

February 1999

**TAX  
ADMINISTRATION**

**Billions in Self-  
Employment Taxes  
Are Owed**



---

---



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

---

General Government Division

B-276940

February 19, 1999

The Honorable Amo Houghton  
Chairman, Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

Dear Mr. Chairman:

This report responds to the Subcommittee's request that we (1) determine the number and characteristics of self-employed taxpayers who receive social security credit for self-employment earnings when they are delinquent in paying the self-employment taxes on those earnings; (2) determine why self-employed taxpayers who have not paid their self-employment taxes are allowed to receive social security credit; and (3) identify any potential actions that could enhance the collection of self-employment taxes. It makes recommendations to the Internal Revenue Service and the Social Security Administration to enhance the administration and collection of self-employment taxes.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies of this report to the former Chair and the Ranking Minority Member of your Committee, the Chairman and Ranking Minority Member of the Senate Finance Committee, other interested Committees and Members, the Secretary of the Treasury, the Commissioner of Internal Revenue, and the Commissioner of Social Security. Copies will also be available to others on request.

Major contributors to this report are listed in appendix V. If you have any questions, please call me on (202) 512-9110.

Sincerely yours,  
James R. White  
Director, Tax Policy and  
Administration Issues

---

# Executive Summary

---

## Purpose

Internal Revenue Service (IRS) data show that the compliance rate for paying Social Security and Medicare taxes is over two times higher for wage-earners and their employers than for self-employed workers. Furthermore, regardless of whether they pay their self-employment taxes, most self-employed individuals can receive Social Security credit for their earnings.

Because of the high self-employment tax noncompliance rate, the Subcommittee on Oversight, House Committee on Ways and Means, asked GAO to (1) determine the number and characteristics of self-employed taxpayers who receive Social Security credit for self-employment earnings when they are delinquent in paying the self-employment taxes on those earnings, (2) determine why self-employed taxpayers who have not paid their self-employment taxes are allowed to receive Social Security credit, and (3) identify any potential actions that could enhance the collection of self-employment taxes.

---

## Background

The Social Security program is based on the concept that when individuals work, they pay taxes into the program based on their earnings, and when they retire, become disabled, or die, they or their spouse and qualified dependents may receive monthly benefits that are based on those earnings. The program was designed to be self-financing from taxes levied on employees' wages and the net earnings of self-employed individuals, plus interest earned on the investment of trust fund balances in government securities.

According to IRS, a key reason for the compliance rate difference between wage-earners and the self-employed is in how the Social Security and Medicare taxes are computed and paid. Employers are required to withhold these taxes from employees' wages, remit withholdings to IRS at least quarterly, and report each employee's earnings to the Social Security Administration (SSA) annually. In 1998, wage-earners and their employers each were required to pay 7.65 percent (a total of 15.3 percent) of an employee's gross salary, up to \$68,400. Self-employed taxpayers, however, were required to pay the entire 15.3 percent on net earnings from self-employment if their net earnings were more than \$400 for the year, and they were generally required to remit self-employment taxes directly to IRS each quarter. From information reported on annual tax returns, IRS submits self-employed taxpayers' earnings data to SSA, which posts them to its taxpayers' accounts up to the earnings limit. This earnings information is used by SSA to determine if an individual is eligible for Social Security benefits and the amount of such benefits.

---

GAO's analysis of self-employment tax delinquencies is based on IRS records of taxpayers who, as of September 27, 1997, owed self-employment taxes for one or more tax years. GAO identified self-employed taxpayers with delinquent self-employment tax by assuming that partial payments made by taxpayers were first applied against self-employment taxes and any remaining payments were then applied to income and other taxes shown on their returns. Thus, if the partial payments were sufficient to cover the self-employment tax liability, these taxpayers were not included in GAO's estimates. While the self-employment tax delinquencies included both Social Security and Medicare taxes, GAO did not examine the number of self-employed delinquent taxpayers who were receiving Medicare benefits. Also, GAO was not able to deduct the Medicare taxes from the total self-employment taxes because the IRS accounts receivable data GAO used did not separately list Social Security and Medicare taxes.

For all sample results, GAO calculated sampling errors and presents them as 95-percent confidence intervals around each sample estimate.

---

## Results in Brief

Analysis of IRS' accounts receivable data as of September 27, 1997, showed that more than 1.9 million self-employed taxpayers were delinquent in paying \$6.9 billion in self-employment taxes on 3.6 million returns. These taxpayers can be generally characterized by their low income and multiple delinquencies. Over 70 percent of their returns reported net self-employment income of less than \$20,000, and over half of the taxpayers owed delinquent taxes for more than one tax year. Also, more than 144,000 taxpayers with delinquent self-employment taxes of \$487 million were receiving about \$105 million in monthly Social Security benefits. The income on which the self-employment taxes had not been paid resulted in at least an estimated \$2.5 million (the 95-percent confidence interval ranged from \$2.5 million to \$9.9 million) in monthly benefits that would not have been paid if those earnings had not been included in the benefit computation.

Self-employed taxpayers can get Social Security benefits based on earnings for which they did not pay taxes because the Social Security Act requires SSA to grant earnings credits, which are used to determine benefit eligibility and amounts, and pay benefits without regard to whether the Social Security taxes have been paid. However, not all self-employed taxpayers can receive credit for their earnings. Under the Social Security Act, when taxpayers do not file their tax returns within 3 years, 3 months, and 15 days after the end of the year in which the income was earned, they are not to receive Social Security credit. Of the 3.6 million returns with delinquent self-employment tax, SSA did not post earnings to its records

---

for 473,755 returns. For an estimated 81.9 percent (plus or minus 6.5 percent) of the returns with unposted earnings, taxpayers filed the returns after the statutory time limit. Many of the taxpayers may not have been aware of the statutory time limit because neither SSA's nor IRS' widely available publications discuss it.

There are several potential ways to enhance the collection of taxes from self-employed individuals. IRS has recently been given the option to continuously levy taxpayers' Social Security benefits and other federal payments to recover delinquent taxes and is in the process of developing a program to do so. This levy program would affect taxpayers that are already delinquent in paying their taxes and should reduce their tax debt. With regard to collecting taxes before taxpayers become delinquent, proposals have been made by the Department of the Treasury and others to require withholding on business payments to certain self-employed individuals, such as independent contractors, which could help reduce self-employment tax delinquencies. However, Congress has not acted on these proposals because of the administrative burden they would place on those businesses that would have to withhold taxes.

Another way to collect taxes before taxpayers become delinquent would be to encourage more self-employed individuals to make their required estimated tax payments. GAO estimated that most self-employed delinquent taxpayers did not make required estimated tax payments, and many were assessed an estimated tax penalty. Taxpayers could be encouraged to make estimated tax payments if IRS had a program to remind previously noncompliant taxpayers to make such payments.

---

## Principal Findings

---

### Number and Characteristics of Delinquent Self-Employed Taxpayers

After applying all payments taxpayers made to their self-employment tax liability, GAO found, as of September 27, 1997, more than 1.9 million taxpayers involving 3.6 million returns still owed more than \$20.5 billion in total tax. Included in that amount were \$6.9 billion in delinquent self-employment taxes, or an average of \$1,917 per return. The tax years involved in these delinquencies ranged from 1963 to 1996. However, about three-fourths of the 3.6 million returns were from tax years 1990 to 1996. The average self-employment income per return was over \$16,000, and over 70 percent of the returns showed self-employment income of less than \$20,000. For 51 percent of the 3.6 million tax returns involving about \$3.3 billion in delinquent self-employment tax, the taxpayers filed the

---

required returns and self-assessed their taxes. For the remaining 49 percent, tax assessments were made as a result of one of IRS' compliance programs. Also, even though IRS was in the process of taking some sort of collection action on the majority of the delinquencies, IRS said there was no guarantee that it would collect those taxes.

GAO's analysis of IRS and SSA records showed that as of April 21, 1998, 144,473 of the 1.9 million taxpayers delinquent in paying their self-employment tax were receiving monthly Social Security retirement or disability benefits. These taxpayers owed \$487 million in self-employment tax and were receiving \$105 million a month in benefits, or an average of \$727 per taxpayer per month. At GAO's request, SSA recalculated the Social Security benefits for a representative sample of these taxpayers by excluding from the benefit computation those earnings on which the self-employment taxes had not been paid. On the basis of SSA's recalculations, GAO estimates that the benefit amount would be reduced by at least \$2.5 million (the 95-percent confidence interval ranged from \$2.5 million to \$9.9 million) monthly, or \$30 million annually (the 95-percent confidence interval ranged from \$30 million to \$118.8 million). The average monthly benefit payment would be reduced by about \$43 per taxpayer.

---

### The Social Security Act Requires That Coverage Be Based on Self-Employment Earnings, Not Taxes Paid, But There Is an Exception

The Social Security Act requires SSA to grant credits for coverage and pay benefits without regard to whether the taxes have been paid. There were congressional proposals in the past to make credits for self-employment earnings conditional upon the payment of the tax because of the perception that the current policy undermines the compulsory contribution principle of the Social Security program and that it is unfair to others who pay their taxes. However, Congress took no action on those proposals.

Making self-employment earnings credits conditional on the payment of the tax would reduce the total amount of Social Security benefit payments. For the 144,473 self-employed delinquent taxpayers collecting Social Security benefits as of April 21, 1998, the benefit payments would be reduced by at least \$30 million per year, or about 2 percent of the \$1.3 billion in annual benefit payments paid to them.

Under current law IRS cannot administratively allocate taxpayers' tax payments among self-employment tax and other income taxes reported on returns. Thus, if Congress made the posting of earnings conditional on the payment of taxes, it would have to specify how IRS should allocate taxpayer payments among self-employment taxes and other income taxes. Whatever allocation formula was mandated would require IRS to develop a

---

system to track payments by type of tax and send SSA information on the self-employment tax payments made. SSA would also have to establish procedures for tracking and posting the information received from IRS. It was beyond the scope of GAO's review to evaluate the effects of making Social Security credit for earnings conditional on the payment of self-employment taxes on the Social Security program or the tax system.

Not all taxpayers can get Social Security credit for their earnings. Under the Social Security Act, to get Social Security credit, self-employed taxpayers must file their income tax returns within 3 years, 3 months, and 15 days after the end of the calendar year in which the income was earned. About \$9.6 billion of the \$60 billion in self-employment income reported on 473,755 returns, did not get posted to SSA's records for the delinquent taxpayers in GAO's population. In an estimated 81.9 percent (plus or minus 6.5 percent) of those returns, the earnings were not posted because the taxpayer filed after the statutory time limit. In an estimated 11.3 percent (plus or minus 4.9 percent) of these returns, the taxpayers were making payments to clear their tax debt. Many of these taxpayers may not have known that they would not receive credit for their self-employment earnings because SSA's and IRS' widely available publications for the self-employed made no mention of the time limit. GAO also found that when IRS contacts taxpayers under its Non-Filer Program, it does not inform taxpayers about the time limit for filing returns in order to get Social Security credit.

---

### Potential Actions to Reduce Self-Employment Tax Delinquencies

The Taxpayer Relief Act of 1997 gave IRS the option of using a new type of levy that would continuously levy up to 15 percent of federal payments (including Social Security benefits) made to delinquent taxpayers until the tax debt is paid in full. With this authority, IRS plans to give the Department of the Treasury's Financial Management Service, which is to be responsible for levying payments, information on the delinquent accounts to be levied. IRS and the Financial Management Service expect the levy program to be operational by July 2000. IRS does not plan to levy against all the delinquent taxpayers. For example, IRS does not plan to levy Social Security benefits for those taxpayers whose accounts are classified as currently-not-collectible because of hardship or those who have installment agreements in effect. Applying IRS' levy criteria, GAO found that IRS would levy about 41,000 of the 144,473 taxpayers who, as of April 21, 1998, were receiving Social Security benefits and who were delinquent in paying about \$108 million in self-employment tax.

In general, self-employed taxpayers are less likely to file their returns and report their earnings than wage-earners, who are subject to withholding.



---

Thus, it seems likely that withholding on business payments to certain self-employed individuals, such as independent contractors, could reduce the amount and number of self-employment tax delinquencies. As far back as 1979, Treasury proposed mandatory withholding on business payments to independent contractors, but Congress did not act on the proposal because of the costs and burdens on the businesses that would have to withhold. In 1992, GAO proposed withholding on payments made by businesses to independent contractors, and in 1995, a panel of former senior Treasury and IRS officials presented several options for increasing the compliance of self-employed taxpayers, including withholding on business payments to independent contractors. GAO categorized 1.1 million delinquent self-employed taxpayers by business activity and found that 40 percent could be subject to such withholding as independent contractors under the various proposals. Any provision to withhold on payments made by businesses to the self-employed would increase the burden on both the self-employed and the businesses making the payments.

Taxpayers not subject to withholding are generally required to make quarterly estimated tax payments. However, GAO found that most delinquent self-employed taxpayers did not make these required payments. GAO estimated that the taxpayers for 2.5 million (plus or minus 200,000 returns) of the 3.6 million returns with delinquent self-employment taxes should have made estimated payments, but in an estimated 2.3 million returns (plus or minus 200,000 returns), the taxpayers failed to make these required payments.

In 1991, IRS initiated a reminder notice program to get more taxpayers to make required estimated payments. IRS sent reminder notices to all taxpayers who were compliant in making estimated payments during the previous year but had not made any in the current year. However, IRS stopped sending the notices because taxpayer response to them was negative. The taxpayers considered the notices intrusive because they believed IRS was making assumptions based on the previous year that might not apply to the current year. IRS had no data to show whether the reminder notices increased the estimated tax payment compliance of individuals who received notices. Taxpayers would have less cause for concern if the notices were sent only to taxpayers who were not compliant in making estimated tax payments during the previous year—that is, to those who (1) in the current year had not made an estimated tax payment and (2) in the previous year owed self-employment taxes and were assessed an estimated tax penalty. GAO estimated that about 1.2 million of the 2.5 million returns (plus or minus 200,000 returns) where estimated payments were required met these criteria.

---

## Recommendations

To enhance the administration and collection of self-employment taxes, GAO is making two recommendations to the Commissioner of Internal Revenue and one recommendation to the Commissioner of Social Security. GAO recommends that

- the Commissioner of Internal Revenue revise IRS' self-employment publications, including those given under its Non-Filer Program, to ensure that self-employed taxpayers know about the need to file tax returns with self-employment earnings within the statutory time frame;
- the Commissioner of Internal Revenue undertake a pilot project to test the feasibility of sending notices to noncompliant self-employed taxpayers; and
- the Commissioner of Social Security revise SSA's publications dealing with self-employed individuals to inform them about the need to file tax returns with self-employment earnings within the statutory time frame.

---

## Agency Comments

In written comments on a draft of this report, both the Commissioner of Internal Revenue and the Commissioner of Social Security agreed to implement the recommendations. Their written comments, discussed in chapters 3 and 4, set forth the agencies' specific strategies for implementing the recommendations. In addition, both IRS and SSA included technical comments that GAO incorporated throughout the report as appropriate.

---

---

---

# Contents

---

<b>Executive Summary</b>		2
<b>Chapter 1</b>		14
<b>Introduction</b>	Background	14
	Objectives, Scope, and Methodology	17
<b>Chapter 2</b>		21
<b>Self-Employed Delinquent Taxpayers Owe Billions in Self-Employment Taxes</b>	Number and Characteristics of Self-Employed Delinquent Taxpayers	21
	Some Self-Employed Delinquent Taxpayers Are Receiving Social Security Benefits	25
	Conclusions	26
<b>Chapter 3</b>		27
<b>Taxpayers Receive Social Security Credit When Taxes Are Not Paid, With One Exception</b>	The Social Security Act Requires Credits for Social Security Coverage to Be Based on SE Earnings, Not SE Taxes Paid	27
	Self-Employment Earnings Do Not Get Posted When Returns Are Filed After a Certain Date	28
	Conclusions	30
	Recommendation to the Commissioner of Internal Revenue	31
	Recommendation to the Commissioner of Social Security	31
	Agency Comments	31
<b>Chapter 4</b>		33
<b>Potential Ways to Reduce Self-Employment Tax Delinquencies</b>	Levying Social Security Benefit Payments	33
	Withholding on Payments Made by Businesses to Self-Employed Taxpayers	34
	Reminding Delinquent Self-Employed Taxpayers to Make Estimated Tax Payments	36
	Conclusions	36
	Recommendation to the Commissioner of Internal Revenue	37
	Agency Comments	37
<b>Appendixes</b>		
	Appendix I: Sampling and Data Analysis Methodology	40
	Appendix II: Additional Characteristics of Delinquent Self-Employed Taxpayers	42

---

Appendix III: Comments From the Internal Revenue Service	45
Appendix IV: Comments From the Social Security Administration	47
Appendix V: Major Contributors to This Report	50

---

**Tables**

Table 2.1: Returns With Delinquent SE Tax by Taxpayer and Amount of SE Tax Owed	22
Table 2.2: Returns With Delinquent SE Tax and the Amount of SE Tax Owed by Tax Year	22
Table 2.3: Returns and Amount of Delinquent SE Tax by Self-Employment Income	23
Table 2.4: Collection Status of Returns and the Amount of Delinquent SE Tax	24
Table 2.5: Returns and Delinquent SE Tax by Years in Accounts Receivable Inventory	24
Table 2.6: Monthly SSA Benefits Retained by Taxpayers After Benefit Amount Recalculation	25
Table II.1: Reasons IRS Categorized SE Returns With Balance Due as Currently-not-Collectible	42
Table II.2: Collection Status of Returns for Which Delinquent Taxpayers Were Receiving Social Security Benefits	43
Table II.3: Delinquent SE Taxes Assessed Through IRS Compliance Programs	43
Table II.4: Age of Delinquent Taxpayers Currently Collecting Social Security Benefits and Delinquent SE Tax	44
Table II.5: Age of Delinquent Taxpayers Not Yet Receiving Social Security Benefits and Delinquent SE Tax	44

---

**Contents**

---

---

**Abbreviations**

FMS	Financial Management Service
IRS	Internal Revenue Service
SE	Self-employment
SSA	Social Security Administration

---

---

# Introduction

---

Self-employed workers have to pay Social Security and Medicare taxes, which are called self-employment (SE) taxes, when their net earnings from self-employment exceed \$400 in a tax year. The collection of these SE taxes has long been a problem. The Internal Revenue Service (IRS) estimated that the noncompliance rate for the amount of these SE taxes that were owed but not paid voluntarily and timely has been over 50 percent since 1984. Since 1951, self-employed taxpayers have been covered by Social Security, and they can receive Social Security credit for their earnings regardless of whether their SE taxes are paid.

This report responds to a request from the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, that we (1) determine the number and characteristics of self-employed taxpayers who receive Social Security credit for self-employment earnings when they are delinquent in paying the SE taxes on those earnings, (2) determine why self-employed taxpayers who have not paid their SE taxes are allowed to receive Social Security credit, and (3) identify any potential actions that could enhance the collection of SE taxes.

---

## Background

Several types of employment taxes have been established to pay for Social Security and medical benefits to entitled workers. Social Security taxes are imposed on earnings to provide benefits and protect against the loss of earnings when individuals retire, die, or become disabled. Social Security is the largest income maintenance program in the United States and is financed by flat-rate taxes levied on wages and self-employment income. In 1998, the Social Security tax rate for employees and their employers was 6.2 percent each on gross wages up to \$68,400 and 12.4 percent on earnings net of expenses for self-employed individuals up to \$68,400.<sup>1</sup> In addition, hospital insurance (Medicare) was established to help pay for hospital, home health, skilled nursing, and hospice care for the aged and disabled. In 1998, the Medicare tax rate for employees and employers was 1.45 percent each and 2.9 percent for self-employed workers. There is no earnings limit for the Medicare tax.

All Social Security and Medicare taxes are first deposited in the general fund of the Treasury. For Social Security, the revenues are allocated to the Social Security trust funds (one for old-age and survivors insurance and the other for disability insurance) and for Medicare, the revenues are allocated to the Medicare trust fund for hospital insurance. The exact amount of the Social Security and health insurance contributions are not

---

<sup>1</sup>Self-employed individuals are not required to pay SE taxes unless earnings net of expenses are \$400 or more for the year.



---

known at the time taxes are deposited because they are not specifically identified in collection reports. Thus, the allocation to each of the trust funds is estimated. Periodic adjustments to the trust funds are subsequently made based on earnings reports filed with the Social Security Administration (SSA) by employers for each of their employees and tax returns filed with IRS by the self-employed. IRS subsequently provides reports of each self-employed taxpayer's earnings net of expenses to SSA. SSA records these reported earnings in each worker's account. It then certifies the amount of Social Security earnings in its records to the Treasury, which uses the certified amounts in conjunction with the appropriate tax rates to adjust the trust fund records. All program benefits are paid from the trust funds. To the extent that tax revenues are greater than program operating expenses and benefit payments, the excess revenues are invested in interest-bearing federal securities. This process gives no consideration to whether Treasury has collected all Social Security taxes.<sup>2</sup>

---

## Tax Compliance Is Lower for Self-Employed Individuals Than Wage-Earners

The Social Security program is based on the concept that when individuals work, they pay Social Security taxes into the system, and when they retire, become disabled, or die, they or their spouse and qualified dependents receive monthly benefits based on the insured worker's average lifetime earnings. According to IRS data, the compliance rate for paying Social Security and Medicare taxes is considerably higher for wage-earners and their employers than for self-employed workers. IRS estimated that in 1994, the gross Social Security and Medicare tax gap,<sup>3</sup> which is the annual amount of Social Security and Medicare taxes that were owed but not paid voluntarily and timely, was between \$17.1 billion and \$18.1 billion for wage-earners and their employers, which represents a compliance rate between 95.8 percent and 96 percent. The SE taxes that were owed but not paid voluntarily and timely by self-employed individuals was between \$27.9 billion and \$31.6 billion, which represents a compliance rate of between 41.3 percent and 44.4 percent.

IRS data also indicate that its enforcement programs (i.e., Examination and Collection) were able to reduce the gross tax gap associated with Social Security and Medicare taxes for wage-earners and their employers by about 40 percent. IRS did not have data on how much the gross tax gap

---

<sup>2</sup>In a report, Social Security: Reconciliation Improved SSA Earnings Records But Efforts Were Incomplete (GAO/HRD-92-81, Sept. 1, 1992), we said Congress should consider revising section 201(a) of the Social Security Act to provide that the trust funds receive revenue based on the amount of Social Security taxes collected each year.

<sup>3</sup>The gross tax gap consists of taxes that were not reported on returns and taxes that were reported but not paid.

---

for self-employed taxpayers was reduced through its enforcement programs.

---

## How Social Security and Medicare Taxes Are Computed, Paid, and Reported

A key difference between wage-earners and self-employed individuals is in how the Social Security and Medicare taxes are computed and paid. Wage-earners and their employers each are required to pay half of the Social Security and Medicare taxes.<sup>4</sup> The Internal Revenue Code requires employers to withhold the employees' share of these taxes from their wages. Wage withholding is mandatory for employees, and taxes are imposed starting with the first dollar of earnings. Employers are responsible for remitting withholdings and their share of the taxes to IRS at least quarterly and for reporting each employee's earnings to SSA annually.

Self-employed taxpayers are required to pay all of their SE taxes. Self-employed individuals get two deductions that reduce their tax liability to treat them in much the same way as employers and employees for Social Security and income tax purposes. First, in determining SE tax liability, self-employment earnings net of expenses are reduced by the product of the taxpayer's net earnings from self-employment and one-half of the SE tax rates. This is similar to the way employees are treated under the tax laws in that the employer's share of Social Security and Medicare taxes is not considered income to the employee. Second, self-employed individuals can deduct half of their SE tax as a trade or business deduction from their gross income in determining adjusted gross income for income tax purposes. This is similar to the way employers are treated under the tax laws in that the employer's share of Social Security and Medicare taxes can be deducted from gross income.

Unlike wage-earners, self-employed taxpayers do not have a third party (employer) to withhold and pay taxes to the Treasury. Instead, these taxpayers are to make their own quarterly estimated payments each year to cover their expected tax liability. Taxpayers who make insufficient tax payments to cover the expected tax liability are subject to estimated tax penalties. Generally, no estimated penalty is to be assessed if the amount of tax due at filing is less than \$1,000 or the amount of withholding and credits is 90 percent of the total current year tax liability or 100 percent of the taxpayer's prior year tax liability.

---

<sup>4</sup>Most economists agree that the burden of Social Security and Medicare taxes is borne by wage-earners in the form of lower wages. For example, both the Congressional Budget Office and the Joint Committee on Taxation attribute these taxes to wage-earners when making estimates of the distributional effects of taxes.

---

In addition to the differences in the computation and payment of taxes, there is also a difference in how the earnings are reported between wage-earners and self-employed individuals. For wage-earners, employers are to report employee earnings annually to SSA on Form W-2 (Wage and Tax Statement). However, self-employed individuals are to report their earnings to IRS on Schedule SE (Self-Employment Tax), which is required to be filed with their annual Form 1040 (U.S. Individual Income Tax Return). IRS is to subsequently submit Schedule SE earnings data to SSA.

---

## How SSA Credits Earnings and Determines Benefit Amounts

When SSA receives earnings data, it is to post them to the taxpayers' accounts on its Master Earnings File up to the earnings limit. This earnings information is used by SSA to determine the number of Social Security coverage credits and amount of benefits for individuals seeking Social Security benefits. For example, to be eligible for retirement benefits, a person needs 40 credits, which is equivalent to 10 years of work. In 1998, both wage-earners and self-employed taxpayers earned one coverage credit for each \$700 in earnings. A maximum of four credits can be earned per year. The amount of earnings required to earn a coverage credit is statutorily set to increase each year as average wage levels rise.

Generally, the amount of a Social Security benefit is based on each person's average lifetime earnings. When an eligible taxpayer requests Social Security retirement or disability benefits, SSA computes the benefit amount by (1) determining the number of years of earnings to use as a base, (2) adjusting those earnings for inflation, (3) determining the average adjusted monthly earnings, and (4) multiplying the average adjusted earnings by percentages in a formula specified by law.

---

## Objectives, Scope, and Methodology

Because of the high SE tax noncompliance rate, the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, asked us to review various issues relating to SE tax delinquencies. Our specific objectives were to (1) determine the number and characteristics of self-employed taxpayers who receive Social Security credit for self-employment earnings when they are delinquent in paying the SE taxes on those earnings, (2) determine why self-employed taxpayers who have not paid their SE taxes are allowed to receive Social Security credit, and (3) identify any potential actions that could enhance the collection of SE taxes. (See app. I, which describes how we selected, analyzed, and projected our sample.)

---

## What Are the Number and Characteristics of SE Taxpayers?

To determine the number and characteristics of taxpayers who receive Social Security credit for their self-employment earnings when delinquent in paying the SE taxes on those earnings, we first contacted IRS National Office staff in the Information Systems Development, Research, Collection, and Examination Divisions. Next, we obtained an extract from IRS' Individual Master File, as of September 27, 1997, for all returns with delinquent SE tax included in the total tax liability.<sup>5</sup> At the same time, we obtained access to IRS' Accounts Receivable File, which contained detailed information on returns with delinquent taxes. We matched the two files to create a new database containing both master file and accounts receivable data. This match produced a population of 6,020,291 tax returns with SE tax included in total tax liability.

IRS does not allocate taxpayer payments to any particular type of tax; therefore, we met with various IRS officials to discuss how we could determine the amount of SE taxes that were still owed. We agreed to the most conservative methodological approach, which was to assume that partial payments were applied to the SE tax portion of the delinquency until paid in full and then to income and other taxes owed. Working with IRS officials, we developed a two-step formula that we used to determine if taxpayers were delinquent in paying their SE tax. For the first step in the formula, we subtracted the total tax owed for each delinquent return, as of September 27, 1997, from the original total tax liability. The difference represented the total amount of tax paid by the taxpayer as of September 27, 1997. In the second step, we subtracted the total amount of taxes paid by the taxpayer from the SE tax amount included on the return. If the amount of SE tax exceeded the total amount of taxes paid by \$1 or more, we considered the taxpayer delinquent in paying SE taxes on that return.

To confirm whether these taxpayers were receiving credit at SSA for their earnings, we matched delinquent taxpayers against SSA's earnings records. In addition, we matched the universe of delinquent taxpayers against SSA's Master Benefit Record to determine how many of these delinquent taxpayers were currently receiving Social Security retirement or disability benefits under their own entitlement.<sup>6</sup> While the SE tax delinquencies included both Social Security and Medicare taxes, we did not examine the number of self-employed delinquent taxpayers who were receiving

---

<sup>5</sup>The data extracted included the (1) taxpayer identification number, (2) master file tax code, (3) delinquent tax year, (4) adjusted gross income, (5) taxable income, (6) total tax liability per taxpayer, (7) SE tax amount, and (8) SE income.

<sup>6</sup>Individuals may be eligible for Social Security benefits under their own entitlement or that of a parent or spouse.

Medicare benefits. Also, we were not able to deduct the Medicare taxes from the total SE taxes because the IRS accounts receivable data we used did not separately list Medicare and Social Security taxes.

To determine what effect, if any, the earnings on which the SE taxes had not been paid had on the SSA's monthly benefit amount, we asked staff at SSA's Kansas City Program Service Center to recompute benefits for a random sample of 125 current benefit recipients, excluding such earnings. This sample was weighted to project to the population of self-employed delinquent taxpayers collecting Social Security benefits.

To determine if taxpayers were making estimated payments when required to cover their tax liability, we selected a stratified random sample of 352 returns with delinquent SE tax as of September 27, 1997. This sample was weighted to project to the total population of returns with delinquent SE tax. For each of the returns, we reviewed IRS transcripts of the taxpayers' accounts to determine if (1) the taxpayer should have made estimated tax payments, (2) such payments were made, and (3) IRS assessed an estimated tax penalty against the taxpayer when such payments were not made.

---

### **Why Do Self-Employed Individuals Receive Credit for Earnings on Which SE Taxes Are Unpaid?**

To determine why taxpayers receive credit for their earnings when the SE taxes on such earnings have not been paid, we interviewed officials in IRS' National Office as well as various staff at SSA headquarters. We also researched the Social Security Act to determine if it required SSA to post self-employment earnings regardless of whether IRS had collected the related SE tax. In addition, we obtained and analyzed IRS' and SSA's policies and procedures relative to the posting of self-employment earnings to determine (1) the type of self-employment data IRS sends to SSA and how frequently IRS sends the data to SSA and (2) how SSA posts self-employment earnings to its Master Earnings File.

While analyzing SSA posted earnings on which the SE taxes had not been paid, we identified a universe of taxpayers who had earnings per IRS records that were not posted by SSA. To determine why these earnings were not posted, we analyzed a sample of 143 returns randomly selected from the total population of returns with unposted earnings. This sample was weighted to project to the total population of 473,755 returns.

All sample results are subject to sampling error because we reviewed only a sample of the population. For all sample results, we calculated sampling errors and present them as 95-percent confidence intervals around each sample estimate.

---

**What Potential Actions  
Could Enhance SE Tax  
Collection?**

To identify any potential actions that could enhance the collection of SE taxes, we interviewed SSA headquarters officials in various offices, including the Offices of Legislation and Congressional Affairs, Program Benefits Policy, and Financial Policy and Operations. In addition, we interviewed IRS National Office officials in the Submissions Processing, Collection, and Examination Divisions. We also visited IRS' St. Louis and Chicago District Offices and discussed options for change with Collection and Examination officials. We also reviewed prior reports by IRS and us relative to self-employed individuals.

We reviewed legislative changes in the Taxpayer Relief Act of 1997 that gave IRS the option of using a new type of levy to continuously levy up to 15 percent of federal benefit payments, including Social Security benefits, made to delinquent taxpayers. In addition, we met with IRS and Financial Management Service officials to document the status of efforts to implement the continuous levy program and the milestones for such implementation.

We obtained written comments on a draft of this report from the Commissioner of Internal Revenue and the Commissioner of Social Security. We have summarized the relevant portions of their comments at the end of chapters 3 and 4 and reprinted the written comments in appendixes III and IV. In addition, we incorporated technical comments provided by both IRS and SSA throughout the report, as appropriate.

We did our work from April 1997 to September 1998 in accordance with generally accepted government auditing standards.

# Self-Employed Delinquent Taxpayers Owe Billions in Self-Employment Taxes

Our analysis of IRS' accounts receivable data, as of September 27, 1997, showed that more than 1.9 million taxpayers owed \$6.9 billion in SE taxes on about 3.6 million returns. The taxpayers were delinquent in paying their SE taxes for tax years 1963 to 1996, and over half owed taxes on two or more returns. For almost half of the 3.6 million returns, tax assessments were made as a result of one of IRS' compliance programs. Although the other taxpayers filed their returns and self-assessed their tax liability, they did not pay the liability in full. IRS was in the process of taking some sort of collection action on the majority of the delinquencies; however, according to IRS, there is no guarantee that IRS will be able to collect those taxes.

SSA posts reported self-employment earnings without considering whether the SE taxes on those earnings have been paid. When an individual applies for benefits, those earnings are used in determining eligibility for benefits and in computing monthly Social Security benefits. Thus, even though they had not paid about \$487 million in SE taxes for the years 1963 through 1996, more than 144,000 taxpayers were receiving at least an estimated \$2.5 million in monthly Social Security benefits that were based on earnings for which the SE taxes were delinquent.<sup>1</sup>

Below, we describe some of the characteristics of the 1.9 million self-employed delinquent taxpayers. Appendix II describes additional characteristics.

## Number and Characteristics of Self-Employed Delinquent Taxpayers

IRS' accounts receivable data as of September 27, 1997, showed that over 6 million tax returns filed by 3.4 million taxpayers included SE tax in the total tax liability. These returns reported total tax liabilities of \$28 billion, including about \$14 billion in SE taxes. We applied the payments taxpayers had made to the SE tax portion of their total tax liability first and found that more than 1.9 million taxpayers, involving nearly 3.6 million returns, still owed more than \$20.5 billion in total tax, including over \$6.9 billion in SE taxes, or an average SE tax delinquency of \$1,917.

## Profile of SE Tax Delinquencies

Many of the 1.9 million taxpayers delinquent in paying their SE tax were delinquent for more than one tax year. Our analysis of IRS' accounts receivable data as of September 27, 1997, showed that about 59 percent of the taxpayers were delinquent on two or more returns, accounting for over 86 percent of the \$6.9 billion delinquent SE taxes. Forty-five percent of the delinquent SE tax was owed by 15 percent of taxpayers who had five or more returns with delinquent taxes. (See table 2.1.)

<sup>1</sup>The 95-percent confidence interval ranged from \$2.5 million to \$9.9 million.

**Chapter 2**  
**Self-Employed Delinquent Taxpayers Owe Billions in Self-Employment Taxes**

**Table 2.1: Returns With Delinquent SE Tax by Taxpayer and Amount of SE Tax Owed**

Returns per taxpayer	Delinquent taxpayers	Percent of total	Delinquent SE tax	Percent of total
1	786,181	40.8	\$943,563,492	13.7
2	422,798	22.0	970,706,066	14.0
3	256,964	13.4	975,864,003	14.1
4	163,777	8.5	910,840,190	13.2
5	109,684	5.7	821,945,830	11.9
6-10	175,191	9.1	2,067,039,263	29.9
More than 10	10,703	0.6	222,975,171	3.2
<b>Total</b>	<b>1,925,298</b>	<b>100.0</b>	<b>\$6,912,934,015</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

Source: GAO analysis of IRS' accounts receivable data.

IRS data showed that the tax years involved in these delinquencies ranged from 1963 to 1996.<sup>2</sup> About three-fourths of both the 3.6 million returns and \$6.9 billion in delinquent SE taxes were for tax years 1990-96. Tax year 1996 accounted for the highest percentage of returns, with about 480,000 or 13.5 percent, and 11.8 percent of the \$6.9 billion in delinquent SE taxes. (See table 2.2.)

**Table 2.2: Returns With Delinquent SE Tax and the Amount of SE Tax Owed by Tax Year**

Tax year <sup>a</sup>	Number of returns	Percent of total	Delinquent SE tax	Percent of total
1996	480,357	13.5	\$818,715,284	11.8
1995	403,973	11.3	762,721,779	11.0
1994	381,160	10.7	771,164,165	11.2
1993	379,496	10.6	778,524,728	11.3
1992	357,834	10.0	762,761,167	11.0
1991	333,548	9.4	717,788,098	10.4
1990	322,218	9.0	678,678,014	9.8
1980-89	906,051	25.4	1,618,274,425	23.4
1963-79	3,958	0.1	4,756,546	<sup>b</sup>
<b>Total</b>	<b>3,568,595</b>	<b>100.0</b>	<b>\$6,913,454,590</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

<sup>a</sup>We obtained our data as of September 27, 1997, and it included 32 returns for tax year 1997 and \$70,384 in delinquent SE tax, which we included in our analysis, but not in this table.

<sup>b</sup>Less than one-tenth of one percent.

Source: GAO analysis of IRS' accounts receivable data.

IRS' accounts receivable data as of September 27, 1997, showed that the delinquent taxpayers reported about \$60 billion in self-employment income on the 3.6 million returns, for an average of over \$16,600 per return. About

<sup>2</sup>Typically, by statute, IRS has 3 years from the date of the return to assess taxes and 10 years from the date of assessment to collect the taxes. However, IRS and the taxpayer could agree to extend the statutory limit at any time before its expiration. The IRS Restructuring and Reform Act of 1998 restricts the situations where the statute may be extended by agreement and requires IRS to notify the taxpayer of his or her right to refuse to extend the statute.



70 percent of the returns showed self-employment income of less than \$20,000, and they accounted for about 40 percent of the delinquent SE tax. Fifteen percent of the returns with over \$30,000 in self-employment income accounted for over 40 percent of the delinquent SE tax. (See table 2.3.)

**Table 2.3: Returns and Amount of Delinquent SE Tax by Self-Employment Income**

Self-employment income range	Number of returns	Percent of total	Delinquent SE tax	Percent of total
Less than \$10,000	1,501,424	42.1	\$1,100,835,389	15.9
Between \$10,000 and \$19,999	1,041,328	29.2	1,642,986,945	23.8
Between \$20,000 and \$29,999	490,598	13.8	1,368,492,069	19.8
Between \$30,000 and \$39,999	237,115	6.6	948,033,032	13.7
Between \$40,000 and \$49,999	149,444	4.2	768,871,356	11.1
\$50,000 or more	148,718	4.2	1,084,235,799	15.7
<b>Total</b>	<b>3,568,627</b>	<b>100.0</b>	<b>\$6,913,454,590</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

Source: GAO analysis of IRS' accounts receivable data.

## How Delinquent Taxes Were Assessed

Our analysis of IRS' accounts receivable data showed that taxpayers responsible for over 51 percent of the 3.6 billion returns involving about \$3.3 billion in delinquent SE taxes filed the required return and self-assessed their SE tax. However, these taxpayers did not pay their tax liability in full. For the remaining 49 percent of returns, involving over \$3.6 billion in delinquent SE tax, assessments were made as a result of one of IRS' compliance programs, such as its Examination, Non-Filer, Substitute-for-Return, or Underreporter Programs.

Our analysis showed that about \$0.9 billion in SE tax was assessed under IRS' Examination Program. Also, about \$2.7 billion in SE tax was assessed through IRS' document matching program, which covers the Non-Filer, Substitute-for-Return, and Underreporter Programs. The document matching program matches tax return information against data on information returns, such as Form 1099-MISC (Miscellaneous Income), to identify people who either fail to file returns or underreport their income. The Substitute-for-Return Program is similar to the Non-Filer Program except that IRS prepares the return for the taxpayer, using available information.

## Collection Status of Self-Employed Delinquent Taxpayers

As of September 27, 1997, IRS' records showed that returns with delinquent SE taxes were in various collection stages. IRS was pursuing collection in 60 percent of the returns involving about 63 percent of the delinquent SE taxes through installment agreements with the taxpayer, telephone calls to taxpayers through its Automated Collection System, delinquency notices to taxpayers, and revenue officer contacts with taxpayers. The remaining 40 percent were in an inactive status because

they had been classified as currently-not-collectible, the delinquency amounts were below the dollar tolerance for pursuing collection, or they were in the queue awaiting assignment to revenue officers in the field for enforced collection action. Table 2.4 shows the collection status of the 3.6 million returns and the amount of delinquent SE tax associated with such returns.

**Table 2.4: Collection Status of Returns and the Amount of Delinquent SE Tax**

Collection status	Number of returns	Percent of total	Delinquent SE tax	Percent of total
<b>Active</b>				
Installment agreement	738,951	20.7	\$1,280,707,155	18.5
Automated Collection System	683,366	19.1	1,186,892,127	17.2
Delinquency notice	406,216	11.4	844,411,019	12.2
Field collection - revenue officers	309,090	8.7	1,061,750,197	15.4
<b>Inactive</b>				
Currently-not-collectible <sup>a</sup>	1,003,105	28.1	2,071,673,761	30.0
Below tolerance	208,775	5.9	65,188,458	0.9
In queue awaiting assignment	219,021	6.1	402,539,810	5.8
Other <sup>b</sup>	103		292,063	
<b>Total</b>	<b>3,568,627</b>	<b>100.0</b>	<b>\$6,913,454,590</b>	<b>100.0</b>

<sup>a</sup>Appendix II, table II.1 provides information on the reasons why IRS classified the returns as currently-not-collectible.

<sup>b</sup>Other includes returns on which IRS was taking no collection action because (1) returns had not been posted, (2) taxpayers had been granted extensions for filing, or (3) IRS' Examination or Criminal Investigation units were reviewing the case.

Source: GAO analysis of IRS' accounts receivable data.

IRS' records as of September 27, 1997, showed that the agency was pursuing collection in the majority of returns with delinquent SE tax; however, according to IRS officials, there is no guarantee IRS will actually collect the taxes. For example, IRS' financial statement data for fiscal year 1997 indicated that about 65 percent of all types of delinquent taxes may be uncollectible. According to IRS officials, the longer a delinquency is in the accounts receivable inventory, the less likely it is that IRS will collect those taxes. Table 2.5 shows the number of years returns with delinquent SE taxes have been in the accounts receivable inventory.

**Table 2.5: Returns and Delinquent SE Tax by Years in Accounts Receivable Inventory**

Years in inventory	Number of returns	Percent of total	Delinquent SE tax	Percent of total
Less than 1	935,242	26.2	\$1,851,512,531	26.8
Between 1 and up to 2	565,853	15.9	1,174,591,505	17.0
Between 2 and up to 5	1,243,026	34.8	2,520,074,103	36.5
Between 5 and up to 10	781,455	21.9	1,299,981,157	18.8
More than 10	43,051	1.2	67,295,294	1.0
<b>Total</b>	<b>3,568,627</b>	<b>100.0</b>	<b>\$6,913,454,590</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

Source: GAO analysis of IRS' accounts receivable data.

## Some Self-Employed Delinquent Taxpayers Are Receiving Social Security Benefits

As of April 21, 1998, a match of taxpayers with delinquent SE tax with Social Security benefit records showed that 144,473 of the 1.9 million self-employed delinquent taxpayers who owed \$487 million in SE taxes were receiving \$105 million in monthly Social Security benefits, or an average monthly benefit of \$727 per taxpayer.

Of the 144,473 delinquent taxpayers receiving Social Security benefits, nearly two-thirds were receiving retirement benefits while the remaining one-third were receiving disability benefits. The taxpayers were delinquent in paying their SE tax on 291,114 returns. Also, almost 60 percent of the returns were in an inactive collection status (e.g., currently-not-collectible or below tolerance). Appendix II, tables II.2, II.3, and II.4 describe additional characteristics of the 144,473 taxpayers currently collecting Social Security benefits.

At our request, SSA recomputed the monthly benefit amounts for a sample of delinquent taxpayers currently receiving benefits. The recomputed benefit amounts show the effect of excluding earnings on which the SE taxes had not been paid from the benefit computation. On the basis of SSA's recalculation, we estimate that the monthly benefit payments to the delinquent self-employed taxpayers would be reduced by at least \$2.5 million, or \$30 million annually.<sup>3</sup> As shown in table 2.6, the benefits for an estimated 34 percent of the taxpayers would not be affected by the recalculation because either SSA had posted no self-employment earnings for the delinquent years or the earnings excluded were low and not used in the original benefit computation.<sup>4</sup> The table also shows that about 3 percent of the taxpayers would have lost all of their benefits.<sup>5</sup>

**Table 2.6: Monthly SSA Benefits Retained by Taxpayers After Benefit Amount Recalculation**

<b>Percent of benefits remaining after recalculation</b>	<b>Number of taxpayers</b>	<b>Percent of total</b>
0	4,096	2.8
50-89	11,699	8.1
90-99	80,043	55.4
100	48,635	33.7
<b>Total</b>	<b>144,473</b>	<b>100.0</b>

Source: GAO analysis of IRS and SSA data.

<sup>3</sup>The 95-percent confidence interval ranged from \$2.5 million to \$9.9 million monthly, or from \$30 million to \$118.8 million annually.

<sup>4</sup>The 95-percent confidence interval ranged from 22.9 percent to 44.5 percent

<sup>5</sup>The 95-percent confidence interval ranged from 0.1 percent to 5.5 percent.

The effect on Social Security benefits of excluding earnings for which SE taxes were not paid would be dependent upon the significance of the earnings excluded relative to a beneficiary's total lifetime earnings, as shown in the following examples.

- An individual who owed SE taxes on more than \$160,000 in self-employment earnings for 5 years, was receiving \$1,121 per month in disability benefits. According to SSA, when these earnings were excluded from the benefit calculation, the recomputed benefit amount was zero because without the excluded earnings, the individual lacked sufficient earnings credits to be eligible for the disability benefits.
- An individual who owed SE taxes on earnings of more than \$290,000 over a 12-year period was receiving \$990 per month in retirement benefits. If those earnings had been excluded, the benefit amount would have been reduced to \$688 per month—a reduction of about \$302.

In most instances, however, the effect of excluding such earnings was much less significant, as shown in the following examples.

- For an individual receiving \$824 in retirement benefits, the recomputation had no effect on the benefit amount after excluding over \$1,300 in earnings for one tax year. Because the earnings during the delinquent tax year were low, SSA had not used them in computing the original benefit amount.
- An individual's \$349 monthly benefit would have been reduced by \$19, to \$330, after SSA excluded over \$26,000 in earnings for 2 tax years.

The number of taxpayers delinquent in paying their SE tax and collecting Social Security benefits could increase in the future. We found that as of September 27, 1997, 72,000 taxpayers who still owed SE taxes were over age 62, the minimum age to be eligible for SSA retirement benefits, and could begin drawing benefits at any time. However, we cannot say with any certainty how many taxpayers delinquent in paying their SE tax will receive Social Security benefits in the future.

---

## Conclusions

Substantial numbers of self-employed individuals do not pay all of their SE taxes. These taxpayers can be generally characterized by their low income and multiple delinquencies. Owing SE taxes does not prevent individuals from receiving Social Security benefits, and some do receive them.

---

# Taxpayers Receive Social Security Credit When Taxes Are Not Paid, With One Exception

---

The Social Security Act requires SSA to credit individuals' earnings for Social Security coverage without regard to whether their SE taxes have been paid. As a consequence, individuals can receive Social Security benefits based on earnings for which they have not paid SE taxes. An exception prevents certain individuals (including the self-employed) from receiving credit for their earnings when tax filing was not timely, even if the taxes eventually are paid. Congress could make Social Security credit conditional on payment of SE taxes and has considered proposals to do so in the past. Making credit conditional would raise a number of issues, such as how to allocate payments between SE and other income taxes.

---

## The Social Security Act Requires Credits for Social Security Coverage to Be Based on SE Earnings, Not SE Taxes Paid

As noted in chapter 2, a significant number of self-employed individuals are collecting Social Security benefits, a portion of which are based on earnings for which the SE taxes have not been paid. The Social Security Act requires SSA to grant credits for coverage and pay benefits without regard to whether the taxes have been paid. This issue has been addressed by the Supreme Court. In a 1960 decision, the Court stated that the amount of Social Security benefits do not in any true sense depend on contributions to the program through the payment of taxes, but rather on the earnings record of the beneficiary.<sup>1</sup>

Past congressional proposals have sought to make credits for self-employment earnings conditional upon the payment of the tax because of the perception that to give credit for earnings where taxes have not been paid undermines the compulsory contribution principle of the Social Security program and that it is unfair to others who pay their taxes.<sup>2</sup> However, no action was taken on those proposals. While wage-earners can also receive credit for Social Security coverage when their Social Security and Medicare taxes are not paid, these proposals were not directed at them because they do not have the same responsibilities for assessing and paying the taxes as the self-employed. For wage-earners, employers are responsible for assessing and withholding taxes and remitting those withheld taxes to IRS. Thus, while wage-earners can be considered innocent third parties when their employers fail to pay withheld taxes, the self-employed cannot because they are responsible for assessing their taxes and paying those taxes to IRS.

---

<sup>1</sup>*Flemming v. Nestor*, 363 U.S. 603 (1960).

<sup>2</sup>During the 95th Congress, the Chairman of the Ways and Means Oversight Subcommittee introduced H.R. 12565, the "Self-Employment Tax Payment Act of 1978," which contained such a change. In 1979, the Subcommittee Chairman reintroduced the bill, which was renumbered as H.R. 5465.

---

Excluding the earnings on which the SE taxes had not been paid from benefit calculations would reduce the total amount of Social Security benefit payments made. For example, we found that for the 144,473 delinquent self-employed taxpayers receiving benefits as of April 21, 1998, the benefit amount would be reduced by an estimated \$74.4 million (plus or minus \$44.4 million) annually, which is about 6 percent of their \$1.3 billion in annual benefit payments.

If Congress made the posting of earnings conditional on payment of SE taxes, it would have to resolve some issues related to tax payments. For example, Congress would have to specify how to allocate taxpayer payments between SE taxes and other income taxes because IRS cannot, under current law, administratively make these allocations. Furthermore, since only a minimum amount of earnings are required to get Social Security credit, the Social Security Act would have to include a provision as to when SSA could give taxpayers credit for their earnings. To illustrate, taxpayers could get credit when they paid taxes on the minimum earnings amount or when they paid their full SE tax liability.

In addition, making Social Security credit conditional on the payment of SE taxes could require IRS to develop a system to track payments and send SSA the information when SE taxes were paid. SSA may also have to develop procedures to post the earnings data more frequently than it does now, depending upon whether IRS would send the earnings data to SSA after each SE tax payment or when the liability was completely paid. Currently, IRS forwards self-employment earnings data to SSA after it processes the Schedule SE, and SSA then posts the earnings to the person's earnings record. Generally, the posting occurs once a year for each taxpayer when SSA receives the Schedule SE data. It was beyond the scope of our review to evaluate the effects of making Social Security credit for earnings conditional on the payment of SE taxes on the Social Security program or the tax system.

---

## **Self-Employment Earnings Do Not Get Posted When Returns Are Filed After a Certain Date**

The Social Security Act provides that the posting of self-employment earnings is conditional upon taxpayers filing their income tax returns within 3 years, 3 months, and 15 days after the end of the tax year in which the income was earned. However, the law applies the time limitation differently to self-employed individuals than to wage-earners. It requires SSA to strictly enforce the time limitation when posting the reported earnings of self-employed individuals, but allows the posting of the earnings of wage-earners after expiration of the time limitation if the wage-earners submit proof of earnings, such as pay records and tax returns.

---

In comparing the self-employment earnings reported to IRS with the earnings posted by SSA for the 3.6 million returns with delinquent SE tax, we found 473,755 returns where the self-employment earnings did not get posted to Social Security records. The earnings not posted by SSA amounted to \$9.6 billion, or 16 percent of the over \$60 billion in SE income reported to IRS by 273,476 taxpayers. In the majority of these returns, the earnings were not posted because taxpayers had not filed their income tax returns within the statutory time limit. On the basis of our analysis of a representative sample of self-employed delinquent taxpayers whose earnings were not posted to SSA records, we estimate that 81.9 percent of the returns were filed after the statutory time limit had expired.<sup>3</sup> IRS had pursued these returns under its Non-Filer Program but had not secured the returns in time for the taxpayers to get Social Security credit for their earnings. Although the remaining returns were filed within the statutory time limit, SSA officials told us there could be a number of reasons why the earnings were not posted, including the taxpayers' use of invalid Social Security numbers and names on their tax returns.

The following two examples illustrate how late-filed returns affect the posting of earnings for self-employed individuals.

- One taxpayer reported over \$14,000 in self-employment earnings on his 1992 individual tax return. To receive Social Security credit, the return had to be filed by April 15, 1996. However, IRS did not receive the return until December 19, 1996, which was 8 months after the 3-year, 3-month, and 15-day time limit. Therefore, SSA did not post the earnings.
- Another taxpayer did not file a tax year 1991 return, so IRS, using data from information returns, filed a substitute return for the taxpayer. On April 21, 1996, IRS assessed over \$8,000 in SE tax on earnings of more than \$53,000. SSA did not post the earnings because the assessment was made after the April 15, 1995, time limit for filing a timely return.

Even if the taxpayers in these instances were to eventually pay the SE tax owed, they would not receive credit for their self-employment earnings. We estimate that in about 11.3 percent of the returns where taxpayers filed returns after the statutory time limitation expired, they were making payments to clear their tax debt even though their self-employment earnings would not be posted by SSA.<sup>4</sup>

---

<sup>3</sup>The 95-percent confidence interval ranged from 75.4 percent to 88.4 percent.

<sup>4</sup>The 95-percent confidence interval ranged from 6.4 percent to 16.2 percent.

---

SSA officials told us that self-employed taxpayers who file their returns too late for their earnings to be posted may not realize they will not receive credit toward Social Security benefits. They said they receive many inquiries from taxpayers applying for benefits who question why they did not receive credit for their self-employment earnings. In 1995, SSA began sending Personal Earnings and Benefit Estimate Statements automatically to workers who had reached age 60. Starting in fiscal year 2000, SSA plans to send the statements annually to almost every worker in the country age 25 and older—an estimated 123 million people each year. These six-page statements provide workers with a list of their yearly earnings on record at SSA, information about their eligibility for benefits, and estimates of those benefits. The statement also provides workers with a toll-free number for any questions they may have concerning the statement.

Our review of widely available SSA and IRS publications that address self-employment issues showed no mention of the time limit.<sup>5</sup> We also found that when IRS contacts taxpayers under its Non-Filer Program, it does not inform them about the time limit for filing returns in order to get Social Security credit. Letting taxpayers know about the statutory time limit could increase the number of taxpayers who would file within that time limit.

---

## Conclusions

The Social Security Act requires SSA to post all of the reported earnings of a self-employed person, regardless of whether the SE taxes on those earnings have been paid, as long as the return is filed within the statutory time limit. While this may be unfair to taxpayers who pay their taxes, changing it to make getting Social Security credit conditional on paying taxes would require congressional action. This change would require a detailed analysis of all costs and benefits as well as an evaluation of the effect such a change would have on other aspects of the Social Security program and the tax system. Such analysis was beyond the scope of our review.

When individuals apply for benefits, their earnings are used to determine eligibility and compute their monthly benefit amount. However, as of September 27, 1997, SSA had not posted about \$9.6 billion in self-employment earnings from 473,755 returns. We estimate that SSA did not post the self-employment earnings in 81.9 percent (plus or minus 6.5 percent) of those returns because they were not filed within the statutory time limitation. Many of these taxpayers may be unaware that they will not

---

<sup>5</sup>These publications include SSA Publication 05-10022: [If You're Self-Employed](#) and IRS Publication 533: [Self-Employment Taxes](#).



---

receive Social Security credit for these earnings. Neither IRS nor SSA publications relating to self-employment make note of this time limitation.

---

## Recommendation to the Commissioner of Internal Revenue

To better inform taxpayers of the importance of filing tax returns within the statutory time limit, we recommend that the Commissioner of Internal Revenue revise IRS' self-employment publications, including those given under its Non-Filer Program, to ensure that self-employed taxpayers know about the need to file tax returns with self-employment earnings within 3 years, 3 months, and 15 days after the end of the calendar year in which the self-employment income was earned in order to get Social Security credit for those earnings.

---

## Recommendation to the Commissioner of Social Security

To better inform potential Social Security recipients of the importance of filing tax returns within the statutory time limit, we recommend that the Commissioner of Social Security revise SSA's publications for self-employed individuals to inform them about the need to file tax returns with self-employment earnings within 3 years, 3 months, and 15 days after the end of the calendar year in which their self-employment income was earned in order to get Social Security credit for those earnings.

---

## Agency Comments

In written comments on our draft report, the Commissioner of Internal Revenue and the Commissioner of Social Security agreed with the recommendations to better inform self-employed taxpayers of the statutory time limit for filing returns with SE income in order to receive Social Security credit.

The Commissioner of Internal Revenue said that IRS has included information on the statutory time limit for filing returns in the 1998 revision of Publication 533, Self-Employment Tax. Also, IRS plans to revise the 1999 versions of Publication 583, Starting a Business and Keeping Records, and Publication 334, Tax Guide for Small Business, to provide such information. In addition, the Commissioner agreed to modify IRS' non-filer notices to make it clear to taxpayers that they will not receive Social Security credit for their earnings if they do not file their returns within the time limit.

The Commissioner of Social Security agreed to include information on the statutory time limit in all publications for the self-employed as those publications are revised. The Commissioner stated that SSA Publication 05-10022: If You're Self-Employed, was recently revised, but will be updated in the Fall of 1999 to include information on the statutory time limit. The Commissioner also stated that SSA plans to use a public information package that is distributed monthly to all field offices to better

---

**Chapter 3****Taxpayers Receive Social Security Credit When Taxes Are Not Paid, With One Exception**

---

inform taxpayers of the statutory time limit for filing. This package includes, among other information, a newspaper column that the field offices provide to local newspapers as part of an ongoing column on Social Security matters. According to the Commissioner, the February 1999 column will focus on self-employment issues and will include information on the statutory time limit.

# Potential Ways to Reduce Self-Employment Tax Delinquencies

There are several potential ways to enhance the collection of delinquent taxes from self-employed individuals.<sup>1</sup> IRS has recently been given the option to continuously levy taxpayers' Social Security benefits and other federal payments to recover delinquent taxes and is in the process of developing a program to do so. This levy program affects taxpayers that are already delinquent in paying their taxes and should reduce their tax debt. With regard to collecting taxes before taxpayers become delinquent, proposals have been made by Treasury and others to require withholding on certain types of payments made to the self-employed, which could help reduce SE tax delinquencies. However, Congress has not acted on these proposals because of the administrative burden they would place on those businesses that would have to withhold taxes. Also, since most self-employed delinquent taxpayers did not make required estimated tax payments, a program, such as one that reminds taxpayers to make the payments could enhance self-employment tax collections.

## Levying Social Security Benefit Payments

The Taxpayer Relief Act of 1997 gave IRS the option of using a new type of levy to continuously levy up to 15 percent of federal payments (including Social Security benefits) made to delinquent taxpayers until their entire tax debt is paid in full. Although IRS had the authority to levy Social Security benefits prior to the 1997 act, it did not have authority to levy such benefits continuously. Federal payments are made by the Department of the Treasury's Financial Management Service (FMS), and it is to be responsible for developing and administering the program, including levying the payments and forwarding levy payments to IRS. Under the program, IRS plans to give FMS information on the delinquent accounts to be levied. For Social Security payments, FMS is to match these accounts against its file of Social Security benefit recipients and levy benefit payments. Because of the sensitivity of levying delinquent taxpayers' Social Security benefit payments, IRS wants to ensure that the program will function as authorized and will not result in inappropriate levies. Therefore, IRS plans to issue two notices before levying Social Security payments to give taxpayers time to resolve their delinquencies. The first notice is to be sent when the match is made, and a second 30 days later.

Initially, IRS officials believed the levy program could be implemented by January 1999. However, both IRS and FMS officials told us that they had jointly agreed to delay implementation of the program until July 2000. The delay is to afford both IRS and FMS time to negotiate a mutually

<sup>1</sup>It was beyond the scope of this review to examine all potential options that could enhance the collection of SE taxes. For example, we did not examine what impact increased IRS enforcement action might have on compliance.

acceptable set of implementation requirements as well as time for FMS to make necessary modifications to its offset program. Also, the delay will allow both IRS and FMS more time to develop regulations for the levy program.

IRS plans to levy the federal payments (including Social Security benefits) for the total tax liability including interest and penalties. The 144,473 delinquent self-employed taxpayers who were receiving Social Security benefits as of April 21, 1998, owed about \$2.1 billion in total taxes, of which \$487 million was SE tax and \$1.6 billion was income tax. In addition, the taxpayers owed \$4.6 billion in assessed and accrued interest and penalties. However, IRS does not plan to levy against all delinquent taxpayers. For example, IRS does not plan to levy Social Security benefits for those taxpayers whose accounts are classified as currently-not-collectible because of hardship or those who have installment agreements.<sup>2</sup> Applying IRS' levy criteria, we found that IRS would levy about 41,000 of the 144,473 taxpayers delinquent in paying about \$108 million in SE tax.

---

## **Withholding on Payments Made by Businesses to Self-Employed Taxpayers**

While the continuous levy program should result in recovering some delinquent SE taxes, it would be preferable to get taxpayers to pay their SE taxes at the time they earn their income instead of when they begin collecting Social Security benefits. IRS officials in Collection and Examination told us that withholding taxes from payments by businesses to certain self-employed individuals could reduce the number of SE tax delinquencies. In general, self-employed taxpayers are less likely to report their earnings or pay their tax liability than are wage-earners, who are subject to withholding. IRS data show that the compliance rate for reporting income for taxpayers subject to withholding is 99 percent versus 80 percent for self-employed taxpayers.

Withholding on payments by businesses to self-employed individuals is not a new idea. As far back as 1979, the Department of the Treasury proposed withholding by businesses on payments made in the course of a trade or business for services provided by independent contractors, who include subcontractors, accountants, lawyers, and engineers. It proposed withholding at a flat rate of 10 percent, but would have exempted workers who normally worked for five or more businesses in a calendar year or expected to owe less tax than the withheld amount. However, this proposal was not enacted by Congress because of the administrative

---

<sup>2</sup>Section 3462(b) of the IRS Restructuring and Reform Act of 1998 prohibits IRS from levying while an installment agreement is pending or in effect or while an offer-in-compromise is pending.

burden that would have been placed on those businesses that would have to do the withholding.

In July 1992, we reported that the noncompliance among independent contractors was serious enough to warrant some form of withholding and proposed that Congress consider legislation to improve compliance through withholding, but Congress took no action.<sup>3</sup> In addition, in 1995, a panel of tax experts, including former senior officials in IRS and Treasury, presented several options for increasing the compliance of self-employed taxpayers. One such option supported by most panelists was withholding on business payments to independent contractors. Furthermore, various IRS studies have recognized that withholding could be an up-front tool to reduce the number of SE tax delinquencies. Of the 1.9 million delinquent SE taxpayers, we were able to categorize 1.1 million by type of business using IRS data. Of the 1.1 million, 40 percent were engaged in personal, professional, or business services and would have been subject to the mandatory withholding under the various proposals.

Mandatory withholding by employers of taxes from employees has been the cornerstone of the U.S. tax compliance system for years, and it has worked very well with over 99 percent of wages voluntarily reported. Implementing mandatory withholding on business payments to independent contractors could have a similar effect on the tax compliance of these individuals. However, there are administrative concerns that would need to be resolved, such as determining the rate of withholding so that the tax withheld approximates the tax due for the year.

In addition to administrative considerations, withholding on business payments to independent contractors would increase the burden on both the independent contractors and the businesses that use them. It could adversely affect the cash flow of some independent contractors who could have business expenses that reduce their annual net income and taxes owed below the withheld amount. In addition to the burden on taxpayers, businesses would have costs and burdens associated with withholding and depositing the taxes into the Treasury as well as reporting the income and taxes to IRS. Businesses would also have the burden of identifying those independent contractors who would be exempted from withholding.

---

<sup>3</sup>Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO-GGD-92-108, July 23, 1992).

---

## Reminding Delinquent Self-Employed Taxpayers to Make Estimated Tax Payments

Taxpayers not subject to withholding are generally required to make quarterly estimated tax payments. IRS' Statistics of Income data for tax year 1994 showed that about 4.4 million of the 12.2 million taxpayers who reported SE taxes on their returns made estimated tax payments. About 5 million taxpayers were assessed an estimated tax penalty because they failed to make required quarterly payments.

As of September 27, 1997, we estimate that of the 3.6 million returns with delinquent SE tax, the taxpayers responsible for 2.5 million returns (69 percent) were required to make estimated tax payments.<sup>4</sup> However, in an estimated 2.3 million (92 percent) of those returns, taxpayers failed to make the required estimated payments.<sup>5</sup>

In 1991, IRS sent reminder notices to all taxpayers who were compliant in making estimated tax payments in the prior year but had not made any in the current year. According to an IRS official, the taxpayer response to these notices was negative, and taxpayers considered them to be intrusive because they believed that IRS was making assumptions based on the previous year that might not apply to the current year. As a result of the negative taxpayer reaction, IRS stopped sending the notices. IRS had no data to show whether the reminder notices increased the estimated tax payment compliance of individuals who received notices.

However, taxpayers would have less cause for concern if the notices were sent only to taxpayers who were not compliant in making estimated tax payments during the previous year--that is, to those who (1) in the current year had not made an estimated tax payment and (2) in the previous year had filed a Schedule SE and were assessed an estimated tax penalty. We estimate that about 1.2 million of the 2.5 million returns (48 percent) where the taxpayer was required to make estimated payments met these criteria.<sup>6</sup> Sending such a reminder notice would not be costly and could encourage noncompliant taxpayers to make required estimated payments.

---

## Conclusions

IRS now has the option to continuously levy taxpayers' Social Security payments to collect delinquent taxes. How much delinquent SE taxes IRS would be able to secure through the continuous levy program is unknown; however, less than 30 percent of delinquent self-employed taxpayers that

---

<sup>4</sup>The 95-percent confidence interval ranged from 2.3 million to 2.7 million returns.

<sup>5</sup>The 95-percent confidence interval ranged from 2.1 million to 2.5 million returns.

<sup>6</sup>The 95-percent confidence interval ranged from 1.0 million to 1.4 million returns.

---

we identified as receiving Social Security benefits would meet IRS' criteria for levying.

Intervening with taxpayers before they become delinquent may reduce the amount and limit the number of SE tax delinquencies. One potential way to do this would be to implement withholding on payments made by businesses to independent contractors. This would help ensure that some portion of the tax liability is collected at the time the income is earned. However, withholding would impose costs and burdens on those businesses that would have to withhold the taxes and could affect the cash flow of independent contractors. Congress has not enacted prior proposals to implement withholding on independent contractors.

Since self-employed taxpayers are not subject to withholding, many are required to make estimated payments to cover their tax liability. However, we found that 2.3 million taxpayers did not make required estimated tax payments. In the past, IRS tried sending notices to all self-employed taxpayers who had made estimated payments in the prior year but not the current year, reminding them that they may be liable for estimated payments in the current year. According to an IRS official, taxpayers considered these notices intrusive because they believed that IRS was making assumptions based on the previous year that might not apply to the current year. IRS could send a reminder notice only to those taxpayers who were noncompliant in making estimated tax payments in the previous year. We estimate about 1.2 million of the 2.5 million returns where the taxpayer was required to make estimated payments met these criteria.

---

## **Recommendation to the Commissioner of Internal Revenue**

To reduce SE tax delinquencies, we recommend that the Commissioner of Internal Revenue undertake a pilot project to test the feasibility of sending notices to noncompliant self-employed taxpayers who in the current year had not made estimated payments and in the previous year had filed a Schedule SE and were assessed an estimated tax penalty.

Although this report discusses the issue of extending mandatory withholding to cover payments by businesses to certain self-employed individuals, such as independent contractors, such action would require legislation, which would require Congress to make a value judgment as to the need for such a change. A full-scale evaluation of the costs and burdens of withholding was beyond the scope of our review. Therefore, we do not make a recommendation on this issue.

---

## **Agency Comments**

In written comments on our draft report, the Commissioner of Internal Revenue agreed with the recommendation to pursue a pilot project to test

---

the feasibility of sending reminder notices to noncompliant self-employed taxpayers. The Commissioner stated that IRS plans to incorporate the recommendation into its national non-filer strategy. Under this strategy, IRS plans to improve compliance and service to taxpayers by emphasizing delinquency prevention. The Commissioner also stated that IRS had selected an executive to head up the non-filer strategy, and expected the strategy to be in place by the end of fiscal year 1999.



---

---

---

# Sampling and Data Analysis Methodology

---

This appendix describes how we selected, analyzed, and projected the sample data for three random samples to the universe of returns of taxpayers delinquent in paying their SE taxes. The samples pertain to (1) computing Social Security benefit amounts, (2) determining whether the taxpayers were required to make estimated payments, and (3) determining why SSA did not post self-employment earnings in some cases.

---

## Recomputation of SSA Benefits

Our computer analysis of IRS and SSA records showed that of the 1.9 million taxpayers delinquent in paying their SE tax as of September 27, 1997, 144,473 were collecting \$105 million in monthly Social Security retirement or disability benefits as of April 21, 1998. To determine what effect, if any, the earnings on which the SE taxes had not been paid had on SSA's monthly benefit amount, we selected a stratified random sample of 125 taxpayers from the population of delinquent taxpayers receiving Social Security benefits. The population was divided into 14 strata based on the amount of delinquent SE tax and the Social Security monthly benefit amount. Once the sample was selected, we asked staff at SSA's Kansas City Program Service Center to recompute benefits for those taxpayers, excluding from the computation earnings on which the SE taxes had not been paid. In the analysis, the sample selections were weighted to represent the total population of 144,473 taxpayers receiving monthly Social Security retirement or disability benefits.

---

## Nonposting of Self-Employment Earnings by SSA

In the process of confirming that self-employment earnings were being posted at SSA, we identified about \$9.6 billion from 473,755 returns that SSA did not post to the taxpayers' accounts. The Social Security Act provides that for self-employed individuals, SSA will post earnings to their account so long as the return is filed timely. The act defines "timely" as being within 3 years, 3 months, and 15 days after the end of the calendar year in which the income was earned. For returns filed after that date, no self-employment earnings are to be posted.

Discussions with SSA officials led us to believe that late-filed returns was the primary reason earnings were not posted by SSA. To determine if our belief was valid, we selected a stratified random sample of 143 returns from the population of 473,755 returns for which no earnings were posted. The population was divided into 10 strata based on the amount of SE tax owed as of September 27, 1997. Our review of IRS transcripts of account for the 352 returns selected for the estimated payment sample identified 40 returns for which SSA had posted no earnings. However, that sample was too small to produce reliable estimates. As a result, we selected a supplemental sample of 103 returns with unposted earnings. The 40 returns previously identified were excluded from the supplemental sample.

---

For the 143 returns, we reviewed IRS transcripts of account to determine if the returns were filed timely and if the taxpayers were making payments to satisfy their liability.<sup>1</sup> In our analysis, the sample selections have been weighted to represent the total population of 473,755 returns with self-employment earnings per IRS records that were not posted to the taxpayer's account by SSA.

---

## Estimated Payments

Self-employed taxpayers are not covered by mandatory withholding. As a result, they are to make estimated tax payments when, after subtracting withholding and credits from the tax liability, they expect to owe more than \$500.<sup>2</sup> There are some exceptions to this requirement. For example, if the taxpayer's withholding and credits are equal to 100 percent of their prior year's tax or 90 percent of the current year's tax, no estimated payment is required. Because not all self-employed taxpayers are required to make estimated payments, we selected a stratified random sample of 352 returns from the total population of 3.6 million returns for which taxpayers were delinquent in paying their SE tax. The population was divided into 10 strata based on the amount of SE tax owed as of September 27, 1997, and the source of the taxpayers' income. For each of the returns, we reviewed IRS transcripts to determine if (1) the taxpayer should have made estimated tax payments, (2) such payments were made, and (3) IRS assessed an estimated tax penalty against the taxpayer when such payments were not made. In the analysis, the sample selections have been weighted to represent the total population of 144,473 receiving monthly Social Security retirement or disability benefits.

---

## Sampling Errors for Key Estimates Used in the Report

Because our results come from samples, the estimates used in the report are subject to sampling errors. Sampling errors measure the extent to which estimates from samples of these sizes and structure can be expected to differ from the total population values. From the sample estimates, together with estimates of their sampling errors, interval estimates can be constructed with prescribed confidence that they each include actual population values. Each of our sample estimates is surrounded by a 95-percent confidence interval indicating that we are 95-percent confident that the results for the total population will be within each confidence interval.

---

<sup>1</sup>Because of difficulties in obtaining a transcript for one of the 143 returns, we reviewed transcripts for only 142 returns.

<sup>2</sup>For tax year 1998, the \$500 requirement has been raised to \$1,000.

# Additional Characteristics of Delinquent Self-Employed Taxpayers

This appendix provides additional characteristics of the taxpayers delinquent in paying their SE tax. These characteristics include IRS' reasons for classifying returns as currently-not-collectible, collection status of delinquent taxpayers collecting Social Security benefits, IRS enforcement actions required to obtain a return and assess the taxes owed for those taxpayers currently collecting Social Security benefits, and the ages of both those currently collecting Social Security benefits and those not yet collecting benefits.

As noted in chapter 2, table 2.4, IRS had classified 28 percent of the 3.6 million returns with delinquent SE tax and 30 percent of the delinquent SE tax as currently-not-collectible. Table II.1 shows, as of September 27, 1997, the most common reasons IRS used in categorizing a balance due as uncollectible.

**Table II.1: Reasons IRS Categorized SE Returns With Balance Due as Currently-not-Collectible**

Reason	Number of returns	Percent of total	Delinquent SE tax	Percent of total
Undue hardship on taxpayer	746,845	74.5	\$1,597,301,095	77.1
Unable to contact taxpayer	127,376	12.7	199,878,431	9.7
Unable to locate taxpayer	86,924	8.7	197,054,660	9.5
Deceased taxpayer	40,718	4.1	75,511,492	3.6
Other <sup>a</sup>	1,242	0.1	1,928,083	0.1
<b>Total</b>	<b>1,003,105</b>	<b>100.0</b>	<b>\$2,071,673,761</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

<sup>a</sup>Other includes returns with a balance due below the tolerance for collection action.

Source: GAO analysis of IRS' accounts receivable data.

Analysis of IRS and SSA data showed that, as of September 27, 1997, about 58 percent of the returns for the 144,473 taxpayers collecting Social Security benefits were in an inactive collection status because they had been classified as currently-not-collectible, were below the tolerance for collection action, or were in the queue awaiting assignment to revenue officers in the field. These returns accounted for 56 percent of the \$487 million in delinquent SE tax. (See table II.2.)

**Appendix II**  
**Additional Characteristics of Delinquent Self-Employed Taxpayers**

**Table II.2: Collection Status of Returns for Which Delinquent Taxpayers Were Receiving Social Security Benefits**

Collection status	Number of returns	Percent of total	Delinquent SE tax	Percent of total
<b>Active</b>				
Installment agreement	45,442	15.6	\$62,172,414	12.8
Automated Collection System	36,719	12.6	56,063,820	11.5
Delinquency notice	21,597	7.4	37,732,427	7.7
Field collection by revenue officers	19,559	6.7	60,408,421	12.4
<b>Inactive</b>				
Currently-not-collectible	132,046	45.4	239,899,340	49.2
Below tolerance	20,426	7.0	5,517,467	1.1
In queue awaiting assignment	15,319	5.3	25,424,191	5.2
Other	6		8,731	
<b>Total</b>	<b>291,114</b>	<b>100.0</b>	<b>\$487,226,811</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

Source: GAO analysis of IRS' accounts receivable data.

Taxpayers voluntarily filed returns self-assessing the taxes owed in about 51 percent of the returns for taxpayers who were receiving Social Security benefits. These returns accounted for 45 percent of the delinquent SE tax.

For the remaining 49 percent of the returns, IRS enforcement action was required to obtain the return or assess the taxes owed. As of September 27, 1997, these returns accounted for 55 percent of the \$487 million in delinquent SE tax. As shown in table II.3, IRS used various compliance programs to assess the taxes due.

**Table II.3: Delinquent SE Taxes Assessed Through IRS Compliance Programs**

IRS compliance program	Number of returns	Percent of total	Delinquent SE tax	Percent of total
Non-Filer	57,373	40.5	\$102,303,549	38.0
Substitute-for-Return	26,094	18.4	65,961,971	24.5
Audit by Examination	35,617	25.1	80,412,961	29.9
Underreporter	15,496	10.9	12,716,049	4.7
Other <sup>a</sup>	7,136	5.0	7,946,358	2.9
<b>Total</b>	<b>141,716</b>	<b>100.0</b>	<b>\$269,340,888</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

<sup>a</sup>Other includes adjustments, math errors, and penalties.

Source: GAO analysis of IRS' accounts receivable data.

About 69 percent of the 144,473 delinquent taxpayers receiving Social Security benefits were age 63 and over and accounted for about 76 percent of the delinquent SE tax.

**Appendix II**  
**Additional Characteristics of Delinquent Self-Employed Taxpayers**

**Table II.4: Age of Delinquent Taxpayers Currently Collecting Social Security Benefits and Delinquent SE Tax**

<b>Age</b>	<b>Number of taxpayers</b>	<b>Percent of total</b>	<b>Delinquent SE tax</b>	<b>Percent of total</b>
30 and under	575	0.4	\$614,212	0.1
31-40	5,829	4.0	10,650,448	2.2
41-50	12,559	8.7	30,631,544	6.3
51-55	8,967	6.2	25,549,207	5.2
56-62	15,533	10.8	47,264,519	9.7
63-65	24,746	17.1	88,609,353	18.2
66-70	41,481	28.7	163,081,601	33.5
Over 70	33,145	23.0	117,809,196	24.2
No date of birth available	1,698	1.1	2,982,291	0.6
<b>Total</b>	<b>144,473</b>	<b>100.0</b>	<b>\$487,192,371</b>	<b>100.0</b>

Source: GAO analysis of IRS and SSA data.

Finally, our analysis of IRS and SSA data showed that, as of September 27, 1997, over 72,000 taxpayers delinquent in paying their SE tax were over age 62, the minimum age to be eligible for Social Security retirement benefits, but were not yet receiving those benefits. In addition, there were about 190,000 taxpayers between the age of 56 and 62 that could become eligible for Social Security benefits within the next several years.

**Table II.5: Age of Delinquent Taxpayers Not Yet Receiving Social Security Benefits and Delinquent SE Tax**

<b>Age</b>	<b>Number of taxpayers</b>	<b>Percent of total</b>	<b>Delinquent SE tax</b>	<b>Percent of total</b>
30 and under	148,313	8.3	\$211,816,368	3.3
31-40	494,819	27.8	1,462,396,521	22.8
41-50	550,376	30.9	2,313,429,461	36.0
51-55	211,827	11.9	1,025,227,749	16.0
56-62	189,928	10.7	915,022,838	14.2
63-65	31,304	1.8	164,336,108	2.6
66-70	21,173	1.2	100,336,474	1.6
Over 70	19,642	1.1	56,038,381	0.9
No date of birth available	113,443	6.4	177,137,744	2.8
<b>Total</b>	<b>1,780,825</b>	<b>100.0</b>	<b>\$6,425,741,644</b>	<b>100.0</b>

Note: Percentages may not add to 100 because of rounding.

Source: GAO analysis of IRS' accounts receivable data.

# Comments From the Internal Revenue Service



COMMISSIONER

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

January 21, 1999

Mr. James R. White  
Director, Tax Policy and Administration Issues  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. White:

Thank you for the opportunity to review and comment on your recent draft report entitled "Tax Administration: Billions in Self-Employment Taxes Are Owed." Overall, we agree with the findings and recommendations contained in the report. Indeed, we commend you for providing recommendations which are proactive in nature and will help taxpayers become more compliant in the future. Because I am so concerned about the lack of knowledge and understanding of this issue on the part of many in the taxpaying public, my staff is already taking steps to implement your two recommendations. Our comments regarding each specific recommendation are below:

Recommendation 1: To better inform taxpayers of the importance of filing tax returns within the statutory time limit, GAO recommends that the Commissioner of Internal Revenue revise IRS' self-employment publications, including those given under its Non-filer Program, to ensure that self-employed taxpayers know about the need to file tax returns with self-employment earnings within 3 years, 3 months, and 15 days after the end of the calendar year in which the self-employment income was earned in order to get social security credit for those earnings.

Comments: We fully agree with this recommendation and have already included this information in the 1998 revision of Publication 533, Self-Employment Tax. We will also revise the 1999 versions of Publication 583, Starting a Business and Keeping Records, and Publication 334, Tax Guide for Small Business, to provide information about the time limit for posting self-employment income to SSA records. In addition, we plan to modify our nonfiler notices to make it clear to taxpayers that they will not receive social security credit for their earnings if they do not file their returns within the time limit.

We want you to know that for the past few years, one of our top priorities has been to improve the compliance of self-employed taxpayers. We already send nearly one million return delinquency notices annually to self-employed persons, advising them of their requirement to file and make estimated tax payments. We send three types of return delinquency notices to: a) taxpayers who were self-employed the previous

**Appendix III**  
**Comments From the Internal Revenue Service**

2

year based upon filing a Schedule SE (for tax year 1995, we sent 170,000 such notices); b) taxpayers with nonemployee compensation income (we sent 400,000 of these notices for tax year 1995); and c) taxpayers with an expired extension of time to file or a credit balance (200,000 of these for tax year 1995). We will modify these return delinquency notices to include specific language about the loss of social security credit if returns are not filed before the 3 years, 3 months, and 15 days deadline.

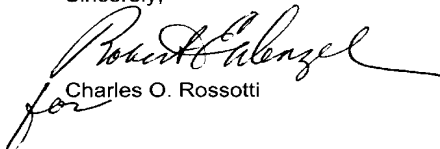
Recommendation 2: To reduce self-employment tax delinquencies, GAO recommends that the Commissioner of Internal Revenue undertake a pilot project to test the feasibility of sending notices to noncompliant self-employed taxpayers who in the current year had not made estimated payments and in the previous year owed self-employment taxes and were assessed an estimated tax penalty.

Comments: We plan to incorporate this recommendation into the National Nonfiler Strategy which we are currently developing. Under this strategy, we will improve compliance and service to taxpayers by emphasizing delinquency prevention. We have just selected an executive to head up the National Nonfiler Strategy. He will incorporate into the Strategy your recommendation to pursue a pilot research project to test the feasibility of sending reminder notices to noncompliant self-employed taxpayers. The Strategy will be in place by the end of this fiscal year.

Our comments regarding technical revisions that are needed in the narrative of your report are contained in the enclosure to this letter.

In conclusion, the Internal Revenue Service (IRS) actions outlined in this response are in keeping with my intention to take early steps to intervene in noncompliance cases and fit in with my efforts to modernize and reform the IRS. We look forward to working with you and your staff in the future to identify and implement additional enhancements to the way we do business so we can continue to administer our tax laws with integrity and fairness to all.

Sincerely,

  
for Charles O. Rossotti

Enclosure



# Comments From the Social Security Administration



## SOCIAL SECURITY

Office of the Commissioner

January 12, 1999

Mr. James R. White  
Director, Tax Policy and  
Administration Issues  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. White:

We appreciate the opportunity to comment on the General Accounting Office (GAO) draft report, "Tax Administration: Billions in Self-Employment Taxes Are Owed" (GAO/GGD-99-18).

The Social Security Act provides that the posting of self-employment earnings is generally conditional upon income tax returns being filed within a statutory time limit. We agree that increased efforts to let self-employed taxpayers know about the time limit could increase the number of taxpayers who file timely and who subsequently receive social security credits for their self-employment earnings. Accordingly, SSA will revise all of its publications on self-employment to include this information. Our enclosed comments describe specific implementation actions.

If you have any questions, please have your staff contact Sandy Miller at (410) 965-0372.

Sincerely,

A handwritten signature in black ink that reads "Kenneth S. Apfel".

Kenneth S. Apfel  
Commissioner  
of Social Security

Enclosure

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

**Appendix IV**  
**Comments From the Social Security Administration**

COMMENTS OF THE SOCIAL SECURITY ADMINISTRATION (SSA) ON THE  
GENERAL ACCOUNTING OFFICE (GAO) DRAFT REPORT, "TAX  
ADMINISTRATION: BILLIONS IN SELF-EMPLOYMENT TAXES ARE OWED"  
(GAO/GGD-99-18)

We appreciate the opportunity to comment on this draft report. We agree that increased efforts to educate self-employed taxpayers about the statutory time limit for filing self-employment (SE) income tax returns could increase the number of taxpayers who file in a timely manner and who subsequently receive social security credits for SE earnings. Specific implementation actions are described below. We are also providing information on one of the recommendations to the Internal Revenue Service (IRS).

GAO Recommendation to the Commissioner of SSA

Revise SSA's publications dealing with self-employed individuals to inform them about the need to file tax returns with SE earnings within 3 years, 3 months, and 15 days after the end of the calendar year (CY) in which the self-employed income was earned in order to get social security credit for those earnings.

SSA Comment

We agree. SSA revises its publications and fact sheets on a cyclical basis. We will include the revisions recommended by GAO in all publications for the self-employed when the publications are revised. The publication cited in the report, SSA Publication 05-10022: If You're Self-Employed, was recently revised and will be updated in the Fall of 1999 to include GAO's suggested language.

In addition, on a monthly basis, SSA prepares a public information package that is distributed to all Field Offices (FOs). This package includes, among other information, a newspaper column that the FOs provide to local newspapers as part of an ongoing column on Social Security matters. The column in the February 1999 information package will focus on self-employment issues and will include information on the statutory time limit as suggested by GAO.

GAO Recommendation to the Commissioner of IRS

Revise IRS' SE publications, including those given under its Non-Filer Program, to ensure that self-employed taxpayers know about the need to file tax returns with SE earnings within 3 years, 3 months, and 15 days after the end of the CY in which the self-employment income was earned in order to get social security credit for those earnings.

---

**Appendix IV**  
**Comments From the Social Security Administration**

2

SSA Comment

In September 1998 SSA was asked to review and comment on IRS Publication No. 533, "Self-Employment Tax." The publication was being revised to inform self-employed taxpayers of the need to file their tax returns within the statutory time limit in order to receive credit for their SE earnings. SSA concurred with the proposed revision.

# Major Contributors to This Report

---

**General Government  
Division, Washington,  
D.C.**

James M. Fields, Senior Social Science Analyst  
James J. Ungvarsky, Computer Specialist  
Elizabeth W. Scullin, Communications Analyst

---

**Health and Human  
Services Division,  
Washington, D.C.**

William J. Staab, Senior Evaluator  
Vanessa R. Taylor, Evaluator

---

**Office of General  
Counsel, Washington,  
D.C.**

Shirley A. Jones, Senior Attorney

---

**San Francisco Office**

Ralph Block, Assistant Director

---

**Kansas City Office**

Terry Tillotson, Evaluator-in-Charge  
Yong Meador, Evaluator  
Thomas N. Bloom, Computer Specialist

---

---

---

---

---

### **Ordering Information**

**The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.**

**Order by mail:**

**U.S. General Accounting Office  
P.O. Box 37050  
Washington, DC 20013**

**or visit:**

**Room 1100  
700 4<sup>th</sup> St. NW (corner of 4<sup>th</sup> and G Sts. NW)  
U.S. General Accounting Office  
Washington, DC**

**Orders may also be placed by calling (202) 512-6000 or by using fax number (202) 512-6061, or TDD (202) 512-2537.**

**Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touch-tone phone. A recorded menu will provide information on how to obtain these lists.**

**For information on how to access GAO reports on the INTERNET, send e-mail message with "info" in the body to:**

**[info@www.gao.gov](mailto:info@www.gao.gov)**

**or visit GAO's World Wide Web Home Page at:**

**<http://www.gao.gov>**

---

**United States  
General Accounting Office  
Washington, D.C. 20548-0001**

**Bulk Rate  
Postage & Fees Paid  
GAO  
Permit No. G100**

**Official Business  
Penalty for Private Use \$300**

**Address Correction Requested**

---

