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TAX ADMINISTRATION

IRS Can Better Pursue Noncompliant Sole Proprietors

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Chairman, Joint Committee on Taxation

The Honorable Samuel Gibbons
Vice Chairman, Joint Committee on Taxation
Congress of the United States

The Internal Revenue Service (IRS) estimated that noncompliance with income reporting by sole proprietors accounted for more than one-third of the $94 billion individual gross income tax gap for 1992.[1] The income tax gap is the difference between the amount of income taxes owed and the amount voluntarily paid.[2]

This report responds to your request that we (1) analyze the extent of noncompliance by type of sole proprietor; (2) review steps that IRS is taking to correct such noncompliance; and (3) identify additional steps, if any, that IRS could take to improve compliance.

Background

Sole proprietors are required to file a Schedule C (Profit or Loss From Business) with their Individual Income Tax Return Forms 1040 to report business income and expenses.[3] Using TCMP data, we estimated that about 13 million individuals filed a Schedule C for 1988.[4] In 1992, about 6.6 million individuals had Schedule C income as their primary source of income. IRS treats these individuals as sole proprietors when selecting returns to audit.

IRS relies on two ways to detect sole proprietor noncompliance—(1) auditing tax returns and (2) computer matching information returns to tax returns. IRS selects tax returns for audit by

[1]In this report, the term "sole proprietors" refers to self-employed individuals other than farmers.

[2]IRS issued its most recent tax gap estimate in 1988 using Taxpayer Compliance Measurement Program (TCMP) data from 1979 and 1982 and other IRS data. Under TCMP, IRS' examiners do detailed audits of tax returns for a random sample of taxpayers. During 1994, IRS will make new tax gap estimates based on the TCMP survey for tax year 1988 returns which was completed in 1992.

[3]In addition to those filing a Schedule C, sole proprietors also include nonfarm individuals who should have filed a Schedule C but did not (according to TCMP results).

[4]Unless otherwise indicated, all statistical data in this report are GAO estimates from IRS' 1988 TCMP data or IRS' tax gap estimates. Tax gap and TCMP estimates differ significantly. To account for noncompliance that TCMP is unlikely to identify, IRS' tax gap estimates include a multiplier for underreported income and an estimate for sole proprietors operating on an informal basis (i.e., informal suppliers). In contrast, TCMP estimates rely on actual changes made during the TCMP audit.

focusing on returns with the greatest chance for error and as part of special compliance programs. One compliance program involves audits done as part of district offices' Information Gathering Projects (IGP). An IGP focuses on a specific type of taxpayer or compliance issue to identify the nature of the noncompliance and corrective actions needed to reduce it.

IRS also may audit sole proprietor returns in its Compliance 2000 projects. These projects emphasize improving compliance in a selected market segment (i.e., homogeneous groups of taxpayers with similar behavior) by educating and assisting taxpayers before they become noncompliant. The underlying theme of the Compliance 2000 philosophy is that many taxpayers want to comply, but they may have difficulty doing so because of inadequate information or complexity of the tax laws. At the end of fiscal year 1992, IRS had 1,162 IGPs and 67 Compliance 2000 projects.

The second detection method involves computer matching. Third parties such as banks and other businesses are required to file annual information returns to report various payments made to individuals.[5] IRS then matches amounts reported on information returns against amounts reported on tax returns. After matching, IRS attempts to contact taxpayers about any discrepancies in the income reported on the tax return.

Results in Brief

Sole proprietors have a disproportionate share of noncompliance. Although they accounted for an estimated 13 percent of individual taxpayers, sole proprietors accounted for an estimated 40 percent of underreported total income by individuals in the 1988 TCMP—IRS' most recent. They also accounted for an estimated 36 percent of the $94 billion individual tax gap for 1992. Further, 1988 TCMP data showed that sole proprietors reported only 75 percent of their net business income while individuals reported almost 98 percent of nonbusiness total income, which we view as comparable to Schedule C net income. IRS believes that this higher compliance results from withholding and information reporting.

Even with these compliance disparities, we did not find a comprehensive linkage between IRS' compliance strategy and its compliance efforts for sole proprietors. While important as a conceptual frame of reference, this strategy is not a detailed operating plan for improving sole proprietor compliance and for linking disparate compliance efforts—such as audits,

[5]Businesses report payments to individuals on Forms W-2 for wages and 1099s for other income such as interest and dividends.

computer matching, and compliance projects—to each other and to the strategic goal of reducing the tax gap.

IRS' compliance efforts cover all types of taxpayers but have limitations. Because audits require many resources, they reach relatively few sole proprietors. In 1992, IRS audited only 2.3 percent of the 6.6 million individuals whose primary income was the sole proprietorship. This represented about 15 percent of all individual audits. Computer matching is limited because information returns are not required for much sole proprietor income. Information returns largely cover income that sole proprietors earn from providing services to other businesses but not from selling goods.

IRS also audits returns in its IGP and Compliance 2000 programs, which also have limitations. IRS often judgmentally selected compliance projects on the basis of local officials' knowledge and experience rather than more objective data, such as from TCMP or local studies and databases. As a result, IRS has little assurance that projects addressed the most significant compliance problems for the local area and beyond. Even if projects succeeded locally, IRS' system to consolidate and communicate the results was limited. IRS provided each district with a list of projects but not with information on the projects' scope or results.

IRS is developing new information systems to better identify the causes of noncompliance and target enforcement resources, but the systems are not expected to be fully implemented until after the turn of the century. IRS does not know whether they will produce the data needed to systematically improve sole proprietor compliance. IRS also plans to improve its 1994 TCMP so that local problems and causes can be identified. However, such data will not be available until at least 1998.

Meanwhile, IRS could better use existing TCMP data to identify the root causes of some sole proprietor noncompliance. Our analysis of TCMP data indicated that truckers were among the less compliant sole proprietors. The primary reason, as found in the TCMP workpapers, was inadequate books and records. IRS could work with the trucking industry to fix this problem. Similarly, TCMP workpapers indicated that unincorporated automobile body shops did not report all income from work done for businesses such as insurance companies. Although businesses are required to send information returns to the shops, the shops seldom received them. This suggests that IRS may need to work with businesses on sending these information returns.

Objectives, Scope, and Methodology

Our objectives were to (1) analyze the extent of noncompliance by type of sole proprietor, (2) review the steps IRS is taking to correct sole proprietor noncompliance, and (3) identify any additional efforts that IRS could take to address this problem.

To determine the extent of noncompliance, we analyzed IRS' TCMP data on sole proprietors for 1988—the most recent available—and IRS' tax gap estimates. To measure the noncompliance of sole proprietors, we determined that focusing on audit adjustments to their Schedule C net income was the most reasonable approach. We evaluated sole proprietor noncompliance by their audit class (IRS' current method of categorizing individual tax returns by income and type of return), major industrial group, and primary business activity within each industry group.

To review the steps IRS is taking to improve sole proprietor compliance, we interviewed IRS officials at the National Office, the Western Regional Office, the Fresno Service Center, and the San Francisco District Office. In the National Office, we talked to officials in the Examination, Taxpayer Services, and Research Divisions and to representatives responsible for Compliance 2000. We reviewed IRS documents and progress reports for Compliance 2000 projects and discussed IRS' plans for upgrading its computer systems through its Tax Systems Modernization (TSM) effort.

To identify additional steps that IRS could take to improve sole proprietor compliance, we first reviewed the workpapers from a judgmental sample of 115 TCMP sample cases. All 115 cases came from the 10 business activities that TCMP data suggested were among the least compliant and that had at least 100 or more cases and $10,000 in understated net income. For these sample cases, we defined least compliant in two ways—the estimated amount and percentage of net business income that was underreported. From this sample, we identified several promising issues, two of which we pursued—inadequate books and records among sole proprietors in the trucking industry and failure of insurance companies to file information returns on payments made directly to the sole proprietors of automotive body repair shops. Both truckers and automobile body shop owners were among the top 10 least compliant sole proprietors by industry in either their compliance rate or dollar value of noncompliance.

Focusing on these two issues, we selected a stratified random sample of 207 trucker cases from TCMP and reviewed the audit workpapers to determine whether inadequate books and records were a significant problem in the industry. In addition, we discussed the books and records issue with industry representatives from the American Trucking Association and the Independent Truckers Association. We also reviewed audit workpapers for 61 automobile body repair shops shown in the TCMP database to determine the extent to which insurance companies made payments directly to body shops and also reported those payments to IRS. Appendix I discusses our sampling methodology and statistical analysis.

IRS provided written comments on a draft of this report. These comments are presented and evaluated on page 16 and are reprinted in appendix IV. We did our fieldwork between November 1992 and February 1994 in accordance with generally accepted government auditing standards.

Many Sole Proprietors Are Noncompliant

Sole proprietors have been one of the least compliant segments of the individual taxpayer population. They often fail to comply with requirements of the tax system—to file a timely, accurate, and fully paid return. IRS' data showed the following:

- IRS' filer and nonfiler TCMPs showed that an estimated 2.6 million sole proprietors failed to file a Schedule C for 1988.[6] Of these, (1) 1.8 million did not file at all and (2) 751,000 filed a tax return but not a Schedule C.
- Unreported sole proprietor income accounted for an estimated $33.7 billion (36 percent) of the 1992 individual tax gap.
- For 1988, TCMP data indicated that individuals claiming sole proprietor income accounted for about $39 billion of the estimated $99 billion in underreported total income among all individual taxpayers.[7] Although they accounted for 40 percent of this noncompliance, these sole proprietors represented just 13 percent of all individual taxpayers.
- For 1988, 8.7 million sole proprietors understated their business income by an estimated average of $4,768. Another 1.4 million sole proprietors overstated their business income by an average of $1,656.
- Sole proprietors owed delinquent taxes totaling almost $11 billion as of January 1993. This was 15 percent of the assessed taxes owed by individuals.

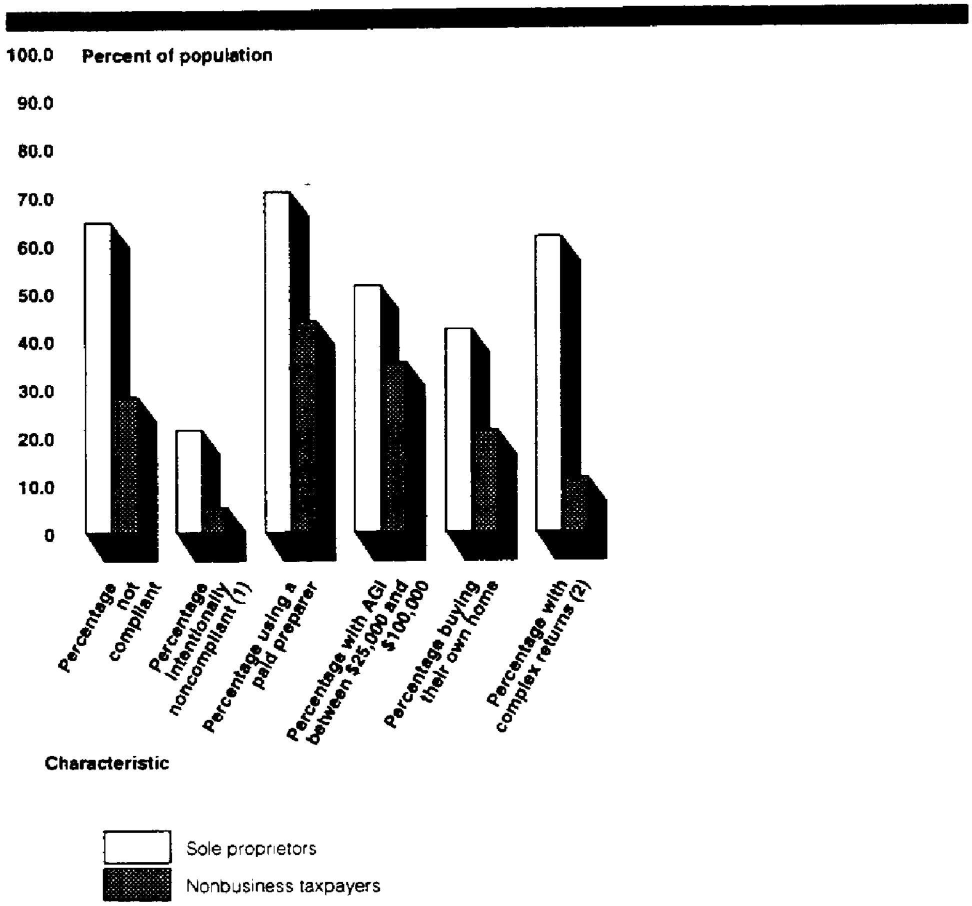
Sole proprietors materially differ from nonbusiness taxpayers. IRS' TCMP data show that they are less compliant, file more complex returns, appear

[6]IRS also does a nonfiler TCMP, most recently for 1988. To do this TCMP, IRS randomly selected Social Security numbers for which no tax return was filed in 1988. IRS then tried to contact the individuals and determine whether a return was required.

[7]The $39 billion in noncompliance resulted from sole proprietors understating their gross business income by an estimated $20 billion and overstating their business expense deductions by an estimated $19 billion.

to be intentionally noncompliant more often, and tend to be better off financially than nonbusiness taxpayers.[8] Also, sole proprietors are less likely to prepare their own returns. Figure 1 compares these and other characteristics of sole proprietors and nonbusiness individuals.

Figure 1: Comparison of Business and Nonbusiness Characteristics



Note 1: Intentional noncompliance is defined as noncompliance where a negligence penalty was assessed.

Note 2: Complex returns are defined as those having 2 or more schedules other than schedule B.

Source: 1988 TCMP database.

[8]IRS has no definition or criteria for intentional or unintentional noncompliance. On the basis of the Internal Revenue Manual's definitions, we believe that the existence of negligence penalties could be considered as reasonable indicators of taxpayer's intent.

A possible reason for compliance differences between sole proprietors and other individuals is that sole proprietors have a lower percentage of income reported on information returns. IRS has found taxpayers are more likely to report income on tax returns when that income is reported on information returns by third parties.

Sole proprietors' compliance may be more similar to compliance for small corporations (i.e., those with gross assets under $10 million) than for individual taxpayers. A comparison of TCMP data shows that neither small business group approaches the compliance level of nonbusiness individuals. Improvements in sole proprietor compliance have been inconsistent, fluctuating between an estimated 68 percent and 80 percent over the past 15 years. Small corporate compliance went from 81 percent in 1980 to 61 percent in 1987. Table 1 compares the voluntary compliance of small corporations in tax year 1987 to sole proprietors in tax year 1988.

Table 1: IRS Estimates of Small Corporation Compliance for 1987 and Sole Proprietor Compliance for 1988 by Industry

	Voluntary compliance level[a]	
Industry	**Sole proprietors[b]**	**Small corporations**
Services	85.1	48.0
Real estate, insurance, finance	84.4	62.9
Wholesale trade	82.8	65.4
Production	75.0	68.6[c]
Transportation and communication	68.9	60.3
Retail trade	67.8	55.5
Agricultural	65.6	74.4
U.S. average	79.8	61.1

[a]Voluntary compliance level, as a percentage, equals the amount of tax reported divided by this amount and additional tax recommended after audit. Sampling error for sole proprietors is less than plus or minus 10 points at the 95 percent confidence level. No sampling errors were provided for corporations.

[b]These percentages reflect recommended tax increases resulting from adjustments to all return items, not just those from the Schedule C.

[c]The production category includes the corporate categories of mining, manufacturing, and construction.

Source: The IRS Research Bulletin, 1992.

Reasons for the higher compliance rate among sole proprietors in the service industry are not known, although IRS officials believe information reporting could explain it. Much of the income from providing services is subject to information reporting. In other industries, such as retail and manufacturing, very little sole proprietor income is subject to information reporting.

The value of information reporting also applies to compliance among small corporations. Corporations generally are not subject to information reporting. As table 1 shows for the service industry, small corporations had only a 48 percent compliance rate compared to 85 percent for sole proprietors.

Across all industry groups, IRS separated sole proprietors into 173 types based on principal business or professional activity code. Compliance in reporting income varied widely by activity code in the 1988 TCMP.[9] For example, doctors voluntarily reported an estimated 95 percent of their net business income. On the other hand, eating places—one of the less compliant groups—reported an estimated 39 percent of this income.[10]

Relying on one compliance measure, however, to devise programs to enhance compliance can be misleading. A fuller analysis of the TCMP database and workpapers could offer insights on the nature and causes of noncompliance among sole proprietors.

Sole Proprietor Compliance Efforts Did Not Link Together Systematically

Inconsistent improvement in the compliance of sole proprietors in reporting income and deductions since at least 1979 suggests that IRS' compliance efforts have not been sufficient. IRS has recently developed a broad strategy for improving compliance, which includes identifying critical compliance issues and directing regions to develop projects to implement the strategy. At the working level, IRS has used audits, computer matching, and projects to identify sole proprietor noncompliance. However, these specific efforts have not been integrated into a cohesive program that links with this broad strategy.

Even without this linkage, IRS' new strategy and compliance efforts have constraints. This compliance strategy identified eight critical issues of which just one—cash businesses and self-employed taxpayers—related to sole proprietor compliance in Schedule C reporting. But national direction and monitoring of regional efforts to implement the strategy have been

[9]Table II.1 in appendix II provides details on reporting rates for the 46 types of businesses in which IRS audited at least 100 TCMP returns. We limited most analyses to these 46 because the estimates were more likely to be statistically reliable. Even so, comparisons across businesses may not be meaningful because confidence intervals for the point estimates might overlap.

[10]The sampling errors for the percentage of underreported net business income are plus or minus 15 points for doctors and plus or minus 22 points for eating places at the 95 percent confidence level.

limited. Moreover, each specific compliance effort, such as audits, has limits to how it can address compliance problems.

Audits and Computer Matching Have Limitations

The audit has been a key enforcement tool to identify and correct noncompliance among sole proprietors. However, audits require many resources, and with IRS' limited enforcement resources, its audit rate is low. According to IRS' fiscal year 1992 annual report, IRS audited 151,000 of the 6.6 million returns (2.3 percent) in which the sole proprietorship provided the individual's primary source of income.[11] Staff available for sole proprietor audits may have been reduced in fiscal year 1993 because IRS shifted over 2,200 audit staff years to pursue nonfilers, a group that accounted for less than 11 percent of the 1992 tax gap.

Though helpful, audits alone cannot resolve sole proprietor noncompliance. IRS has not had enough resources to pursue all noncompliant sole proprietors. According to TCMP data, to audit just sole proprietors who understated net income by $10,000 or more would require that IRS audit at least seven times as many returns from sole proprietors as it audited in 1992. This assumes that IRS could accurately target the least compliant returns in order to have a no change rate of 0 percent.[12] The current no change rate for sole proprietor returns averages over 11 percent.

IRS has successfully used computer matching to identify noncompliance among nonbusiness individuals. For sole proprietors, IRS' match is limited because not all types of sole proprietor income are required to be reported on information returns. Information reporting is generally required for transactions between businesses for services, such as legal and accounting advice. On the other hand, reporting is not required on the sale of goods such as groceries.

Because of such limitations, IRS' computer matching program cannot identify all noncompliant sole proprietors. For example, in the matching program for tax year 1989, the most recent data available, IRS identified 327,064 sole proprietors who underreported Schedule C income. TCMP results indicate the number of sole proprietors that underreport this income exceeded 8 million for 1988. Also, matching for 1991 identified

[11]IRS has no summary information on audits of sole proprietors whose primary income is from a source other than the Schedule C.

[12]The no change rate is the percent of returns in which audits result in no change to the taxes owed.

over 730,000 sole proprietors who did not file a tax return, but 1988 TCMP data suggested that the number exceeded 1,000,000.

Effectiveness of Compliance Projects Is Limited

At the end of fiscal year 1992, IRS had over 1,200 compliance projects, including IGPs and Compliance 2000 initiatives, to identify and correct noncompliance among particular groups of taxpayers. These projects have had limited value in correcting sole proprietor noncompliance for various reasons.

We found that few of these special projects addressed Schedule C reporting compliance by sole proprietors. IRS had 67 Compliance 2000 projects at the end of fiscal year 1992, of which only 11 (16 percent) involved reporting compliance by sole proprietors. Of the 1,162 IGPs open at the end of fiscal year 1992, IRS could not tell us exactly how many dealt with sole proprietor reporting compliance. IRS was able to collect data from four regions.[13] Using such data, we identified 672 IGPs, of which only 56 (8 percent) involved Schedule C reporting compliance.

We found that IRS had not always selected these compliance projects by using objective data. Instead, projects were selected by field staff relying on their experience or perceptions or on leads from outside sources. This may result in these projects being misdirected. For example, less than half of the 56 IGPs targeted sole proprietors that TCMP data showed to have the lowest compliance.

While it is still too early to have results from the Compliance 2000 prototypes, many of the IGPs involving Schedule C compliance have been unproductive. In almost two-thirds of the 56 IGPs terminated during fiscal year 1992 in the 4 regions for which we had data, the suspected noncompliance did not materialize, or the results did not justify the time spent. Such data suggest that these projects are not targeting the least compliant industries.

Even when IGPs were productive, IRS did not effectively communicate IGP results throughout the agency. We also discussed this problem in an

[13]IRS' National Office does not maintain detailed information on IGPs. We asked National officials to survey IRS regional offices for such information. When we finished our work, five of seven regions had responded. Information from one region was not useable because it provided data from a different fiscal year.

April 1990 report to Congress.[14] While some communication does occur, this process is not systematic.

For example, IRS officials stated that regional officials have the option of sending the information to either the National Office or to other regional offices. They also said a list of open IGP titles is disseminated annually, and field staff use this list to keep abreast of IGP activities in other offices. However, we found this listing to have little value. Titles were vague, usually making it difficult to identify the strategic issue being addressed. These informal systems did not ensure that important IGP results were available throughout IRS.

IRS' National Office has taken a more active role in monitoring Compliance 2000 projects. The National Office receives progress reports on Compliance 2000 prototypes and has begun to hold seminars with IRS staff throughout the country to share information on key compliance issues. However, IRS officials told us they had not yet developed an ongoing system to consistently communicate the progress and results of Compliance 2000 projects.

IRS' ongoing reorganization, which consolidated all compliance functions into one core office, presents IRS with an opportunity to address sole proprietor compliance problems in a systematic and coordinated manner. This compliance office could gather information on the many compliance projects, identify those that are worthwhile, and incorporate them into a strategy directed at improving sole proprietor compliance. However, it is too soon to determine how this reorganization will affect sole proprietor compliance.

At the same time, IRS hopes to develop new information systems to support its compliance strategy. As part of its computer upgrades under TSM, IRS is developing an Automated Issue Identification System (AIIS), which it hopes will improve the selection of returns for audit. Other systems are being designed to obtain and analyze data by market segments. Under the market segment approach, IRS puts taxpayers with common filing characteristics or behavior into groups so that similar corrective actions can be undertaken for the entire group. Because these systems are still being developed, it is too early to know whether they will improve sole proprietor compliance. Appendix III discusses some of these new systems.

[14] Tax Administration: Profiles of Major Components of the Tax Gap (GAO/GGD-90-53BR, Apr. 4, 1990).

IRS Can Better Use Existing Data to Improve Sole Proprietor Compliance

IRS will be implementing its planned computer system upgrades and new compliance strategies throughout the next decade. Given existing levels of noncompliance, IRS cannot afford to wait until all its new systems are on line to better focus its compliance efforts. Instead, IRS needs to better use existing objective data to identify pockets of sole proprietor noncompliance and determine the causes.

The TCMP database and workpapers offer large amounts of objective data on national sole proprietor noncompliance. Although it is not shown in the database, information on causes can be found in TCMP workpapers. By reviewing the workpapers for two market segments with significant noncompliance, we obtained deeper insights into the nature and causes of the compliance problem.

Knowing the causes of noncompliance would allow IRS to better focus its compliance efforts and corrective actions for national market segments that TCMP found to be noncompliant. In its next TCMP, IRS plans to obtain data on compliance that will allow projections to the local level as well as identify causes using the database rather than just workpapers. These TCMP results will not be ready until 1998 at the earliest.

To test the usefulness of existing TCMP data to identify causes for noncompliance, we analyzed returns from what appeared to be the 10 least compliant sole proprietor industries in the 1988 TCMP. Our analysis suggested several causes for noncompliance in these industries, including inadequate books and records and the absence of required information reports on payments made to automotive body repair shops.

Inadequate Books and Records

Our initial analysis of the TCMP workpapers showed that sole proprietors in the trucking industry often failed to keep adequate books and records. To determine the extent of this problem, we selected a stratified random sample of 207 trucking industry sole proprietors. We analyzed the TCMP workpapers to determine, where possible, the reasons for noncompliance. Using this sample, we estimate that over 66 percent of noncompliant truckers have inadequate books and records, which hampers their ability to track income and expenses.[15] As a result, these truckers did not fully support some of the claims made on their tax returns, distinguish between

[15]All taxpayers are required by law to maintain adequate books and records to allow for the preparation of a proper return. The taxpayer is to maintain permanent books of accounts and records sufficient to establish the amounts of gross income, deductions, credits, or other matters to be shown on the taxpayer's return.

personal and business expenses, or claim all the expenses they were entitled to deduct. For example:

- One sole proprietor deducted close to $20,000 in Schedule C expenses for items ranging from wages to repairs and supplies. Due to inadequate books and records, the taxpayer could substantiate only $2,000 of these expenses. As a result, the taxpayer was assessed over $2,500 in additional income taxes.
- Due to inadequate books and records, a sole proprietor had not separated insurance payments for the business from those for personal use and deducted all insurance payments as business expenses. By interviewing the taxpayer, the auditor determined that this taxpayer used his vehicle for both business and non-business purposes. The auditor disallowed almost 25 percent of the $4,500 deduction as being personal. This particular change resulted in additional income taxes of about $150.

Inadequate books and records also can cause a sole proprietor to pay more taxes than required. In one case, a sole proprietor failed to deduct any expenses for meals while traveling for the business. The auditor determined that the taxpayer had been on the road for 158 days during 1988 and allowed a $1,770 deduction for meals expenses, based on the $14 per diem rate that is allowed. This adjustment reduced the tax liability by over $250.

Our analysis of TCMP workpapers suggested that IRS could use a nonenforcement approach to improve the compliance of the trucking industry. One approach would be to help develop a set of prototype books and records along with clear instructions aimed specifically at the trucking industry. This approach would provide truckers with a format for keeping track of income and expenses for key Schedule C line items, and the instructions would clearly identify the requirements for deductible expenses and documentation, giving particular emphasis to line items where TCMP data indicate truckers had the greatest problems.

IRS provides some guidance on keeping books and records for small businesses. However, this guidance is not directed at specific industries and their particular problems. IRS has developed an audit technique guide for trucking companies. Although we found that this guide provides information on accounting requirements and record keeping, it focused on large trucking companies. Sole proprietors who could benefit from this guide must request it, assuming that they know the guide exists. IRS officials said taxpayers could obtain copies of this guide only by filing a

Freedom of Information Act request. However, we believe that to effectively reach target populations, IRS may need a proactive approach, such as working with industry groups or providing guidance to all taxpayers within the industry.

We discussed this proactive approach with representatives of the trucking industry, who believed that having this guidance would help truckers become more compliant. Officials from the American Trucking Associations and the Owner, Operator, and Independent Drivers Association indicated a willingness to help develop a prototype and help disseminate the guidance to their members. This approach would be consistent with IRS' Compliance 2000 philosophy.

Information Returns for Automobile Body Shops

During our review of TCMP workpapers, we noted that automobile body shops received few information returns, even though many were paid directly by insurance companies. Insurance companies and other businesses are required to submit information returns for service payments of $600 or more made directly to sole proprietors operating automobile body repair shops.

We reviewed TCMP workpapers for 61 automobile body shops in the TCMP database. In 48 cases, the workpapers contained some information on payments made to the automobile body shop by insurance companies or other businesses. On the basis of information in the TCMP workpapers and IRS' information returns data, we estimated that $5.4 million of the $8.2 million in gross receipts for these 48 automobile body shops should have been reported to IRS on information returns.[16] The data also showed that only $1.1 million of this estimated $5.4 million was reported on information returns by insurance companies and other businesses.

To determine the extent to which insurance companies report payments for repair of physical damage to automobiles, we reviewed a sample of information returns data for 10 insurance companies.[17] Overall, these 10 insurance companies reported about 19 percent of their total payments to automobile body shops. However, for various reasons, we could not determine what portion of these payments were required to be reported on

[16]We did not project the results to the total population of automobile body shops because the TCMP database had too few cases to yield adequate precision for estimation purposes.

[17]The insurance companies were selected judgmentally from companies listed on the Statistics of Income database. The 10 companies were selected based on their size, location, and payments for auto damage claims, according to an industry report (A.M. Best Insurance Report, Property and Casualty).

information returns. For example, insurance companies are not required to report automobile body repair payments made to body shops organized as corporations.[18]

Although we could not tell whether insurance companies and other businesses filed all required information returns, the TCMP workpapers suggested that they did not file all required returns. IRS may need to clarify the information reporting requirements and work with payors to ensure that they understand their information return reporting responsibilities. IRS may also need to develop a compliance program to ensure that information returns are being filed properly.

Conclusions

Noncompliance in reporting sole proprietor income represents a significant challenge for IRS. Such noncompliance spreads over a majority of the estimated 13 million sole proprietors and creates an estimated tax gap of $34 billion a year. Over the past 15 years, sole proprietors' rate of noncompliance has fluctuated with little evidence that IRS' current compliance efforts, such as its many compliance projects, will prompt significant improvements.

IRS' broad strategy for improving compliance has not linked these diverse compliance efforts. Further, IRS' compliance projects are not as effectively managed as they could be. Currently, IRS depends on its field offices to select and implement the projects. Even if projects are successful, the mechanisms to disseminate their results throughout the agency are weak. If IRS improved its project selection process by making it more data-driven and developed the infrastructure to communicate the results, it could address sole proprietor compliance problems more effectively.

The TCMP database and workpapers contain valuable information that IRS is not fully using to identify the source and causes of sole proprietor noncompliance. The TCMP workpapers can be used to indicate the root causes of sole proprietor noncompliance and assist IRS in designing programs to improve compliance. We used this approach to identify sole proprietor compliance issues during our review. We believe that IRS could use the same approach to develop a more comprehensive sole proprietor compliance program.

[18]In the spring of 1993, the administration proposed the Service Industries Compliance (SINC) initiative. SINC would have required that payors report all payments made to independent contractors, even those incorporated. Treasury estimated that SINC would bring in $5 billion in additional taxes over 5 years, whereas the Joint Committee on Taxation estimated that it would bring in less than $0.5 billion.

Our analysis illustrates how TCMP workpapers can help to identify possible causes for specific noncompliance. In analyzing TCMP workpapers, we identified two sole proprietor noncompliance issues—books and records for truckers and insurance company compliance with information reporting requirements. IRS could improve compliance in the two industries by pursuing these issues.

Recommendations

We recommend that the Commissioner of Internal Revenue take the following actions:

- Develop a system for managing and monitoring all sole proprietor compliance projects, linking them to IRS-wide plans, and disseminating their results throughout IRS.
- Use existing TCMP information, including workpapers, to help identify projects that would address the most noncompliant sole proprietor market segments on a nationwide basis and analyze the underlying causes of noncompliance.
- Work with trucking industry groups to improve record keeping and with other sectors where TCMP indicates that record keeping may be a problem.
- Clarify information return filing instructions for insurance companies and work with these companies to improve compliance with information reporting requirements.

IRS Comments and Our Evaluation

In a June 13, 1994, letter, the Commissioner of Internal Revenue commented on our recommendations. This section summarizes these comments and our evaluation of them. IRS' comments are reproduced in appendix IV.

First, IRS pointed to efforts that address our recommendation on developing a system for managing and monitoring sole proprietor compliance projects. IRS said it has produced the Business Master Plan (BMP), which links IRS' strategic objectives and business vision with tactical actions needed to accomplish them, including actions to improve sole proprietor compliance. IRS said its compliance research and analysis system, under development through fiscal year 1997, will be the driving force behind compliance and enforcement activities.

We strongly support IRS' expanded use of planning and research to identify and correct noncompliance. Our concern still centers on linking specific compliance actions such as IGPS to broad plans such as BMP. In reviewing the BMP, we did find broad linkages between general actions and performance goals. For example, BMP cites the action of developing a strategy to improve compliance among cash and privately owned businesses. However, the BMP has no specific references to IGPs and other actions for improving compliance among sole proprietors. Without such specific linkages, IRS cannot tell how efforts such as IGPs or projects coming from the new research efforts advance the objectives in the plans. Because the BMP deals with general actions and goals, making these specific linkages at some level below the BMP could meet the intent of our recommendation.

Also, we believe that IRS should develop a system to monitor compliance actions such as IGPs. Although such a system would cost some money, it could save resources by identifying unneeded duplication among the 1,162 IGPs. It also could identify audit techniques to apply across districts, allowing IGP resources to be used more efficiently.

For our second recommendation on using TCMP data and workpapers to identify projects that address the most noncompliant sole proprietors, IRS pointed to plans to use TCMP data. IRS said its National and District Office Research and Analysis staffs will use TCMP and other data to identify and profile market segments that represent 25 percent of all cash and privately owned businesses. IRS also noted that it will use TCMP data to develop strategies to address noncompliance and improve compliance among these market segments and businesses.

We are encouraged that IRS' research staffs will use TCMP data. On the basis of discussions with IRS Examination officials, we now focus our recommendation on using TCMP data at the national level. IRS districts could use such results to help craft compliance projects for noncompliant market segments.

However, IRS' letter did not indicate whether it would use either the existing TCMP data or the TCMP workpapers. We believe IRS should use both. Because the new TCMP for 1994 will not be completed until late 1998 according to BMP, existing TCMP data offer the best objective compliance data. Also, we found that analyzing samples of TCMP workpapers can help uncover possible causes of sole proprietor noncompliance. In developing ways to automate the new TCMP data, IRS may wish to consider including information from the TCMP workpapers. Such automation could increase IRS' ability to access available information for identifying and understanding the causes of noncompliance.

IRS disagreed with our recommendation to work with the trucking industry on problems with books and records. IRS said various stores and libraries already offer information on keeping books and records. Although these sources also offered such information prior to the 1988 TCMP, this TCMP showed that truckers did not have adequate books and records. IRS also stated that such information and assistance was often available from paid preparers. Even so, the TCMP data showed that sole proprietors using paid preparers other than certified public accountants were less compliant than those preparing their own returns.

IRS also said it would be difficult to create prototype books and records for every industry. We agree. As a result, we recommended working with the trucking industry and other industries if available data pointed to a problem with keeping books and records. Our work identified this problem among truckers and a willingness among trucking industry officials to work with IRS on solutions. We refined our recommendation to emphasize working with industry officials. IRS' letter referred to a similar approach. IRS said if an industry had unique recordkeeping issues, it would use a Compliance 2000 approach in working with that industry. We believe that our recommendation mirrors this approach.

IRS agreed with our recommendation to clarify information reporting requirements for insurance companies making payments to automobile body shops. IRS noted that the instructions need to be clarified and insurance companies need to be made aware of the information reporting requirements.

As agreed with the Committee, unless you publicly release 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 Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We also will make copies available to others upon request.

This report was prepared under the supervision of Natwar M. Gandhi, Associate Director. Major contributors to the report are listed in appendix V. If you have any questions, please contact me at (202) 512-5407.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy
and Administration Issues

Contents

Figure

Abbreviations

BMP	Business Master Plan
CRIS	Compliance Research and Information System
DORA	District Office Research and Analysis
IGP	Information Gathering Project
IRS	Internal Revenue Service
MSSP	Market Segment Specialization Program
SINC	Service Industries Compliance
TCMP	Taxpayer Compliance Measurement Program
TSM	Tax Systems Modernization

Statistical Sampling Methodology and Precision of Estimates

This appendix describes the statistical sampling methodology we used to identify reasons for noncompliance among truckers and how we estimated the amount of casualty payments by insurance companies that were reported to IRS on information returns. We analyzed our sample data to determine the cause of noncompliance among truckers and projected these results to the total population of truckers represented by TCMP. We also analyzed a sample of information returns prepared by insurance companies to determine the extent to which the selected insurance companies had reported auto-related casualty payments to IRS.

The statistical estimates in the report are point estimates that are weighted to account for strata size. Point estimates alone are not adequate representations of statistical results because statistical estimates correspond to range estimates, referred to as the precision of the estimates, stated at a 95 percent confidence level. The narrower a confidence interval, the more reliable a point estimate becomes as being representative of the population. The precision of estimates varies with sample size, variability of sample observations, and the characteristics of the sampling process.

Statistical Estimates on Reasons for Noncompliance Among Truckers

The data we used came from IRS' 1988 Individual TCMP database and the Examination workpapers associated with these files. The TCMP file is a stratified, nationwide IRS sample that included 54,095 tax returns in 32 strata. The IRS strata are defined by taxpayer income and type of return filed. IRS staff audited each tax return selected for the TCMP sample to determine whether the correct taxes had been computed.

We focused on the 17,048 TCMP sample returns that involved a Schedule C for reporting income from a sole proprietorship. As part of our survey, we looked at TCMP audit results for a sample of tax returns from the 10 least compliant types of sole proprietors as indicated by the 1988 TCMP sample. We defined least compliant as those sole proprietors on whose returns the TCMP audits identified the (1) greatest amounts of underreported net Schedule C income and (2) largest percentage of underreported Schedule C net income. On the basis of our review of TCMP workpapers for this sample, we identified several issues, including indications that certain types of sole proprietors, such as truckers, appeared to have problems maintaining adequate books and records.

On the basis of our survey results, we focused on the 517 returns from truckers that involved 25 of the 32 TCMP strata. By eliminating strata that had fewer than 3 returns, we were left with 510 trucker returns in 19 strata. The remaining sample cases represent about 91 percent of the nationwide population of truckers. From these 510 returns, we randomly selected a subsample of 207 tax returns, including (1) all returns in strata with 5 or fewer returns; and (2) 5 returns, or 30 percent of the returns, whichever is greater, from each strata with more than 5 returns. We were able to obtain and review the workpapers for 190 of the sampled returns. Of the 17 returns not reviewed, 2 did not involve a trucker because the auditor had miscoded the industry type. IRS could not provide workpapers for the other 15 sampled returns.

For the 190 tax returns, we analyzed the reasons for noncompliance by reviewing TCMP data and the workpapers. On the basis of these 190 tax returns, we analyzed a population of an estimated 251,836 tax returns. Table I.1 presents point estimates and confidence intervals for estimates on variables involving the reasons for noncompliance in the trucking industry.

Table I.1: Reasons for Noncompliance by Truckers

		95-percent confidence interval	
Reason for noncompliance	Percent of returns where variable occurred	Lower limit	Upper limit
Apparently intentional tax avoidance	17.0	10.0	24.1
Books and records	66.3	55.1	77.5
Problem caused by paid preparer error	33.7	25.3	42.2
Technical issues	10.4	5.3	15.6
Other or unknown	15.8	9.1	22.7

Source: Random sample taken from IRS' 1988 TCMP database

Statistical Estimates of Casualty Payments by Insurance Companies

On the basis of our review of TCMP workpapers, we were concerned that insurance companies were not filing information returns to report payments made directly to automobile body shops. To determine how often insurance companies were filing information returns with IRS, we obtained information returns data for a judgmental sample of 10 insurance companies from those listed in IRS' Statistics of Income database. The 10 companies were selected because of their size and location and because they had made payments for automobile damage claims. The information returns data consisted of transcripts, with each page containing four information return entries. The transcripts showed information on the payor, the payee, and the type and amount of the payment.

For seven of the insurance companies, we reviewed all the information return data provided by IRS. Given the amount of data (over 95,000 pages), we selected a simple random sample from the remaining 3 companies and estimated the total amount paid. To select the sample, we first determined the number of pages that had relevant information return data. Starting from a randomly selected page, we selected a sample of these pages. Table I.2 provides information on this sample selection for the three companies.

Table I.2: Estimated Amount of Payments Reported to IRS by Insurance Companies

Company	Sample size	Estimated payments reported to IRS	95-percent confidence interval: Low estimate	95-percent confidence interval: High estimate
1	447	$ 99,844,661	$ 98,606,587	$101,082,734
2	539	763,289,000	757,030,030	769,547,969
3	523	247,895,868	244,970,696	250,821,039

Source: IRS' Information Returns Master File.

Statistical Information for Estimates

Table I.3 and I.4 provide various statistical information on estimates we cite in the report.

Table I.3: Statistical Information for Number and Dollar Estimates

Dollars in thousands

Description	Point estimate	95-percent confidence interval	
		Lower limit	Upper limit
Number of Schedule C filers	$13,417,055	$13,154,081	$13,680,029
Total taxpayers	104,345,615	104,338,501	104,352,729
Sole proprietor nonfilers	1,814,775	1,556,895	2,072,655
Underreported income for sole proprietors	$39,042,552.3	$37,052,943.9	$41,032,160.8
Sole proprietors with no Schedule C	750,924	597,017	904,831
Number of sole proprietors who underreported income	8,674,371	8,386,180	8,962,563
Average amount of understated income	$4.768	$4.565	$4.856
Number of sole proprietors overstating income	1,400,231	1,272,940	1,527,521
Average amount of overstated income	$1.656	$3.722	$1.365
Underreported total income for all taxpayers	$98,722,878	$96,787,910	$100,657,847
Number of taxpayers who underreported income	34,352,258	33,628,362	35,076,154

Source: IRS' 1988 TCMP databases for filers and nonfilers.

Table I.4: Statistical Information for Percentage Estimates

Description	Point estimate	95-percent confidence interval	
		Lower limit	Upper limit
Reporting rate for sole proprietor net income	75.2	71.4	79.1
Sole proprietor underreported net income as a percent of underreported total income	39.6	37.5	41.6
Voluntary reporting percent for nonbusiness total income	98.0	93.0	103.0
Percent of noncompliant sole proprietors	64.6	61.3	67.9
Sole proprietors as a percent of the population	12.9	12.6	13.1
Percent of all taxpayers who underreported income	32.9	30.8	35.0

Source: IRS' 1988 TCMP database for filers.

Characteristics of Sole Proprietor Compliance

Table II.1: Reporting Rate by Primary Business Activity—With at Least 100 Observations

Understated net income dollars in millions

Primary business activity	Reporting rate (percent)[a]	Percent sampling error (plus or minus)[b]	Dollar amount of understated net income	Sampling error for income (plus or minus)[b]
Antique dealers	32.7	67.3	$93.1	$46.3
Eating places	39.2	21.7	1,309.6	363.5
Grocery stores	45.9	16.6	711.5	191.9
Used car dealers	50.4	40.4	386.5	220.4
General auto repairs	55.2	16.2	605.5	199.0
Lumber and wool products	56.5	17.3	505.5	202.1
Door to door sales	57.3	18.8	586.3	156.3
Sales—nondurable goods	58.3	23.9	516.3	322.3
Specialty auto repairs[c]	59.2	15.5	509.4	151.7
Landscaping	60.8	18.8	471.1	161.5
Other retail stores	61.5	32.2	478.9	151.2
Plumbing, heating, and air conditioning	63.6	15.4	720.5	281.1
Other building trades	64.3	13.0	987.3	261.7
Trucking	64.5	12.9	1,568.5	367.3
Painting	64.6	12.8	771.2	304.7
Residential building	65.8	13.6	1,118.0	401.0
Performers	66.1	31.8	420.2	156.2
Other personal services	66.3	14.1	1,083.1	265.2
Unable to classify	66.9	32.6	454.4	263.9
Janitorial	67.4	13.8	627.6	210.0
Service stations	68.6	26.2	417.8	149.7
Roofing	69.1	22.4	380.5	132.3
Sales—durable goods	69.4	22.7	706.7	496.2
Child day care	70.1	26.7	321.2	112.8
Carpentry	71.2	9.1	1,572.4	323.7
Other equipment repair	71.9	22.5	277.7	116.8
Other recreational services	72.1	40.9	154.9	61.5
Electrician	72.1	21.7	415.9	151.6
Masonry	73.1	17.0	642.8	187.5
Beauty shop	76.9	14.8	432.9	128.9
Other business services	77.0	12.5	2,017.9	475.8
Other real estate	79.3	21.3	521.4	265.4
Teaching	80.7	31.8	198.0	78.6
Realtors	82.1	11.9	1,404.5	274.2

(continued)

Understated net income dollars in millions

Primary business activity	Reporting rate (percent)[a]	Percent sampling error (plus or minus)[b]	Dollar amount of understated net income	Sampling error for income (plus or minus)[b]
Computer/data processing	83.3	31.8	234.1	111.7
Engineering	83.9	19.6	549.3	259.6
Agent—durable goods	85.9	18.8	387.3	171.0
Insurance	86.7	13.6	762.0	256.1
Management consulting	87.8	16.7	771.6	290.2
Ministers	88.7	17.7	229.8	112.3
Other health services	88.7	22.5	235.7	85.1
Accounting	89.9	22.2	238.8	84.6
Attorneys	90.7	19.1	751.5	290.0
Dentists	92.1	16.7	321.3	98.5
Oil and gas	93.8	93.8	158.9	99.8
Doctors	95.0	15.1	602.9	333.3
All Schedule C filers	75.3	[d]	$39,042,535	$1,820.7

[a]The reporting rate is the reported net business income as percent of net business income found by the IRS auditor.

[b]Sampling errors calculated at the 95-percent confidence level.

[c]Includes automobile body repair shops.

[d]Not available; sampling error not calculated for total population.

Source: 1988 TCMP database.

Table II.2: Amount of Understated Net Income for Noncompliant Sole Proprietors

Amount of understated net income	Number of sole proprietors[a]	Confidence interval at 95 percent	
		Lower limit	Upper limit
$1 to $500	2,330,758	2,148,873	2,512,643
$501 to $1,000	1,086,032	968,329	1,203,735
$1,001 to 5,000	3,204,854	3,024,114	3,385,595
$5,001 to $10,000	980,150	898,404	1,061,895
Over $10,000	1,072,578	998,468	1,146,687
Total	**8,674,372**	**8,600,372**	**8,748,372**

[a]The remaining 4,757,999 sole proprietors had either no changes on their Schedule C or overstated their net income.

Source: 1988 TCMP database.

Table II.3: Reasons Given by IRS Examiners for the Primary Type of Noncompliance by Sole Proprietors

Reason for noncompliance	Number of returns	Sampling error returns (plus or minus)	Percent of total
Lack of substantiation	1,582,896	133,123	27.5
Wrong accounting or computation procedures	1,253,694	103,855	21.8
Tax preparer error	1,119,726	106,658	19.4
Lacked tax law knowledge	1,022,246	114,572	17.7
Multiple interpretations possible	316,289	53,606	5.5
Some other reason	448,578	76,597	7.8
Total changes without penalty	**5,743,429[a]**	[b]	**100.0**

[a]The remaining 7,686,403 sole proprietors had either no changes on their tax returns or were assessed penalties.

[b]Not available, sampling error not calculated for total percent.

Source: 1988 TCMP database.

Table II.4: Comparison of Sole Proprietor Returns With and Without Increases in Net Income Resulting From TCMP Audits

Description	Compliant[a]	Noncompliant[a]
Average gross receipts	$28,425	$55,892
Sampling error (plus or minus)	3,154	1,484
Average net income	7,388	14,180
Sampling error (plus or minus)	1,257	414
Average Schedule C income as a percent of adjusted gross income	16.7%	33.9%
Sampling error (plus or minus)	0.6%	0.5%

[a]Compliant taxpayers are those whose reported Schedule C net income was equal to or greater than that found by IRS during the TCMP audits. Noncompliant taxpayers are those whose net income was less than that found by IRS.

Source: 1988 TCMP database.

Table II.5: Estimate of Voluntary Reporting Percentage and Dollar Amount of Noncompliance for Selected Schedule C Line Items

Line item	Voluntary reporting percent[a]	Sampling error percent (plus or minus)[b]	Understated dollar amount	Sampling error in dollars (plus or minus)
Gross income	94.6	3.0	$19,931	$16,087
Deductions				
Advertising	107.3	6.3	352	435
Bad debts	145.1	37.0	194	198
Bank charges	113.0	16.6	81	81
Car and truck expenses	118.3	4.2	2,650	827
Commissions	103.9	16.1	245	1,498
Depletion	99.7	58.6	(1)	395
Depreciation	108.8	4.7	1,869	1,350
Dues and publications	112.6	5.7	232	141
Employee benefit programs	114.5	31.4	82	236
Freight	102.3	40.1	28	666
Insurance	115.0	4.1	1,525	547
Mortgage interest	110.0	14.0	431	819
Other interest	109.6	15.6	507	1,169
Laundry and cleaning	127.8	13.2	197	127
Legal and professional	117.7	8.7	638	420
Office expenses	113.6	5.8	587	332
Pension and profit sharing plans	108.5	42.5	34	236
Rent	107.3	4.6	1,103	1,001
Repairs	114.9	6.3	946	546
Supplies	109.9	6.5	828	733
Taxes	104.5	7.2	377	833
Travel	126.8	8.7	800	349
Meals and entertainment	129.3	8.2	739	279
Utilities	110.0	3.5	1,157	106
Wages	100.1	6.4	30	3,565
Jobs credit	82.1	64.4	(3)	16
Other expenses[c]	108.7	9.1	3,406	4,932
Net profit or loss	75.2	3.8	39,043	8,634

(Table notes on next page)

[a]Voluntary reporting percent equals amounts reported on tax returns divided by amounts that should have been reported. Deductions have been overstated (i.e., noncompliance) if this percentage exceeds 100 percent.

[b]Sampling errors are computed at the 95-percent confidence interval.

[c]The TCMP database did not identify what "other" included.

Source: IRS' 1988 TCMP database.

IRS' Emerging Compliance Strategies

IRS is currently revising some of its compliance systems and processes, taking advantage of the capabilities that will be available as TSM is completed. Examples include developing a Compliance Research Information System (CRIS), a new TCMP, and a program to develop specialized market segment audit skills. These projects have not yet been fully implemented, so we could not determine how they would affect sole proprietor compliance.

Compliance Research Information System

Under TSM, IRS is designing CRIS—an information system for researching and analyzing compliance. IRS will attempt to use CRIS to

- gather data for identifying noncompliance by market segment,
- analyze data to determine underlying causes of noncompliance,
- develop baseline measures of compliance, and
- track results of compliance strategies.

According to IRS officials, this system will be completed by fiscal year 1996. Thereafter, IRS will annually pull a sample of 7 to 10 million taxpayer accounts from its masterfile to identify and profile market segments, recommend actions to improve voluntary compliance, and update workload selection and management systems.

Information from CRIS will be available to each of IRS' District Office Research and Analysis (DORA) sites. As part of CRIS, each DORA site will have access to hardware and software for use in measuring compliance at the local level.

Taxpayer Compliance Measurement Program

IRS is planning major changes in the TCMP. TCMP consists of comprehensive audits of a randomly selected sample of tax returns. Traditionally, each TCMP focused on a single type of return. IRS grouped returns for individuals into 10 exam classes based on the type of return (Forms 1040, 1040 Schedule C, or 1040 Schedule F) and the income level of the taxpayer.

The new TCMP will examine all types of returns, including individual, partnership, small corporation, and subchapter S corporations. Returns will be divided into 30 market segments that are mutually exclusive and comprehensive across all types of returns. For example, market segments focusing on businesses could include Forms 1040 Schedule C, as well as Forms 1120, 1120S, and 1065. IRS will use these data to build and meet the objectives of its new CRIS.

Market Segment Specialization Program

The Market Segment Specialization Program (MSSP) is an Examination program created under the umbrella of Compliance 2000. Market segment specialization calls for increasing the level of expertise of examiners by setting up teams to conduct an in-depth study of a particular market segment, such as an industry or profession. The knowledge gained from these audits will be used to develop written guidelines specific to the business environment. Currently, IRS has audit guides available in about 15 industries and has projects under way in more than 60 others. Examiners nationwide will participate in MSSP by becoming market segment specialists or by using audit guides prepared by others. IRS plans to use market segment specialization to examine returns in the new TCMP.

Comments From the Internal Revenue Service

COMMISSIONER

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

June 13, 1994

Ms. Jennie S. Stathis
Director, Tax Policy and Administration Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Ms. Stathis:

Thank you for the opportunity to review your recent draft report entitled, "Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors."

We concur that the IRS should be directing a considerable amount of its efforts toward noncompliant sole proprietors. Realizing that approximately one-third of the tax gap for individuals is comprised of sole proprietor noncompliance, the Service developed corporate actions and initiatives to confront this problem, and progress is being made in changing the way we do business in order to make an impact.

The Service has developed a Business Master Plan (BMP), which links the Service's strategic objectives and business vision with the tactical actions needed to accomplish them. Actions to improve the compliance of sole proprietors are included in the BMP. In addition, the Service created initiatives as part of our Tax Gap Strategy which will assist us in achieving the goals we have set to improve compliance including compliance by sole proprietors.

We have enclosed our specific comments to each of the report recommendations. We believe the actions described in our comments will help to alleviate the concerns raised in your report.

Sincerely,

Margaret Milner Richardson

Margaret Milner Richardson

Enclosure

IRS COMMENTS ON GAO DRAFT REPORT "TAX ADMINISTRATION: IRS CAN BETTER PURSUE NONCOMPLIANT SOLE PROPRIETORS"

RECOMMENDATION:

Develop a comprehensive plan for systematically selecting sole proprietor compliance projects, managing and monitoring them and disseminating their results throughout IRS.

COMMENT:

The Service has developed a Business Master Plan (BMP) which links the Service's strategic objectives and business vision with the tactical actions needed in FY 1995-1997 to accomplish them. The BMP establishes a performance goal which identifies the result that IRS must attain to achieve its corporate objective of increasing voluntary compliance. This performance goal is to collect at least 90% of the total tax dollars due and owing, through voluntary compliance and enforcement by the year 2001.

Business operations are expected to change over the next three years if we are to achieve our ambitious performance goals for FY 2001. By the end of FY 97, research and analysis activities will play a dominant role in how we identify, prioritize and resolve compliance issues. National Office Research Analysis (NORA) and District Office Research Analysis (DORA) operations will be fully implemented. Compliance levels will be benchmarked for major market segments on an international, national, and local basis. National and field operations will identify and secure information that can facilitate our research and analysis efforts. As a result, research and analysis will be the driving force in selecting issues to be worked; in identifying the best mehtods for working those issues; and identifying ways to change tax law, regulations, or procedures to help taxpayers comply.

Recognizing that sole proprietorships are the largest component of the individual tax gap, the BMP specifically addresses this market segment. The BMP coupled with NORA/DORA will accomplish this recommendation.

RECOMMENDATION:

Use existing TCMP information, including workpapers, to design programs that address the most noncompliant sole proprietor segments and underlying casues of the noncompliance.

COMMENT:

For 1995, the BMP contains three actions that address identifying the most noncompliant sole proprietorships. These are:

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- Develop and implement a comprehensive strategy to address filing, accuracy of reporting, and timely full payment by cash businesses/privately owned business taxpayers.
- NORA and DORA staffs will identify and profile key national market segments involving 25% of all cash businesses/privately owned business taxpayers.
- Develop and test strategies in selected market segments to improve compliance.

TCMP data, along with other information, will be used by the NORA/DORA staffs to identify and profile those market segments that represent 25% of all cash businesses/privately owned taxpayers.

RECOMMENDATION:

Work with industry groups to explore the feasibility of developing a prototype set of books and records for the trucking industry and other sectors where TCMP indicates that this may be a problem.

COMMENT:

We disagree with this proposal. Bookstores, libraries, and office supply stores already carry books, forms, and computer programs to assist people in keeping necessary records. In addition, the trucking companies usually have travel logs available for their employees. GAO stated that many of these taxpayers use tax return preparers. Preparers often have travel logs for their clients and are available to assist in setting up a system designed for that client's needs. The IRS also conducts small business workshops to help people understand their obligations along with providing a variety of publications to help taxpayers comply. It would be difficult for the Service to create specific books and records for every industry. However, if the Service finds that a specific industry is unique, and demonstrates that it has special reporting or record keeping requirements, the Service will use a Compliance 2000 approach and either enter into a written agreement with industry representatives concerning the tax treatment of industry issues or use educational methods to assist taxpayers in becoming compliant.

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RECOMMENDATION:

Clarify information return filing instructions for insurance companies and work with these companies to improve compliance with information reporting requirements.

COMMENT:

We concur with this recommendation. The GAO review deals only with payments by casualty insurance companies to unincorporated automobile body shops. GAO focused on the issue by highlighting the situation where claim payment checks are made out to both the insured and the body shop, and the insurance company is required to file an information return. The Service agrees that the instructions covering this situation should be clarified, and insurance companies need to be made aware of the requirement.

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