Highlights of GAO-09-815, a 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

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.
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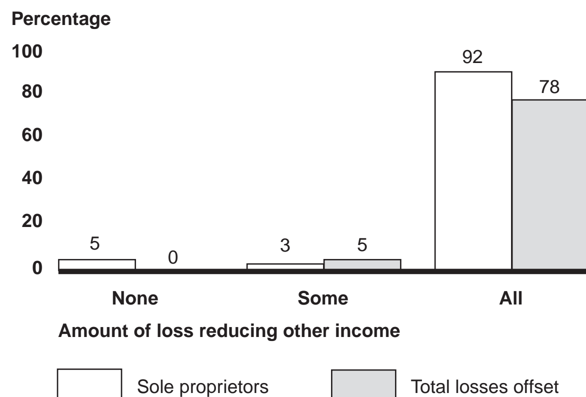
What GAO Found

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.