proprietor returns with	Percentage underreporting net income by at least $100	Percentage underreporting net income by at least $1,000
Net losses	70	55
Net profits	52	40

Source: GAO's analysis of IRS's 2001 NRP.

In terms of aggregate dollars, based on NRP results, about $15 billion of the $28 billion in losses reported in 2001, or about 53 percent, were noncompliant.[15] Assuming 2001 was not unusual, this translates into billions of dollars of unpaid taxes each year because of noncompliant loss claims by sole proprietors. In addition to noncompliant losses, sole proprietors reporting losses also failed to report about $12 billion in net profits.[16]

[15] The confidence interval for the estimate of the percentage of losses that were noncompliant in 2001 is +/- 3.3 percent.

[16] The confidence interval for the estimate of the amount of profits sole proprietors with losses failed to report is +/- 10.8 percent.

Three examples from our NRP case file review illustrate how sole proprietors with a range of incomes used noncompliant losses and expenses to reduce the taxable income they reported on their tax returns.

- On a joint return, one taxpayer was employed and the other reported operating a sole proprietorship described as providing investment advisory services. The taxpayers had over $1 million of adjusted gross income (AGI) for 2001 with reported sole proprietorship losses over $25,000. In 2001, based on a statement from the taxpayer, the examination file noted that the sole proprietorship did not have a business purpose, and IRS disallowed the sole proprietorship loss.
- Another taxpayer's 2001 joint return reported over $50,000 of AGI and included a sole proprietorship loss from competitive athletics. This loss totaled over $5,000. The IRS examiner stated that the taxpayer provided no documentary support for the sole proprietorship receipts and expenses and found that the taxpayer's reported sole proprietorship activity was recreational and not engaged in for profit. IRS reclassified the sole proprietorship receipts as miscellaneous income and did not allow deduction of the undocumented expenses.
- Tax year 2001 was the taxpayer's first year in a construction-related business. The taxpayer had an AGI of over $4,000, which included wages from employment. The return reported no income tax liability after including a sole proprietorship loss of over $4,000. To examine the 2001 return, the IRS staff had to reconstruct the sole proprietorship records from bank account data because books and records were not available from the taxpayer. Based on the examination, the taxpayer owed over $10,000 of income tax. The tax liability following the examination included the recapture of over $1,000 of Earned Income Tax Credit (EITC) paid to the taxpayer because the postexamination AGI was above the $32,121 EITC earning limit in 2001.

IRS's Examination Program and AUR Are Able to Address Only a Small Portion of Sole Proprietor Expense Noncompliance

During fiscal year 2008, IRS used about 2.8 million staff hours to examine sole proprietor returns, about 23 percent of all revenue agent direct examination time.[17] However, even with this relatively large investment, IRS examined about only 1 percent of the estimated noncompliant population of sole proprietors.[18]

Most sole proprietor examinations are field examinations because, as our recent report found, sole proprietor issues are generally too complex to examine through IRS's lower-cost correspondence program.[19] IRS officials cited several reasons why field examinations are more appropriate than correspondence examinations for sole proprietors. Examination at the taxpayer's place of business, which is often also the taxpayer's residence, expedites the determination of whether unallowable personal expenses have been deducted on the sole proprietorship return. Examining sole proprietor expenses often involves complex auditing and legal issues, such as identifying which payments qualify as "ordinary and necessary," which requires the high skill levels of revenue agents (rather than those of the less skilled and less trained correspondence examiners) and interaction with the taxpayers to understand their books and records. As a practical matter, taxpayer records can be voluminous and are therefore best reviewed at the sole proprietor's place of business.

Sole proprietor examinations take longer to complete and have a lower average assessed tax per examination hour than examinations of other categories of taxpayers. For fiscal year 2008, examinations of sole proprietor returns took 40 percent more time to complete and yielded 43 percent fewer dollars per hour of examination time as compared to other small business income tax examinations.[20] Despite the relatively low

[17] For fiscal year 2008, IRS used 2.77 million revenue agent examination hours to examine sole proprietors. Based on revenue agents using 58 percent of their time for examinations (called direct time) with 10,080 revenue agents assigned to examinations rather than support functions, sole proprietors' examinations used 23 percent of direct revenue time.

[18] Of the 22.1 million sole proprietor returns filed for tax year 2006, as reported by SOI, 165,000 sole proprietor returns were examined in fiscal year 2008. Assuming that these returns were noncompliant at about the same rate as tax year 2001 sole proprietor returns (70 percent) examined in the 2001 NRP study and that 90.5 percent of the noncompliant sole proprietor returns were accurately selected (corresponding to the 9.5 percent no change rate in 2008), then about 1 percent of the noncompliant returns were examined.

[19] GAO-07-1014, 22.

[20] These rates are for all examinations within IRS's Small Business and Self-Employed Division, which examines, for example, sole proprietors, individuals with business or farm income, partnerships, and small corporations.

productivity, some sole proprietor examinations may be worth conducting because, as IRS officials told us, they strive for balanced coverage of the taxpayer population along with additional focus on taxpayer groups with high levels of noncompliance, regardless of the yields per hour. However, because most sole proprietors report small amounts of income, greatly increasing the number of examinations may not be cost-effective.

AUR Does Not Focus on Expense Compliance, and Expanding Coverage Faces Significant Obstacles

Little sole proprietor expense noncompliance is detectable from existing information returns. We estimated that at least 91 percent of such noncompliance is in expense categories not reported on information returns. Only one expense item, mortgage interest, is included in AUR. One major reason that little information reporting on sole proprietor expenses exists is because of the difficulty of identifying third-party payees upon whom a reporting requirement could be enforced without undue burden on both the third parties and IRS. For example, there is no third party who could verify the business use of cars or trucks by sole proprietors.

Furthermore, IRS officials have concerns about expanding use of information returns for expenses. AUR is designed to check, through computer matching, that amounts reported on information returns are transferred to the appropriate line of a tax return by taxpayers. Unless all of the business expenses on a given line were subject to information reporting, taxpayers could properly report more expenses than shown on information returns. In such cases, IRS's computers would show a mismatch. According to the IRS staff, resolving these mismatches could be considered a correspondence examination because IRS staff probably would need to examine a taxpayer's records to accept the expenses. However, this defeats the purpose of AUR (relying on computer matching to avoid costly examinations) and may prohibit IRS from completing additional reviews of the taxpayer's return.[21] The program is intended to provide automated, and therefore low-cost, compliance checks to avoid high-cost examinations of taxpayers' records.

[21] IRS is prohibited by law from completing more than one examination of any taxpayer during any tax year. Therefore, IRS may need to determine whether any additional issues on the return need to be examined before concluding the contact with reviewing sole proprietor expenses through the AUR program.

A Loss Limitation Rule and Collecting Data on Not-for-Profit Activities Could Help Address Expense Noncompliance, but a Limitation Rule Would Also Adversely Affect Compliant Taxpayers

A rule limiting taxpayers from deducting sole proprietor losses against other income would involve trade-offs. The primary benefit would be limiting the ability of taxpayers to use noncompliant sole proprietor losses to reduce the amount of tax they owe on their other income. Assuming the 2006 compliance rate is the same as the estimated 2001 compliance rate based on NRP data, an estimated $26 billion of reported sole proprietor losses in 2006 would have been noncompliant.[22] As a result, a rule limiting deductions for sole proprietor losses could have a significant impact on noncompliance, raise significant revenue from noncompliant losses, and correspondingly reduce the tax gap.

A rule limiting deductions for sole proprietor losses would also reduce IRS's costs. Because losses are clearly identified on the return, the rule could be administered as part of the returns filing process through the Math Error Program. This could enable IRS to immediately disallow deductions not allowed by the rule without having to resort to costly examinations.

However, disadvantages of a rule limiting sole proprietor loss deductions could be significant. Such a rule would reduce the fairness of the tax system by limiting loss deductions for compliant taxpayers. The extent would depend upon the specifics of how the rule is structured, as discussed below. The rule could also introduce economic distortions by (1) creating disincentives for starting or running a sole proprietorship[23] and (2) creating incentives to form other types of businesses, such as S corporations, where the tax treatment of some losses may be more beneficial.[24]

The Internal Revenue Code (I.R.C.) already contains limitation rules for many types of deductions. These rules are structured in several ways, including absolute ceilings, ceilings linked to AGI or other information from the return, and carrybacks and carryforwards that allow deductions

[22] As reported earlier, the NRP estimated that $15 billion of reported sole proprietor losses were noncompliant in 2001. We estimated the amount of noncompliant losses in 2006 assuming that the same percentage (53 percent) of dollars of sole proprietor losses reported in 2006 was noncompliant as in 2001.

[23] However, significant sole proprietor noncompliance has also created a distortion that encourages sole proprietor formation.

[24] Taxpayers are allowed to fully deduct allowable losses from S corporations against other income. See Internal Revenue Code § 1366.

over the limit to be carried back or forward to previous or future returns to be used as deductions. For example, only $3,000 of capital losses over the amount of capital gains may be deducted from income. In addition, losses from passive activity are normally deductible only against passive income.[25] The legislated limits have been enacted for a variety of compliance reasons, including preventing taxpayers from manipulating the timing of realizing gains and losses to reduce tax owed, in the case of the capital loss limitation, and addressing the prevalence of tax shelters, in the case of the passive income limitation.[26] Appendix II provides additional examples of loss limitations rules.

A rule limiting the deduction of sole proprietor losses could contain various mechanisms to mitigate some of the disadvantages. The possibilities include the following:

- **Targeting.** A rule could limit the ability to deduct sole proprietor losses deductions from other, non-sole proprietor income. This limit could either be an absolute amount (e.g., up to $3,000 from other income) or an amount determined by formula (e.g., filers may only deduct sole proprietor losses up to a certain percentage of their other income). Our analysis showed that targeting could improve the fairness of a loss limitation rule by better focusing the rule on noncompliance. For example, while 70 percent of sole proprietor returns with losses were estimated to be noncompliant, 82 percent of returns in 2001 that would have been affected by a $3,000 limit on sole proprietor loss deductions were noncompliant.[27] Further, while 53 percent of the dollars of sole proprietor losses in 2001 were noncompliant, 55 percent of the dollars that would have been affected by a $3,000 limit were noncompliant losses.[28]

[25] An exception to the passive activity rule is the case of passive rental activity wherein $25,000 in losses over the amount of passive rental income may be deducted. This $25,000 deduction limit is gradually reduced to zero dollars from AGI of $100,000 to $150,000. See I.R.C. § 469.

[26] Sole proprietorships that are noncompliantly offsetting other income are effectively tax shelters.

[27] The $3,000 ceiling is approximately the median Schedule C loss in 2001, according to NRP data.

[28] The confidence interval for the estimate of the percentage of losses that were noncompliant in 2001 is +/- 3.3 percent and the confidence interval for the estimate of the percentage of losses that would have been affected by a $3,000 limit in 2001 is +/- 4.3 percent.

- **Carry forward or back rule.** A carry forward or back rule would allow taxpayers reporting sole proprietor losses to offset sole proprietor income earned in other years. This would prevent taxpayers from deducting noncompliant losses against other income, but would allow sole proprietors with profits in other years to deduct their losses.

  A carry forward or back rule could mitigate both the risk to business formation and the inequities that can arise from the loss limitation. A significant proportion of sole proprietors who reported losses could avail themselves of a carry forward or back rule, but analysis of IRS data showed that these sole proprietors were not less likely to be noncompliant. An estimated 36 percent of sole proprietorships reporting losses on returns in 2001 would have been able to use their entire loss to offset either previous or future sole proprietor income, and another 10 percent would have been able to use part of their loss.[29]

- **Elective document review or examination.** A rule limiting sole proprietor loss deductions could include an option for sole proprietors to request an IRS review of documents provided by the taxpayer, either pre- or postfiling. For example, new sole proprietors could include their business plans and other evidence of their intent to make a profit. The IRS staff could review these documents in the relatively lower-cost compliance center environment. IRS does something similar in its Innocent Spouse program, which makes a complex determination regarding liability for a tax debt based on a document review, in most cases, in the compliance center environment. If IRS judges it to be helpful (for example, to ensure that documents are valid and supportable), this option could require the sole proprietor extend the statute of limitations for the returns filed with a sole proprietorship loss so that IRS would have more time to examine the taxpayer.[30]

  Elective reviews would create administrative costs for IRS and some compliance burden for taxpayers, but targeting might reduce the number

[29] This analysis assumes that these taxpayers had not filed before 1998 because we did not have data for years before 1998. Also, we assumed that the rule had been in effect since at least 1998, and the taxpayers had already offset as much income as possible from previous years' losses. Finally, we assumed that taxpayers would carry losses back to previous years if possible before carrying them forward.

[30] I.R.C. § 183(e) authorizes a taxpayer to elect a deferral of a determination of the profit motive. However, with the election the taxpayer agrees to extend the statute of limitations for the period of the deferral for up to 2 years after the due date of the return for the last year of the deferral period.

of reviews significantly. Assuming that only sole proprietors with compliant losses of $100 or more would apply for review and assuming that the compliance rate in 2006 is the same as in 2001, we estimated that there were 3 million sole proprietor returns with compliant losses of at least $100 in 2006.[31] Targeting the rule to those with losses above about $7,000 (the top 25 percent of loss filers by the size of filed loss in 2001) could reduce the number of affected returns for which taxpayers might apply for review to about 870,000. Targeting the rule further to only affect those who filed previous losses or exempting those who have gone through a recent review could further reduce the number of reviews. If taxpayers behave differently than our assumptions, the effectiveness and cost of the option would be different.

IRS Has Not Estimated the Extent of Noncompliance with Rules for Activities Not Engaged in for Profit

Neither the 2001 NRP study nor the ongoing NRP study, which started with tax year 2006 returns, collected data on examinations that resulted in additional assessed tax based on noncompliant losses from activities not engaged in for profit (hobby losses). As we noted in the Background section of this report, to be compliant losses must result from business activities with legitimate profit objectives. Without the data from NRP, IRS could not estimate the extent of noncompliance with activities not engaged in for profit in tax year 2001 and will not be able to do so for 2006. The ongoing tax year 2006-2008 NRP added a code for activities not engaged in for profit when the tax return was assigned to the examiner, indicating whether NRP managers thought the issue must be reviewed during the examination.[32] However, neither the 2001 study nor the ongoing study included a specific code in IRS's Report Generation Software (RGS) to identify whether the examinations found activities not engaged in for profit or whether an adjustment was made to the return because of noncompliance with the rules.[33] Without adding this code to RGS, IRS cannot use the NRP sample to estimate the extent of noncompliance with

[31] Forty-eight percent of taxpayers filing losses in 2001 were found to have at least $100 in compliant loss by the NRP examination, giving a population of about 2 million taxpayers in 2001 with compliant Schedule C losses of at least $100 in 2001. For the 2006 estimate, we assumed that the percentage of those filing Schedule C losses that have at least $100 in compliant losses remains stable over time.

[32] The process of identifying issues or return line items for examination is called classification. If an item is classified, the examiner must audit this issue and document the results of this work in the examination workpapers.

[33] RGS is used to prepare examination reports, propose adjustments, and complete examination closing documents. It also provides a taxpayer with a report on tax law and interest computation resulting from an examination.

the activities not engaged in for profit and the extent to which such improper losses contribute to noncompliant sole proprietor losses.

The same problem exists for IRS's regular examination program. The examination program, which also uses the RGS system, does not collect data on the how often issues related to activities not engaged in for profit were classified during examinations or how often those issues resulted in an adjustment to a return. A minimal RGS system update could include a specific code for activities not engaged in for profit classification and adjustment issues. More detailed revisions could include specific reasons why activities not engaged in for profit issues were examined or not examined, such as likely strength of the case or likely tax change when compared to additional examination costs. Without these data, IRS cannot monitor how often the current compliance program addresses activities not engaged in for profit and the connection to noncompliant sole proprietor losses, and will not have the data to improve its examination program.

Conclusions

The large number of relatively small sole proprietorships limits IRS's opportunity to ensure their compliance through its regular compliance programs. On the other hand, based on the NRP analysis from 2001, over half of losses reported by sole proprietorships are not valid losses, and those losses are often used to reduce the taxes owed on other income.

One alternative approach to avoid the obstacles faced by IRS's enforcement programs would be a rule limiting deduction of sole proprietor losses against other income. However, such a rule would treat all sole proprietors with losses, compliant and noncompliant, the same. In considering such a rule, policymakers would have to trade off reducing noncompliance against disallowing some legitimate losses. Because this is a policy judgment, we are not making a recommendation to implement such a rule.

Short of such a policy change, however, there are steps IRS could take that have the potential to help mitigate noncompliant sole proprietor losses. Our review of IRS case files suggests that a portion of noncompliant filers reporting sole proprietor losses that have been examined may have had their losses disallowed because of activities not engaged in for profit. However, because IRS does not estimate a compliance rate for activities not engaged in for profit or how often these provisions are applied in regular examinations, IRS lacks information that could be useful for

improving its enforcement approach and reducing the portion of the tax gap caused by sole proprietor noncompliant losses.

Recommendations for Executive Action

In order to better assess whether changes are needed in the way IRS administers activities not engaged in for profit provisions, we recommend that the Commissioner of Internal Revenue take steps to

- estimate the extent of activities not engaged in for profit noncompliance from its ongoing research programs and
- collect information on examinations of activities not engaged in for profit issues from the compliance program.

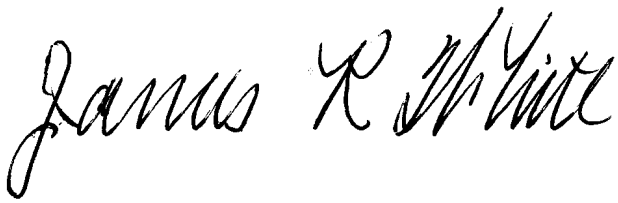
Agency Comments

In commenting on a draft of this report IRS agreed to implement both recommendations and stated that our report covers a timely and important topic because of the potential for increasing sole proprietor losses.

IRS's comment letter is reprinted in appendix III.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days after the report date. At that time, we will send copies to the Commissioner of Internal Revenue and other interested parties. This report also will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.



James R. White
Director, Tax Issues
Strategic Issues

Appendix I: Scope and Methodology

In conducting our work, we employed multiple methodologies, including analyzing data from the Internal Revenue Service's (IRS) National Research Program (NRP), Statistics of Income (SOI) samples, and Individual Master File (IMF); examining a sample of NRP case files; interviewing IRS officials, and reviewing related legislation, regulations, and guidance.[1]

For all of the analysis of NRP, SOI, and IMF data for this report, we analyzed the net profit or loss reported on line 12 of Form 1040. This line contains the sum of all sole proprietor income reported on line 31 of any Schedule C attached to the return. Because line 12 of Form 1040 is a sum of sole proprietorship income from potentially several sole proprietorships, individual sole proprietorships could have had losses while the net sole proprietorship income that we analyzed was positive, if the other sole proprietorships on the return had profits. We did not analyze data from Schedule F, Profit and Loss from Farming, or from corporate taxpayers electing treatment as small business corporations under Subchapter S.

For estimates based on samples of taxpayers in this report, we are 95 percent confident that the estimates are within 10 percent of the population values for dollar amount and counts and 3 percent of population values for percentages, unless otherwise noted.

SOI Data

We used IRS SOI data to describe the population of sole proprietors and construct a panel of sole proprietors to analyze their reporting of profits and losses over a 9-year period from 1998 through 2006. To describe the population of sole proprietors, including those who file losses, we analyzed tax return data from SOI's stratified random sample of 320,987 individuals, including 81,588 sole proprietors, for tax year 2006—the most recent data available. In the data analysis in this report, the term sole proprietor refers to a taxpayer who files a 1040 return with one or more Schedule C forms attached regardless of the filing status of the taxpayer. Therefore, for example, a joint return with two Schedules C forms attached is considered a single sole proprietor.

[1] IMF is IRS's authoritative data source for individual tax account data, including assessed tax liabilities, refunds sent, and tax payments due.

To examine sole proprietors' profits and losses over time, we created two panel data sets based on tax return data from SOI's tax years 2006 and 2001 stratified random samples of taxpayers. The panels followed tax returns with one or more Schedule C forms attached as the unit of analysis. Because the SOI data are a random sample, returns that appear in the 2006 or 2001 sample may not appear in the samples taken in other years. Therefore, to construct the panel, we matched the returns in the 2006 and 2001 samples with the same taxpayers' returns in other years as stored in another IRS database. Specifically, we obtained tax return data from 1998 through 2006 from IMF, a copy of which is stored in IRS's Compliance Data Warehouse (CDW) for access and analysis for research purposes. We matched data from IMF to the data from SOI by taxpayer identification number (TIN) and were able to obtain matching data in the base year from IMF for 99.9 percent of the individuals in the SOI 2006 sample and 99.9 percent of the individuals in the SOI 2001 sample.

Because the filing unit can change over time because of marriage or divorce, an accurate population estimate cannot be calculated for those tax returns. Therefore, we excluded from analysis those tax returns that had a change in marital status from 1998 through 2006. This is a common method for analyzing taxpayer data over time, which conforms to SOI's practice. For the 2006 panel, 20.4 percent of the returns included in the 2006 SOI stratified random sample and 20.9 percent of the estimated net sole proprietorship income was excluded because of a change in marital status from 1998 through 2006. For the 2001 panel, 17.9 percent of returns in the 2001 SOI sample and 16.3 percent of the estimated net sole proprietorship income was excluded.

Based on several analyses of the data, we concluded that the panels sufficiently represent the population of sole proprietors. To assess how representative the panel is, we compared filing status and average Schedule C income as computed from the panel and from the SOI sample for both 2001 and 2006. Regarding filing status, we found similar percentages in the panel and sample data of taxpayers reporting the same status. Approximately 54 percent of returns in the 2006 panel had joint filers, while approximately 60 percent of returns in the 2006 SOI sample had both a primary and secondary taxpayer. Similarly, approximately 63 percent of returns in the 2001 panel had joint filers, while approximately 64 percent of returns in the 2001 SOI sample had joint filers. We also found very similar average income amounts. For 2006, the average estimated Schedule C income in the panel is $13,000 compared to $12,800 in the sample, and for 2001, the average estimated Schedule C income in the panel is $12,200 compared to $11,800 in the sample.

As a final test, we compared adjusted gross income amounts (AGI), return by return, for the years for which we had data for sole proprietorship returns from both SOI and IMF (2001 and 2006). Again, the results supported the accuracy of our panel data. Ninety-eight percent of the returns had AGI that matched within $100 between the two data sets, and 99 percent of the returns data sets had total Schedule C income that matched within $100 between the two data sets. For analyses that required data from multiple years, we used the IMF data from each year for consistency.

NRP Data

To assess sole proprietor compliance, we used data from IRS's compliance research program (NRP). We used these data to profile the compliance of Schedule C taxpayers, assess the relationship between sole proprietor compliance and filing history, assess qualitative information on sole proprietor compliance, and analyze options for a loss limitation targeting rules. The 2001 NRP study was a detailed review and examination of a representative sample of 44,768 individual tax returns from tax year 2001, 20,868 of which reported sole proprietorship income. Unless otherwise noted, we define a taxpayer as noncompliant if the NRP examination revealed that the taxpayer underreported income by $100 or more.

To assess the relationship between sole proprietor compliance and filing history, we created a panel data set based on NRP data. The panel followed tax returns with one or more Schedule C forms attached as the unit of analysis. For the sole proprietor returns in the NRP sample, we obtained tax return data from 1998 through 2006 from IMF in CDW. We matched data from IMF to the data from NRP by TIN, and were able to obtain matching data from IMF for 99.9 percent of the individuals in the NRP 2001 sample. Using the same methodology that we used for the SOI panels, we excluded from analysis those tax returns that indicated a change in marital status from 1998 through 2006. For the NRP panel, 11.8 percent of the returns included in the 2001 NRP sample and 10.2 percent of the estimated net sole proprietorship income was excluded because of a change in marital status from 1998 through 2006. Comparing the differences in estimates between the returns included in the panel and those in the NRP sample, approximately 60 percent of returns in the panel had both a primary and secondary taxpayer, while approximately 65 percent of returns in the NRP sample had joint filers. The average estimated Schedule C income in the panel is about $12,800 compared to the NRP sample estimate of about $12,600.

For 2001, the year for which we had data for individuals from both NRP and IMF, 97 percent of the returns had AGI that matched within $100 between the two data sets, and 99 percent of the returns had total Schedule C income that matched within $100 between the two data sets. For analyses that used data from multiple years, we used the IMF data from each year for consistency.

To provide qualitative information on sole proprietors filing losses and assess how not-for-profit activity issues are considered during exams, we reviewed a sample of NRP examination case files with Schedule C losses. We selected a sample of NRP cases for review that while not intended to allow us to make generalizations to the entire population of sole proprietors, did include sole proprietors of various AGI and Schedule C income levels and both compliant and noncompliant returns. Some cases were selected based on the dollar amount of the Schedule C noncompliance, and some were randomly selected. We requested a total of 234 cases and reviewed 49 cases, ensuring that the cases reviewed represented a range of cases from all income levels.

To determine whether targeting a rule limiting Schedule C loss deductions to a subset of the population could increase the percentage of affected filers and dollars that would be noncompliant, we analyzed items on the return that would be available to the Math Error Program and that could reasonably be used to identify noncompliant returns.

IMF Data

To assess the reliability of IMF data, we reviewed the steps IRS took to create a data set at our request, assessed IRS's use of IMF data, and compared the data to NRP and SOI data to ensure consistency. Based on these steps, we determined that the data were sufficiently reliable for our review.

While we were compiling the three panels of IMF data (the panel based on 2006 SOI data, the panel based on 2001 SOI data, and the panel based on NRP data), an IRS official notified us that about 2,000 returns, all from either 1998 or 1999, which were less than 1 percent of the returns requested, could not be provided from the copy of IMF in CDW because the source data for those returns had been lost. We determined that the unavailable data would not materially affect our findings.

IRS's Enforcement Programs

We used several data sources to analyze the extent to which IRS's enforcement programs address the types of sole proprietor noncompliance found by IRS's most recent research. We reviewed instructions for filing sole proprietor returns, regulations for activities not engaged in for profit, as well as examination program procedures. We analyzed program results data collected from the Automated Underreporter Program (AUR) and data on examination results. The exam data were extracted from IRS's Examination Operational Automation Database. We also interviewed IRS staff on the operations and results of AUR and the correspondence, office, and field examination programs. We reviewed examination plans and *Internal Revenue Manual* procedures and other instructions to IRS staff describing program procedures.

For our previous report on sole proprietors, we used tax gap, NRP, SOI, AUR, and examination data. We determined that the data were sufficiently reliable for our review based on assessments done for those and previous reports, the fact that many of these sources are public and widely used, and additional testing we did to ensure that we were properly interpreting individual data elements.

Our work was completed in accordance with generally accepted government auditing standards from July 2008 through September 2009 at IRS Headquarters in Washington, D.C.

Appendix II: Examples of Current Income Tax Loss Limitation Rules for Individual Taxpayers

The general standard for measuring income is to recognize all sources of gross income less expenses and losses as they occur. Taxable income is computed following this basic principle with some exceptions. In general, gross income from all sources is included when computing taxable income, with some exclusions, such as gifts, inheritances, and some death benefits. Deductions are typically allowed only for expenses related to activities intended to produce income, such as those related to a trade or business, or nonbusiness investment expenses, though some personal expenses can also be deducted to a limited extent.[1]

When expenses exceed income, the resulting loss can be disallowed, limited to a certain amount, or deferred to other tax years. Losses have been limited for several reasons, including preventing tax avoidance, reducing noncompliance, restricting deductibility of losses against other sources of income to reduce tax shelters, and disallowing personal expenses or losses that are not related to the production of income (such as activities not engaged in for profit or the loss of value on the disposition of personal property, including residences).

Several current tax rules limit losses to increase equity and reduce tax shelters and noncompliance. In 1969, the activities not engaged in for profit provisions were enacted, in part, because of the perception that individuals invested in certain aspects of farm operations solely to obtain losses to reduce their tax on other income.[2] Before 1986, taxpayers could realize losses in excess of their actual amounts at risk, typically through limited partnerships, and deduct those losses from other sources of income.[3] The Tax Reform Act of 1986 included several provisions to limit transactions that reduced income. Examples include the following:

- **Tax shelters.** Passive activity losses were limited to prevent taxpayers from using losses from real estate and other investments in which they had minimal participation to offset other sources of income, such as wages,

[1] Some personal expenses can be deducted if the taxpayer itemizes deductions, such as charitable contributions, mortgage interest, or medical expenses. These deductions may have a minimum allowed amount (such as amounts greater than 7.5 percent of a taxpayer's AGI for medical expenses), or a maximum amount (such as charitable contributions in excess of 20 percent, 30 percent, or 50 percent of AGI, depending on the type of contribution), or they may be reduced or disallowed for taxpayers with higher incomes.

[2] S. Rep. No. 552, 91st Cong. 1st Sess., 103 (1969), *U.S. Code Cong. & Admin. News 1969, 1969-3C.B. 635*.

[3] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

salaries, and capital gains. Similarly, at-risk rules were enacted to limit losses to the actual amount of money invested because of the prevalence of tax sheltering.

- **Limitations on interest.** Another example is limiting the deduction of investment interest to the amount of investment income to prevent "taxpayers from sheltering or reducing tax on other, non-investment income by means of the unrelated interest deduction."[4] Personal interest was disallowed as a deduction because it enabled taxpayers to avoid taxes by purchasing consumables rather than purchasing assets that produce taxable income.
- **Capital losses.** Limitations on capital losses were implemented to reduce the reward for timing loss and gain transactions to avoid paying taxes. Taxpayers can control when they realize a gain or a loss, thereby minimizing tax liabilities. The limitations on deducting capital losses are different for corporate and noncorporate taxpayers. For noncorporate taxpayers, capital losses can be carried forward indefinitely, but corporate taxpayers are limited to a 3-year carryback and 5-year carryforward, with some exceptions. For corporations, capital losses can only be allowed up to the amount of capital gains, and individuals are allowed an additional $3,000 loss above the amount of capital gains.

In some cases, taxpayers have losses that exceed their gross income, resulting in a negative income flow or a net operating loss. When this occurs, taxpayers do not owe income tax for that year and can deduct the net operating loss against taxable income by carrying the losses back or forward to profitable years in which they paid taxes or would owe taxes. These deductions allow taxpayers to smooth out business income and taxes over business cycles. Some taxpayers would attempt to avoid paying taxes by purchasing stock or assets of a business that had incurred a net operating loss and using the carryover loss to offset expected future profits. To reduce such tax avoidance, Congress enacted legislation that limited corporations from deducting net operating losses when there is a change in ownership.

Table 2 summarizes examples of common loss limitation rules.

[4] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (Washington, D.C., May 4, 1987), 263.

Table 2: Selected Examples of Loss Limitation Rules for Individuals

Loss	Loss limitation rule
Net operating loss	Limited to extent of taxable income. Can be carried back 2 years or forward 20 years with other carryback periods allowed for eligible losses, such as from casualty, theft, disaster, or farming. There also are rules for limiting what can be deducted for figuring a net operating loss. Items such as personal exemptions, capital gains, and nonbusiness deductions may be adjusted when figuring a net operating loss.
Capital loss	Limited to extent of capital gains plus $3,000, which can be carried forward indefinitely.
Personal expenses	Some are disallowed (e.g., personal interest, primary residence sales, living expenses) while some are limited (e.g., personal property taxes, medical expenses, charitable donations).
Passive activity losses and credits	Generally limited to extent of passive activity income. Exceptions include a phaseout of the limitation if the taxpayer actively participates in the passive rental income and has AGI from $100,000 to $150,000. Also, there is an exemption for real estate professionals who materially participate in the activity.
Gambling	Limited to extent of gambling gains. Cannot be carried forward or back to other tax years.
Not-for-profit activity	Losses cannot be offset against other income if the activity is not engaged in for profit. Additionally, the not-for-profit activity rules presume that the activity is engaged in for profit if it has produced a profit in at least 3 of the last 5 years or for some activities 2 of the last 7 years.

Source: GAO analysis.

Appendix III: Comments from the Internal Revenue Service

DEPUTY COMMISSIONER

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

September 4, 2009

Mr. James R. White
Director, Tax Issues
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. White:

Thank you for the opportunity to review your draft report entitled "Tax Gap: Limiting Sole Proprietors Loss Deductions Could Improve Compliance, but Would Also Limit Some Legitimate Losses (GAO-09-815)." This is a timely and important topic due to the current economic environment, which we expect will increase sole proprietor losses.

We agree that addressing noncompliance among sole proprietors is important because they are responsible for a large portion of the tax gap. As the report acknowledges, we have compliance programs to ensure that sole proprietors are properly reporting expenses.

We concur with both of your recommendations and we expect they will help strengthen our existing programs. We will conduct research to determine the percentage of sole proprietor returns in the total population which report activities not engaged in for profit and quantify the extent of the noncompliance among those returns. We will also capture and analyze similar information from our on-going compliance programs.

A detailed response to your specific recommendations is attached. We appreciate the continued and valuable support from you and your staff on this issue. If you have any questions, or would like to discuss this response in more detail, please contact Christopher Wagner, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

Linda E. Stiff

Enclosure

Enclosure

GAO Recommendations and IRS Responses to
GAO Draft Report
Tax Gap: Limiting Sole Proprietors Loss Deductions Could Improve Compliance, but Would Also Limit Some Legitimate Losses

Recommendation 1
In order to better assess whether changes are needed in the way IRS administers activities not engaged in for profit provisions, we recommend that the Commissioner of the IRS take steps to estimate the extent of activities not engaged in for profit noncompliance from its ongoing research programs.

Comment
IRS Research, Analysis and Statistics and Small Business/Self-Employed Research will conduct research to determine the percentage of sole proprietor returns in the total population which report activities not engaged in for profit and use National Research Program data to quantify the extent of the noncompliance among those returns.

Recommendation 2
In order to better assess whether changes are needed in the way IRS administers activities not engaged in for profit provisions, we recommend that the Commissioner of the IRS take steps to collect information on examinations involving activities not engaged in for profit issues from the compliance program.

Comment
Small Business/Self-Employed Examination will make recommendations on modifying the Report Generation Software to add new reason codes allowing for additional data from all regular income tax examinations to be captured and subsequently analyzed.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

James R. White, (202) 512-9110 or whitej@gao.gov

Acknowledgments

In addition to the contact named above, Kevin Daly, Assistant Director; Michele Fejfar, Leon Green, Shirley Jones, Edward Nannenhorn, Karen O'Conor, Erin Saunders-Rath, Sabrina Streagle, and Ethan Wozniak made key contributions to this report.

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