United States Government Accountability Office

GAO

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

July 2007

TAX GAP

A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance

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GAO-07-1014

July 2007

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A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance

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Highlights

Highlights of GAO-07-1014, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

The Internal Revenue Service (IRS) estimates that $68 billion of the annual $345 billion gross tax gap for 2001 was due to sole proprietors, who own unincorporated businesses by themselves, underreporting their net income by 57 percent. A key reason for this underreporting is well known. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is subject to information reporting to IRS by third parties.

GAO was asked to (1) describe the nature and extent of sole proprietor noncompliance, (2) how IRS's enforcement programs address it, and (3) options for reducing it. GAO analyzed IRS's recent random sample study of reporting compliance by individual taxpayers, including sole proprietors.

What GAO Recommends

GAO recommends that the Secretary of the Treasury ensure that the tax gap strategy (1) covers sole proprietor compliance and is coordinated with broader tax gap reduction efforts and (2) includes specific proposals, such as the options in this report. GAO is not making recommendations regarding specific options. IRS and the Department of the Treasury provided technical comments on a draft of this report, which we incorporated as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-1014.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

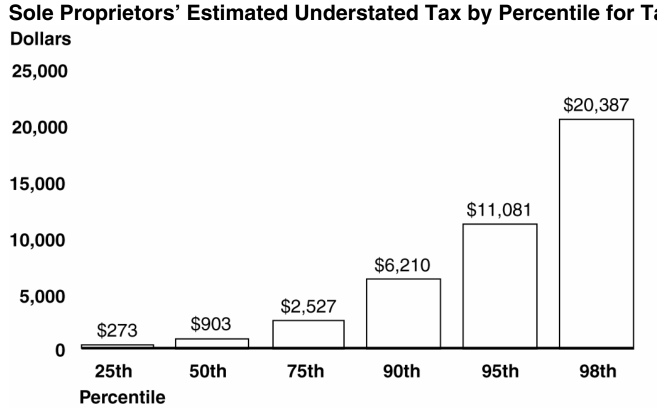
What GAO Found

Based on what IRS examiners could find, most sole proprietors, at least an estimated 61 percent, underreported net business income, but a small proportion of them accounted for the bulk of understated taxes. Both gross income and expenses were misreported. Most of the resulting understated taxes were in relatively small amounts. Half the understatements that IRS examiners could find were less than $903. However, 10 percent of the tax understatements, made by over 1 million sole proprietors, were above $6,200. In this top group, the mean understatement of tax was $18,000.

IRS's two main sole proprietor enforcement programs—the Automated Underreporter Program, which computer matches information on a tax return with information submitted to IRS by third parties, and examinations (audits)—have limited reach. The two programs each annually contact less than 3 percent of estimated noncompliant sole proprietors. The limited reach exists for a variety of reasons. In 2001, about 25 percent of sole proprietor gross income was reported on information returns by third parties; expenses generally are not subject to such reporting. Even when required, various barriers make information reporting inconvenient. Examinations of sole proprietors yield less in additional tax assessed and cost more to conduct than examinations for other taxpayers. However, because of the extent of sole proprietor noncompliance, any effect that examinations have on voluntary compliance by other sole proprietors could result in significant revenue.

The Treasury Department's recently released tax gap strategy discusses neither sole proprietor noncompliance specifically nor the many options that could address it. GAO has reported on the need for such a detailed strategy for years. Specific options that address issues including sole proprietor recordkeeping, underreporting of gross income, overreporting of expenses, information reporting, and IRS's enforcement programs are listed in appendix II.

Sole Proprietors' Estimated Understated Tax by Percentile for Tax Year 2001



Source: GAO analysis of IRS data.

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Abbreviations

AGI	adjusted gross income
AUR	Automated Underreporter Program
EIN	employer identification number
FIRE	Filing Information Returns Electronically
IRS	Internal Revenue Service
NEC	nonemployee compensation
NMA	net misreported amount
NRP	National Research Program
SOI	IRS Statistics of Income Division
TIN	taxpayer identification number

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

July 13, 2007

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

Voluntary compliance with federal tax laws is a critical component of the federal tax system. Each year, however, a gap arises between tax amounts that were voluntarily reported and paid on time and those that should have been paid. The Internal Revenue Service's (IRS) most recent estimate is that the gross federal tax gap for tax year 2001 was $345 billion.

Sole proprietors, who own unincorporated businesses by themselves, have a relatively high rate of tax noncompliance and account for a significant portion of the tax gap. IRS estimates that sole proprietors misreported 57 percent of their business income in 2001 and that $68 billion of the tax gap is attributable to sole proprietors underreporting such income.[1] Key reasons for sole proprietors' relatively high tax noncompliance are well known. Sole proprietors are not subject to tax withholding, and only a portion of their net business income is reported to IRS by third parties. By comparison, misreporting rates for wage and interest income, which are subject to withholding or information reporting by financial institutions, are low (about 1 and 4 percent, respectively).

Congress has been encouraging IRS to develop an overall tax gap reduction plan or strategy that could include a mix of approaches, like simplifying tax law, increasing enforcement tools, and reconsidering the level of resources devoted to enforcement. On September 26, 2006, the Department of the Treasury (Treasury), Office of Tax Policy, issued "*A Comprehensive Strategy for Reducing the Tax Gap*." At the time, Treasury officials said that a more detailed strategy would be forthcoming.

[1]In addition, sole proprietors contributed to an unmeasured extent to the $54 billion in misreported employment taxes, the $34 billion underpayment tax gap, and the $27 billion tax gap created by individuals not filing required tax returns for tax year 2001.

Because of your concern about the tax gap and the importance of sole proprietor compliance, you asked us to identify steps that might improve that compliance. Our objectives were to (1) describe the nature and extent of the noncompliance associated with sole proprietors, (2) describe the extent to which IRS's enforcement programs address the types of sole proprietor noncompliance found by IRS's most recent research, and (3) identify options to close the tax gap related to sole proprietors that could be included in the tax gap strategy being developed by Treasury. To describe the nature and extent of sole proprietor noncompliance, we analyzed IRS's National Research Program (NRP) results on the reporting compliance of individual taxpayers in tax year 2001, IRS's tax gap estimates, and IRS's Statistics of Income (SOI) data to develop a profile of sole proprietors and related tax compliance issues.[2] To determine the extent to which IRS's compliance programs address sole proprietor noncompliance, we reviewed filing guidance and compliance program procedures and analyzed program results. We interviewed IRS staff on the operations and results of the Automated Underreporter Program (AUR), which tests for underreporting by computer matching information returns reporting selected payments made to sole proprietors with income tax returns. We also interviewed staff in IRS's correspondence, office, and field examination (or audit) programs. In addition, we reviewed NRP examination cases to identify examples of barriers when examining sole proprietors.

We used several approaches to identify options for closing the sole proprietor tax gap that could fit into the tax gap strategy. We focused on options that could address the types of sole proprietor noncompliance profiled by IRS's research and the limitations of IRS's enforcement programs that address sole proprietors. We also reviewed existing recommendations from the President's Budget, President's Advisory Panel on Federal Tax Reform, our previous recommendations and reports of the Treasury Inspector General for Tax Administration, IRS's Taxpayer Advocate, and IRS advisory groups. We discussed the options with experts on sole proprietor compliance, including persons who have experience with IRS or other federal programs related to sole proprietors or who published related research. We met with officials from various small business organizations, professionals who provide tax advice to small

[2]NRP studied reporting compliance (versus filing or payment compliance) for a random sample of individual tax returns filed for tax year 2001. In most cases, the returns were audited to determine whether income, expenses, and other items were reported accurately by the taxpayers.

businesses, and tax professional organizations. Further, we reviewed Treasury's tax gap strategy. A more detailed description of our methodology is in appendix I. This report contains estimates which have associated confidence intervals that are conveyed in the body or discussed in the appendix. We conducted our review from July 2006 through June 2007 in accordance with generally accepted government auditing standards.

Results in Brief

Most sole proprietors underreported net business income for tax year 2001, but a small proportion of them accounted for the bulk of understated taxes. This underreported income was caused by misreporting of both gross income and expenses. Based on what was detected in NRP reviews, at least 61 percent of sole proprietors underreported their net income by $93.6 billion in 2001. IRS recognizes that these are underestimates because detecting underreported income is difficult, especially cash receipts. After upward adjustment, IRS estimated that underreported net income resulted in sole proprietors understating their taxes by $68 billion. Although most sole proprietors had understated taxes, the amounts were skewed. Of all sole proprietors who understated taxes, the lower half understated them by less than an estimated $903. Over 1 million sole proprietors had tax understatements above $6,200, which accounted for the upper 10 percent of understatements. These understatements averaged an estimated $18,000 and accounted for 61 percent of all understated taxes on returns filed by sole proprietors.

IRS's main programs to check sole proprietor tax compliance—AUR and the Examination program—have a limited reach. AUR annually contacts about 3 percent of the estimated population of noncompliant sole proprietors while Examination reaches less than 2 percent of them. Information returns that AUR uses to verify sole proprietor income only cover about 25 percent of sole proprietor gross receipts and generally few of their expenses. Barriers to submitting information returns, including complex requirements and lack of convenient electronic filing, also limit AUR's reach. Examinations of sole proprietors' tax returns are more costly and recommend lower additional tax assessments than some other examinations. However, examinations (like other enforcement programs) may have a deterrent effect and increase voluntary compliance by other sole proprietors. Because the rate of noncompliance of sole proprietors is so high, any change in their compliance rate from more enforcement activity could result in significant revenue increases. Even without taking into account any effect on voluntary compliance, IRS's enforcement programs annually make contact with hundreds of thousands of sole proprietors and recommend billions of dollars in additional tax assessments. Finally, IRS did not always apply negligence penalties during NRP for sole proprietors with large tax changes.

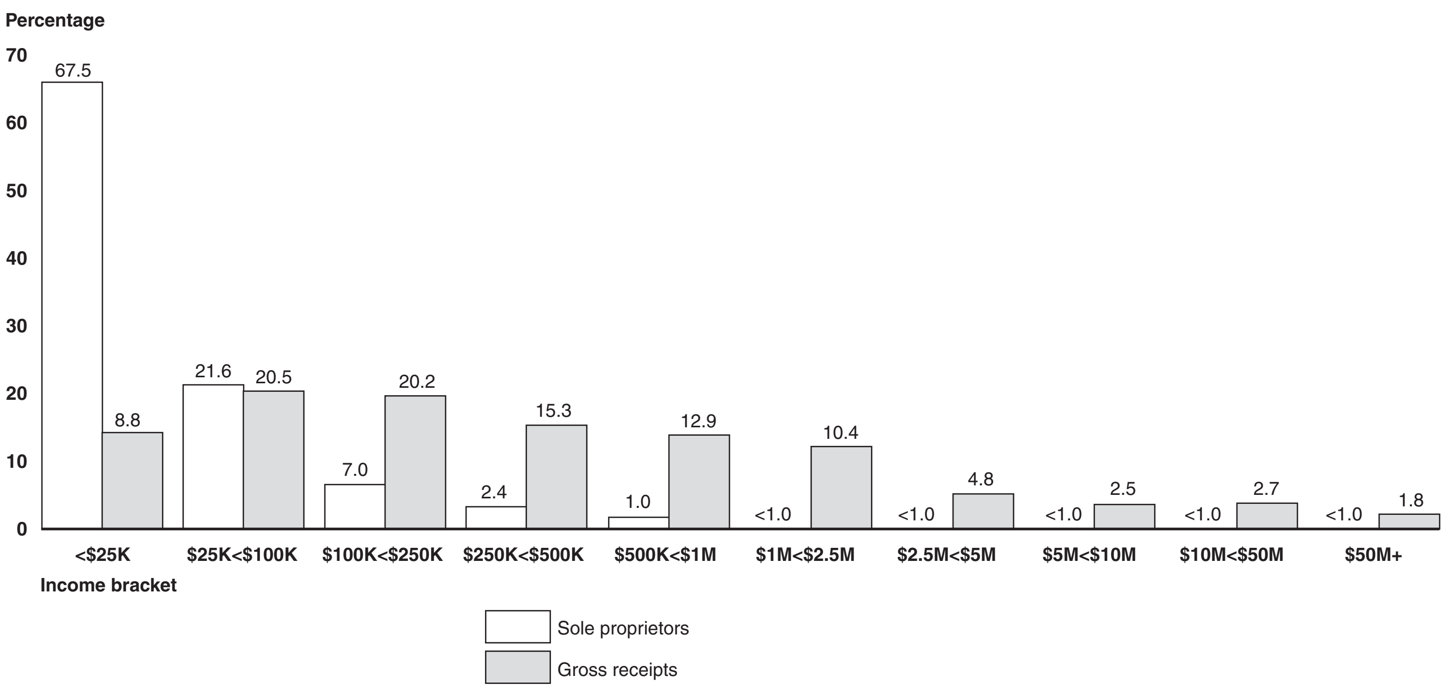
Since the mid-1990s, we have reported on the need for a strategy to address the overall tax gap as well as the part caused by sole proprietors. That need still exists. Treasury's recently released tax gap strategy discusses neither sole proprietor noncompliance nor the many options that could address it. Although the fiscal year 2008 budget request had legislative proposals on the tax gap, including some related to sole proprietors, these proposals do not make up a long-term, comprehensive strategy. Because no single approach is likely to cost effectively reduce the tax gap by sole proprietors, various options could be considered as part of the overall tax gap strategy and would require IRS, Treasury, or legislative action. These options include enhancing assistance to taxpayers, making information return submission more convenient, requiring more information reporting, and increasing IRS enforcement. Each option has pros and cons. In general, the pros include increasing voluntary compliance, enhancing IRS's ability to detect noncompliance, and reducing the burden of complying. The cons include additional burdens imposed on sole proprietors and third parties as well as costs imposed on IRS. We do not rank the options or recommend particular ones because IRS has other compliance objectives in addition to sole proprietor compliance, some options may be substitutes for each other, and quantitative information about the pros and cons is often lacking. Details on all of our options, including some of the pros and cons, are included in appendix II.

We recommend that the Secretary of the Treasury ensure that the tax gap strategy includes (1) a segment on improving sole proprietor compliance that is coordinated with broader tax gap reduction efforts and (2) specific proposals, such as the options we identified, that constitute an integrated package. In commenting on a draft of this report, Treasury said that although not addressed specifically, the seven elements of the department's strategy are intended to apply broadly to all types of businesses and individual taxpayers, including sole proprietorships. Treasury also stated that this report provides valuable insight for applying the strategy to the tax gap. IRS and Treasury also provided technical comments on a draft of this report, which we incorporated as appropriate. IRS did not provide written comments.

Background

Sole proprietors own unincorporated businesses by themselves. As such, they are distinct from corporations and partnerships. In this report, the term sole proprietors refers to both the owners of the businesses and the category of business. In tax year 2003, 20.6 million sole proprietors filed tax returns (the latest year for which detailed IRS data were available). Sole proprietors constitute about 72 percent of all businesses in the United States but are small; they have only 4.8 percent of all business receipts. Sole proprietors include a wide range of businesses, including those that provide services, such as doctors and accountants; produce goods, such as manufacturers; or sell goods at fixed locations, such as car dealers and grocers. These activities may be full time or part time and may be all or part of an individual's income. Figure 1 shows the distribution of sole proprietors and their gross receipts by the size of the proprietorship.

Figure 1: Distribution of Sole Proprietors and Their Gross Receipts by Size of Proprietorship, Tax Year 2003



Source: GAO analysis of IRS data.

Sole proprietors report their business-related net profit or loss on IRS Form 1040, U.S. Individual Income Tax Return, through their Schedule C Profit or Loss from Business (see app. III). The Schedule C requires sole proprietors to classify their type of business or profession, report gross receipts and income, place expenses in 23 categories, and provide additional data on vehicle expenses. Sole proprietors with expenses up to

$5,000 may qualify for simplified tax reporting on Schedule C-EZ, which allows them to report all expenses on one line. Sole proprietors combine their business profits or losses, reported on Schedule C, with income, deductions, and credits from other sources that are reported elsewhere on the Form 1040 to compute their overall individual tax liability.

In addition to income tax obligations, sole proprietors have other tax requirements. If they have employees, sole proprietors are responsible for withholding and paying Social Security, Medicare, and federal income tax, and paying federal unemployment tax under an employer identification number (EIN) that is the tax identification number (TIN) for the business. Whether they have employees or not, sole proprietors are required to pay self-employment tax, which is similar to the Social Security and Medicare tax for wage earners.

Information Reporting

Sole proprietors may prepare and receive information returns for payments made to them or made by them for services, known as nonemployee compensation (NEC), on an IRS Form 1099-MISC.[3] IRS uses the NEC data in its matching programs, such as AUR, to help verify a sole proprietor's receipts. Generally, a Form 1099-MISC needs to be filed with IRS and the recipient of the payment for

- payments of $600 or more for services performed for a trade or business, including a sole proprietor, by people who are not employees, such as contractors;[4]
- rent payments of $600 or more, other than rents paid to real estate agents;[5] and
- sales of $5,000 or more of consumer goods to persons for resale anywhere other than in a permanent retail establishment.

Payments for purchases of goods and service to corporations generally are not required to be reported.[6]

[3]See IRS's Publication 334, *Tax Guide for Small Business*, and Form 1099-MISC instructions.

[4]Other reportable items include other income payments, medical and health care payments, crop insurance proceeds, and gross proceeds to an attorney.

[5]The real estate agent is responsible for reporting payments of rent to the landlord. See Treasury Regulation 1.6041-3(d).

Based on these rules, organizations (including sole proprietors) that make NEC payments for services provided may be required to submit information returns to IRS and the payee. For example, a store owner (a sole proprietor) who hires a self-employed computer programmer (another sole proprietor) to design the business Web site for $10,000 must submit a Form 1099-MISC information return to report the $10,000 payment made to the computer programmer. However, if the programmer is hired to design a personal, nonbusiness Web site for the store owner, no information return is required.

Completing a Form 1099-MISC requires the payer to determine whether the payee is an independent contractor or an employee. To determine independent contractor status, payers are to use 20 common law rules.[7] Numerous controversies over interpretation of the common law rules led to the enactment of Section 530 of the Revenue Act of 1978, which stops IRS and Treasury from issuing new interpretations of these rules.[8] In 1996, we characterized these rules as confusing and resulting in many misclassifications. If the determination results in an employee-employer relationship, the organization is required to prepare a Form W-2 and withhold tax from each payment to the employee.

Similarly, the payer must determine if the payee is a corporation, since such payments generally are not subject to Form 1099-MISC reporting. To determine if the service is provided by a corporation, service providers are asked to declare their corporation status and, if not a corporation, provide a TIN. To ensure that payees provide correct TINs on information returns filed with IRS, NEC payments may be subject to backup withholding. Independent contractors and Section 530 are discussed in appendix IV, and backup withholding rules are discussed in appendix V.

IRS Enforcement Programs

IRS's two main programs for ensuring compliance among sole proprietors are AUR and Examination. AUR matches the NEC income reported on the Schedule C of the sole proprietor's tax return with the NEC income reported on Form 1099-MISC. AUR may send a notice to the sole

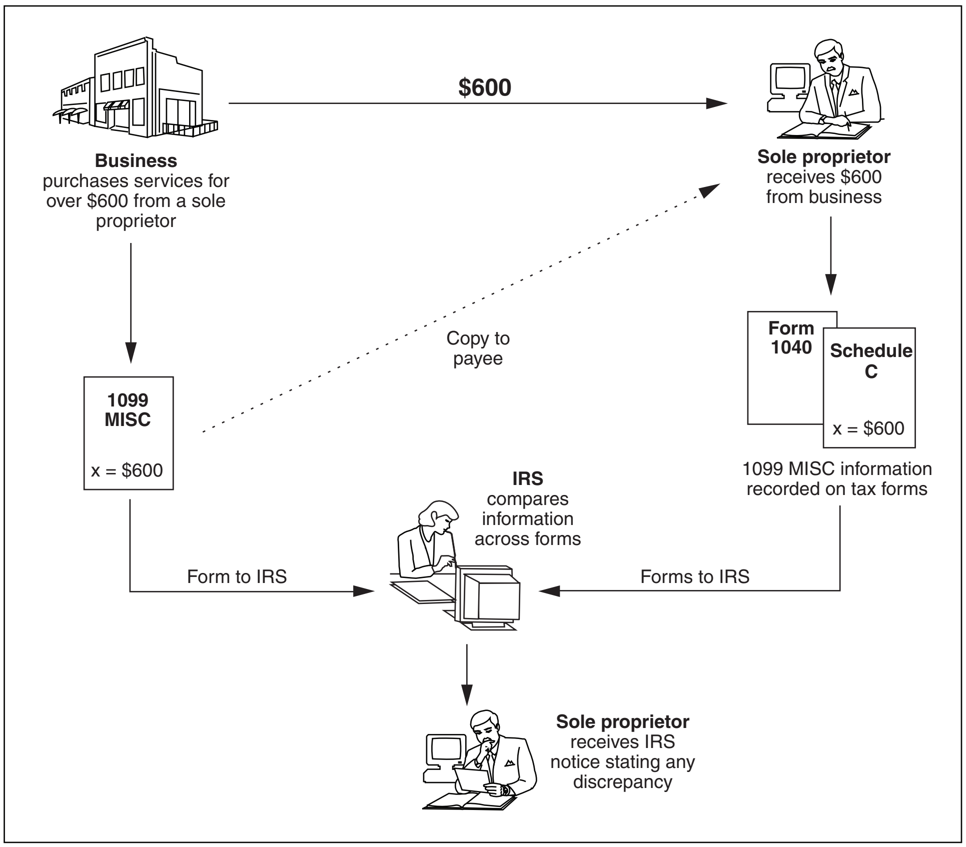
[6]Payments for merchandise, telegrams, telephone, freight, storage, and similar items are also not reported nor are payments to informers from government agencies about criminal activity.

[7]See GAO, *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*, GAO/T-GGD-96-130 (Washington, D.C.: June 20, 1996).

[8]Pub. L. No. 95-600, November 16, 1978.

proprietor if the AUR matching identifies a discrepancy between the NEC reported. The notice proposes adjustments to the tax return filed and requests payment of additional tax, interest, or penalties related to the discrepancy. If the taxpayer disagrees with the notice, the taxpayer is requested to explain the difference and provide any supporting documents. Figure 2 describes the NEC information reporting process.

Figure 2: IRS's Nonemployee Compensation Information Returns Matching Process



Sources: GAO analysis of IRS information, Art Explosion (images).

Examinations may address any type of noncompliance issue and come in three forms. Correspondence examinations are conducted through the mail and usually cover a narrow issue or two. Office examinations are also limited in scope but involve taxpayers going to an IRS office. For field examinations, IRS will send a revenue agent to a taxpayer's home or business to examine the compliance problem that IRS suspects.

Compliance Measurement and the Tax Gap

IRS estimates the gross tax gap—the difference between what taxpayers actually paid and what they should have paid on a timely basis—to be $345 billion for tax year 2001, the most recent estimate made. IRS also estimates that it will collect $55 billion, leaving a net tax gap of $290 billion. IRS estimates that a large portion of the gross tax gap, $197 billion, is caused by the underreporting of income on individual tax returns. Of this, IRS estimates that $68 billion is caused by sole proprietors underreporting their net business income. This estimate does not include other sole proprietor contributions to the tax gap, including not paying because of failing to file a tax return, underpaying the tax due on income that was correctly reported, and underpaying employment taxes. According to IRS, estimates for some parts of the tax gap are more reliable than those for others. For both these reasons, the precise proportion of the overall tax gap caused by sole proprietors is uncertain. What is certain is that the dollar amount of the tax gap associated with sole proprietors is significant.

IRS bases its estimates of the tax gap caused by underreporting of individual income on its compliance research program—NRP. The individual reporting compliance study was a detailed review and examination of a representative sample of 46,000 individual tax returns from tax year 2001. IRS generalized from the NRP sample results to compute estimates of underreporting of income and taxes for all individual tax returns. Because even the detailed NRP reviews could not detect all noncompliance, IRS adjusted the NRP estimates to develop final estimates of income misreporting and the resulting tax gap. IRS did not adjust all the NRP population estimates, only those necessary for developing its final tax gap estimates. However, NRP population estimates are a rich source of data about the nature and extent of sole proprietor noncompliance. Consequently, our report sometimes presents NRP population estimates and sometimes final tax gap estimates.

Most Sole Proprietors Underreported Business Income, but a Small Proportion Accounted for the Bulk of Unpaid Taxes

The significant amount of sole proprietor noncompliance reported in IRS's tax gap estimates is caused by underreporting of net business income, including the misreporting of both gross business income and expenses. The distribution of the resulting unpaid taxes is uneven. A small proportion of sole proprietors, but still a significant number, has relatively large amounts of unpaid taxes.

Most Sole Proprietors Underreported Net Business Income, Misreporting Both Gross Income and Expenses

Based on the unadjusted NRP results, an estimated 70 percent of Schedule C filers in 2001 (about 12.9 million) made an error when reporting net business income (that is, net profit or loss on line 31 of Schedule C). Most of the misreporting was underreporting. These NRP results showed that an estimated 61 percent of Schedule C filers underreported their net income and 9 percent overreported.

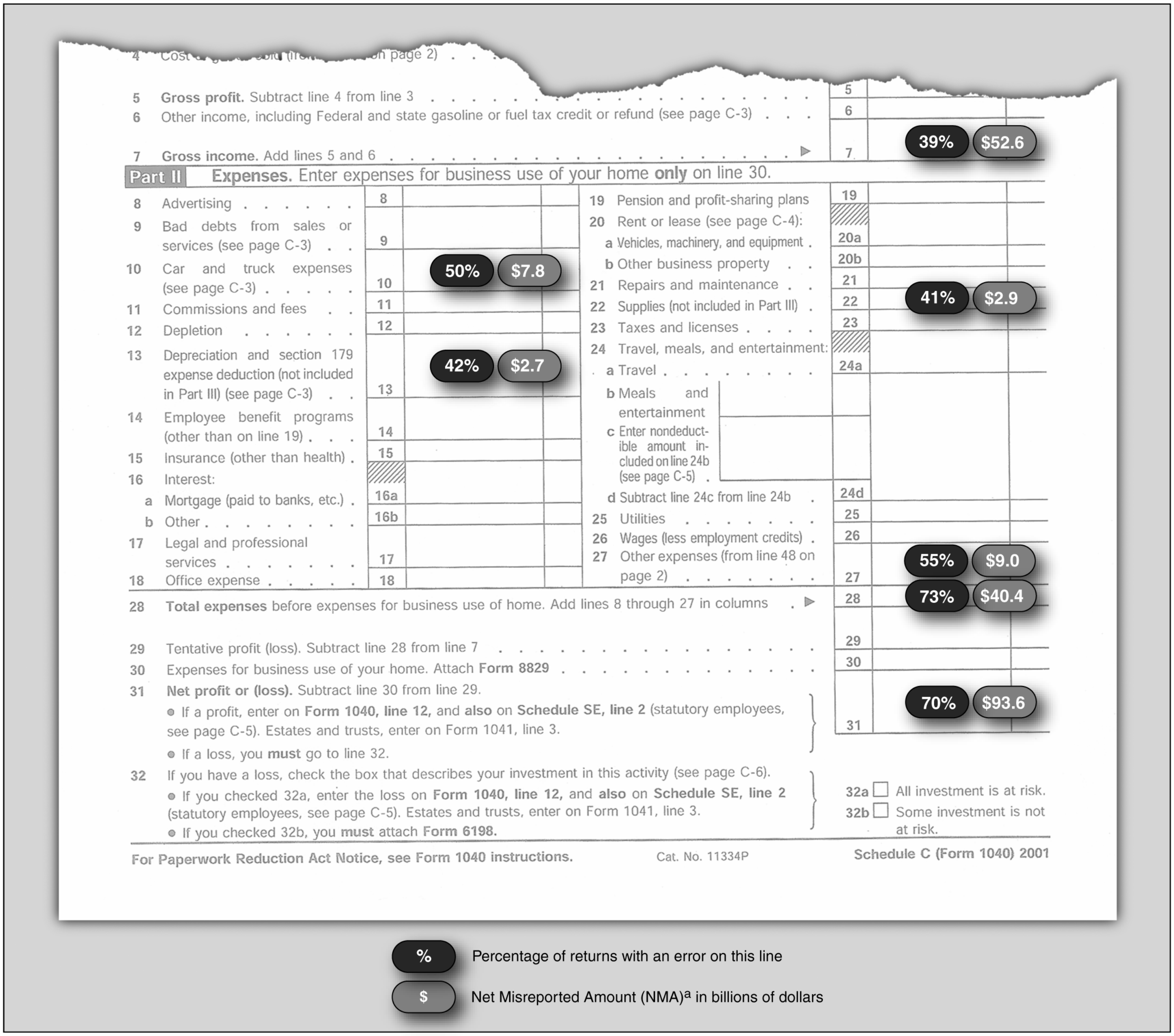
These reporting errors resulted in $93.6 billion, before adjusting, of misreported net business income as shown in figure 3. This misreporting included an estimated $99 billion of underreported and $5.4 billion of overreported net income.

The underreporting of net business income was caused by misreporting of both gross income and expenses, as shown in figure 3. An estimated 39 percent of sole proprietors (6.9 million) made an error on the gross income line of Schedule C and underreported about $53 billion net after subtracting overstatements from understatements. An estimated 73 percent of sole proprietors (10.9 million) made an error on the total expense line of the Schedule C and overreported about $40 billion net after subtracting understatements from overstatements.[9] Overstating expenses reduces net business income and thus taxes. However, understating expenses may also contribute to understated tax if it is done to disguise understating higher amounts of gross income.

The misreporting of expenses was spread over all the 23 expense categories on the Schedule C. However, 55 percent of expense misreporting was concentrated in four categories: car and truck, depreciation, supplies, and other.

[9]IRS NRP and Research officials cited various reasons why a higher percentage and number of sole proprietors misreported expenses compared to overall net income. For example, some taxpayers who misreported expenses were not counted as misreporting net income because of other income or expense adjustments made during the examinations that produced the correct net income amounts.

Figure 3: Summary of Unadjusted NRP Population Estimates for Schedule C Misreporting, Tax Year 2001



Source: GAO presentation of IRS information.

Notes: Each line estimate is computed separately. For example, the estimate of total expenses is based on a different number of tax returns than for net profits. For this reason, in part, the percentage of returns with errors for total expenses is greater than those for net profits. The computations and confidence intervals are discussed in app. I.

[a]A positive NMA refers to misreporting that could understate tax. Therefore, the NMA for income items is understatements minus overstatements, and the NMA for expense items is overstatements minus understatements.

The unadjusted NRP results underestimate the amount of misreporting. The estimates in figure 3 are based on errors detected in the NRP reviews. IRS knows that not all misreporting is detected during its examinations, including NRP reviews. Unreported cash receipts, for example, are difficult to detect. IRS uses various methodologies and other sources of data (on cash transactions, for example) to adjust the aggregate NRP results (but not individual line items) to estimate misreporting. The NRP data limitations are more fully described in appendix I.

After these adjustments, IRS estimates that sole proprietors misreported 57 percent of their net business income in 2001 and that the tax gap caused by this misreporting of sole proprietor net business income in 2001 was $68 billion. This is a substantial upward adjustment from the estimated $36.9 billion in understated taxes from all sources on returns with a Schedule C attached based on what NRP detected.[10]

Taxpayers misreport income and expenses for a variety of reasons. Some misreporting is intentional; some is unintentional. How much misreporting is in each category is not known. IRS refers some misreporting for criminal prosecution, but often it is impossible to tell from a tax return whether errors are intentional. Beyond intentional misreporting, reasons for errors include transcription mistakes, misunderstanding of the relevant tax laws or regulations, and poor recordkeeping. Examples from our review of NRP examination case files illustrate some of these types of reporting errors:

- The sole proprietor operated a cash-card business and reported about $900,000 in gross receipts on the Schedule C. The business is largely done with cash transactions. The examiner found evidence of more than $1 million in additional sales income, as well as additional expenses from purchases, leading to an adjustment of about $30,000 for Schedule C net

[10]The $36.9 billion estimate excludes returns with no understatement and is based on unadjusted NRP results. We are 95 percent confident that the actual estimate is between $34.7 billion and $39.0 billion.

income. The adjustment contributed to a total proposed additional tax assessment of about $8,000.

- The sole proprietor owned a construction business and reported Schedule C losses of over $30,000. The examiner found that that the sole proprietor had poor business skills and shoddy records. Organizing the documentation to support the Schedule C required over 25 hours of examiner time and resulted in net adjustments to receipts and expenses on the Schedule C of over $45,000.
- The sole proprietor owned a retail business and reported Schedule C gross income of almost $250,000. The examiner proposed adjustments of about $9,000 to Schedule C expenses because the expenses were undocumented or were personal living expenses not associated with the business. In protesting the related assessment to IRS Appeals, the taxpayer's representative said that the taxpayer's records were spread across several store accounts, several accounts for rental properties, and two personal accounts. Eventually, Appeals identified additional records and sent the case back to Examination.
- The taxpayer was selling craft-related items and admitted to the IRS auditor that the sales were not engaged in for profit. Accordingly, the taxpayer should not have filed a Schedule C, and several thousand dollars of expenses reported by the taxpayer on Schedule C were disallowed.
- The taxpayer was a minister and filed a schedule C. The examiner explained that although the taxpayer was self-employed in performing ministerial services for Social Security purposes, the taxpayer was considered an employee for income tax purposes. The taxpayer should not have filed a Schedule C.

Although a Small Proportion of Sole Proprietors, More Than 1 Million Accounted for the Majority of Understated Taxes

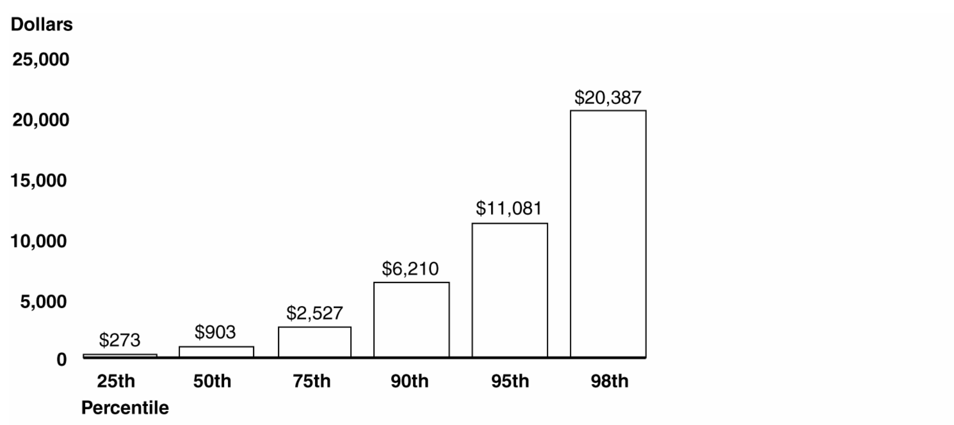
Understated taxes are spread unevenly among the population of sole proprietors, and slightly more than 1 million sole proprietors accounted for most of the understatements. On one hand, the amount of tax understatement caused by underreported net Schedule C income cannot be calculated precisely. Understated taxes on a return could result from the misreporting of multiple items, and the tax calculations depend on all such misreporting rather than just one item.[11] On the other hand, using the best available data on underreporting detected by NRP, we estimate that 72 percent of the underreported adjusted gross income (AGI) on income

[11]This tax calculation is difficult to do and requires assumptions to account for how tax changes on one part of the income tax return affect the rest of the tax return (including changes to other types of wage, business, or investment income as well as to itemized deductions, exemptions, and credits), and ultimately flow through to the final tax liability and tax rate to be used.

tax returns filed by sole proprietors was caused by changes in Schedule C income.[12] As a result, it is likely that most of the NRP-estimated $36.9 billion (unadjusted) in understated taxes on these returns can be attributed to underreported net business income on Schedule C.

Although most sole proprietors had understated taxes, the amounts were skewed. Based on NRP estimates, half of sole proprietors who understated taxes on their individual income tax returns, understated less than an estimated $903 (the 50th percentile amount), as shown in figure 4. Above the 50th percentile, the amount of tax understatement significantly increased to an estimated $2,527 at the 75th percentile, $6,210 at the 90th percentile, and $20,387 at the 98th percentile. About 1.25 million sole proprietors accounted for the largest 10 percent of understatements for which the mean was about $18,000; for the largest 5 percent, the mean understatement was about $27,000. By comparison, as will be discussed further in the next sections, IRS's field examiners assessed on average $27,800 of additional tax for examinations of individual returns without Schedule Cs.

Figure 4: Estimated Understated Tax Amounts by Percentile for Form 1040s with Schedule Cs Attached, Tax Year 2001



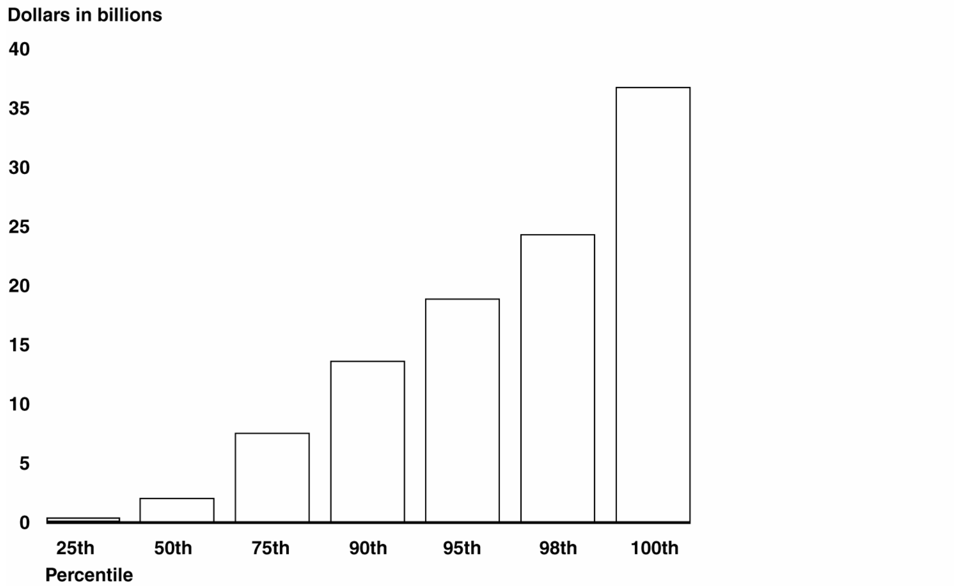
Source: GAO analysis of IRS data.

Notes: Figure 4 excludes returns with no understatement and is based on unadjusted NRP results. Confidence intervals are discussed in app. I.

[12] We are 95 percent confident that the actual estimate is between 68 percent and 76 percent.

Most of the aggregate $36.9 billion of understated taxes (unadjusted NRP estimate) on returns filed by sole proprietors was concentrated in a small proportion of sole proprietors. As shown in figure 5, the 11.2 million sole proprietors at and below the 90th percentile understated their taxes by a cumulative $14.3 billion. The remaining 10 percent (1.25 million) above the 90th percentile understated a cumulative $22.6 billion in taxes, accounting for 61 percent of the total.

Figure 5: Estimated Cumulative Understated Taxes by Percentile for Form 1040s with Schedule Cs Attached, Tax Year 2001



Source: GAO analysis of IRS data.

Notes: Figure 5 excludes returns with no understatement and is based on unadjusted NRP results. Confidence intervals are discussed in app. I.

When arrayed by the size of the sole proprietor and based on reported gross receipts, understated taxes are less skewed. Based on Schedule C gross receipts, those sole proprietors at or below the 90th percentile ($127,462) accounted for 65 percent of cumulative understated taxes ($23.9 billion of $36.9 billion).[13] Those with the largest 10 percent of gross

[13]We are 95 percent confident that the actual 90th percentile amount is between $124,720 and $134,263 and the cumulative amount is between $22.1 billion and $25.8 billion.

receipts accounted for the other 35 percent or $12.9 billion of the understated taxes.

Enforcement Programs Have Limited Reach over Sole Proprietors but Still Make Billions of Dollars in Recommended Assessments

IRS's two main programs for addressing sole proprietor reporting compliance[14]— AUR and Examination—have limited reach over noncompliant sole proprietors, although they annually contact hundreds of thousands of taxpayers and recommend billions of dollars in assessments. Table 1 shows the types of sole proprietor noncompliance that AUR and Examination investigate, the percentage of the noncompliant sole proprietor population with recommended assessments, and the limitations of the programs.

Table 1: Percentage of Recommended Assessments and Limitations of IRS Enforcement Programs for Detecting Sole Proprietor Reporting Noncompliance

IRS program	Sole proprietor noncompliance addressed	Percentage of noncompliant population with recommended assessments	Program limitations
AUR	Inaccurately reported gross receipts	2.7[a]	• Form 1099-MISC is not required to be filed on all gross receipts (e.g., sales of goods). • Form 1099-MISC is not always filed as required because of various barriers. • Does not address sole proprietor expenses. • Does not follow up on all the mismatches identified. • Some information submitted by taxpayers is not verified.
Examination	Receipts and expense noncompliance	1.4[b]	• Most examinations are not designed to address sole proprietor tax issues. • Examinations can take a lot of time. • Recommended assessments are lower from examining sole proprietor issues compared to examining other types of tax return issues.

Source: GAO analysis of IRS data.

[a]Tax year 2003, the most recent year for which the appropriate AUR data were available.

[14]IRS also has programs for addressing nonpayment and nonfiling types of noncompliance, as well as taxpayer service programs for encouraging all types of tax compliance. Because this report focuses on sole proprietor reporting noncompliance, references to "noncompliance" refer to misreporting unless otherwise noted.

[b]Examinations conducted in fiscal year 2005 on calendar year 2004 returns, the most recent year for which the appropriate Schedule C filing data were available.

Assuming that Schedule C filers would misreport net income at the same rate in subsequent years as they did in 2001, AUR recommended that additional tax be assessed on about 2.7 percent of noncompliant sole proprietors for tax year 2003.[15] Similarly, Examination recommended that additional tax be assessed on about 1.4 percent of noncompliant sole proprietors for returns from tax year 2004.[16]

AUR Is Restricted by Limits on Information Reporting and Other Program Constraints but Still Identifies Significant NEC Noncompliance

AUR cannot detect all sole proprietor misreporting because the third-party information returns used for matching do not report all sole proprietor receipts or expenses. One quarter of sole proprietor receipts reported on a Schedule C in 2001 also appeared on a Form 1099-MISC that year. Since not all receipts are reported on a Schedule C, the true percentage would be lower. Exemptions to information reporting requirements prevent greater coverage of sole proprietor receipts. Most merchandise sales, nonbusiness services (such as construction or repairs for homeowners), and payments of less than $600 are exempt from Form 1099-MISC reporting. Additionally, because payments to corporations are generally exempt, sole proprietors that want to avoid information reporting of their receipts could incorporate.

Several barriers may inhibit information return filing on NEC payments. First, preparing a Form 1099-MISC to report NEC payments can be a complex process.[17] The general instructions for filling out any information return are 21 pages long, and the instructions for Form 1099-MISC are 8 pages long. Payers must figure out whether the businesses they have hired are independent contractors or exempt corporations and whether the payments meet other exemption criteria as well as acquire the payees TINs or EINs.

[15]This percentage should not be confused with IRS's "examination coverage rate," which is merely the number of returns examined divided by the number of returns filed.

[16]For both AUR and Examination, amounts of recommended assessments should not be construed as amounts ultimately collected. For example, recommended assessments could be abated in appeals or the amounts may not be collectible.

[17]We have started work on a study that will more fully discuss taxpayer burdens in filing 1099-MISC forms.

Second, submitting Form 1099-MISC returns is not convenient. In its instructions, IRS requires payers to use forms printed with red, magnetic ink so that IRS scanners can more easily process the forms; payers are instructed not to print Form 1099-MISC off of IRS's Web site. However, we observed plain paper Form 1099-MISC returns being scanned in IRS's Ogden, Utah, processing center. Furthermore, payers must submit Form 1099-MISC returns separately from their tax returns. There is $50 penalty, as the instructions prominently remind payers, for failing to use the correct form. In practice, IRS may not assert the penalty for every violation because of the administrative and collection costs.

IRS has an Internet-based system for submitting information returns called Filing Information Returns Electronically (FIRE), but barriers exist to the use of that system. FIRE requires payers to put return information in a particular format that IRS can use, which requires appropriate software that payers must purchase. Payers cannot simply call up a Web site and fill out an online form, and they need to register with IRS before using the system.[18] The likelihood that a payer would submit a Form 1099-MISC return electronically decreases as the number of forms that the payer files decreases. For example, IRS data from tax year 2005 show that 93 percent of paper Form 1099-MISC returns were filed by payers with 24 or fewer submissions. One common tax preparation software package allows users to print Form 1099-MISC and submit them to IRS on paper, but the users cannot transmit Form 1099-MISC returns electronically as they can income tax returns. This software vendor said that it had a special arrangement with IRS for its users to print Form 1099-MISC on plain paper.

Paper forms are more costly for IRS to process than electronically filed forms. With paper, IRS workers scan forms into a database and visually verify that the information was scanned correctly, a labor-intensive process. A substantial number of Form 1099-MISC returns are filed on paper. For filing year 2005, the Form 1099-MISC constituted 87 percent of all the paper information returns submitted that IRS could scan. Nearly 40 percent of Form 1099-MISC returns (31.5 million) were submitted via paper that year.

[18] Payers filing 250 or more information returns must use FIRE or send IRS special cartridges with the data.

AUR Is Limited by a Lack of Resources, Expense Matching, and Examination Authority

Because of resource constraints, IRS officials said they do not contact taxpayers in all cases where AUR finds a mismatch between what was reported on an information return and what was reported on a tax return. The annual average of NEC-related contacts for tax years 1999 through 2003 is much less than half of the roughly 2 million cases that AUR officials say they annually identify for taxpayer contacts caused by potential NEC underreporting.[19]

Also, AUR matching generally does not address misreported Schedule C expenses. First, according to IRS, AUR does not match sole proprietors' Schedule C expenses with the information returns they file for their own payments. Second, third-party information generally is not required on sole proprietor expenses.[20]

AUR reviewers are directed to consider the reasonableness of the taxpayers' responses to notices but generally do not examine the accuracy of the information in the responses because they do not have examination authority.[21] IRS officials said that addressing larger issues raised in the returns would take more time and possibly reduce the productivity of AUR overall. Consequently, taxpayers could, after being contacted by AUR about underreported NEC, create fictitious expenses to offset the underreported NEC.

AUR does not systematically check for related parties trying to shift income from a tax return in a high-rate bracket to another return with a lower bracket. Related parties may include taxpayers who own multiple businesses, husbands and wives who file separate tax returns, unmarried couples, siblings, or parents and their children. IRS data showed that 3 percent of all Form 1099-MISC returns had the same address for the payer and the payee—one indicator that a related-party transaction might exist. A nonrandom file review of 55 Form 1099-MISC filings at IRS's Ogden, Utah, campus found 8 examples in which the payer and payee had similar addresses or names. We did not determine the appropriateness of the

[19] AUR contacts do not always lead to a tax change. For example, from tax years 1999 through 2003, 26 percent of the NEC contacts did not lead to a tax change.

[20] We have started work on a study that will more fully discuss Schedule C expense reporting.

[21] AUR may refer suspicious cases to Examination, but IRS officials have told us that historically, that happens infrequently. IRS started a test in March 2007 on referring such suspicious cases to Examination for questionable NEC income and expenses.

apparent related-party transactions in the IRS Form 1099-MISC data based on the incidence of name and address matches.

Two NRP cases are illustrative of apparent related-party transactions involving Form 1099-MISCs. In one case, a couple shared a financial account, and one of them was a sole proprietor. The sole proprietor, who earned more than $450,000 as an executive at a separate company, paid the other individual to run the sole proprietorship and deducted the payment on a Schedule C. The sole proprietorship had over $100,000 in losses and less than $1,000 in revenue. In the case file, an examiner noted that a Form 1099-MISC was filed on the NEC income paid from the executive to the person at the same address. This case file did not note whether the payment inappropriately shifted income to lower the couple's overall tax liability or whether the payment was an allowable business deduction for services actually rendered as an ordinary and necessary expense of carrying out a business, as required by the Internal Revenue Code.[22] In another case, however, IRS disallowed deductions for wages that a psychiatrist paid to his children because the taxpayer did not show that the children had rendered services or even that the wages were paid—only that the deductions were taken.

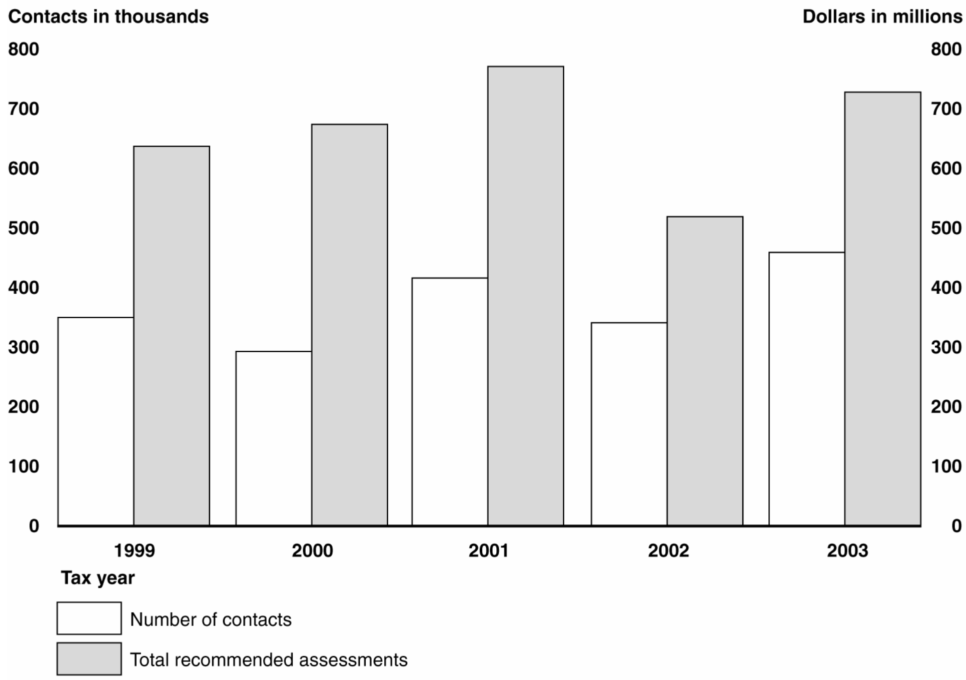
Despite Limitations, AUR Annually Recommends Hundreds of Millions of Dollars in Assessments on NEC Misreporting

Annually, AUR receives more than 80 million 1099-MISC forms. From those submissions, AUR contacts hundreds of thousands of taxpayers about potential sole proprietor misreporting on those forms and makes billions of dollars in recommended assessments. From tax years 1999 through 2003,[23] AUR annually, on average, sent 371,989 notices on NEC cases and recommended $666 million in tax assessments. Figure 6 shows the trends in NEC contacts and total recommended assessments that AUR made from 1999 through 2003.

[22]I.R.C. § 162(a).

[23]Because IRS officials said data for 2004 were not complete when we requested them, we used only data through 2003. It is possible that contacts and assessments related to NEC are somewhat higher, but IRS does not have the data to separate all contacts that included NEC as well as other types of misreporting. NEC figures used here only refer to those cases where 50 percent or more of the taxpayer's income was NEC or where the tax change was 80 percent or greater than the original tax reported.

Figure 6: Number of AUR NEC Contacts Made and Total Recommended Assessments, Tax Years 1999-2003



Source: GAO analysis of IRS data.

Contacts and assessments related to underreported NEC make up a significant portion of the AUR caseload. Of more than 60 categories that AUR uses to sort income data, the two NEC categories combined rank first in the number of contacts with taxpayers and in the dollars of recommended assessments made from tax year 1999 through tax year 2003. NEC cases constituted 17 percent of all AUR contacts and 21 percent of all AUR assessments for tax years 1999 through 2003.

Examination Program Is Not Geared toward Schedule C Issues but Still Finds Significant Noncompliance

Most of IRS's examinations do not focus on noncompliance by sole proprietors.[24] Correspondence examinations account for the majority of IRS's examinations that IRS did in fiscal year 2006 and generally take the least amount of time to conduct, typically an hour or less, because they deal with simple, limited issues. Schedule C tax issues are generally too complex to make an examination through correspondence practical. For example, in our review of NRP files, we found a case in which an examiner manually sorted through a taxpayer's records and organized them to accurately calculate the taxes owed—a task that could not occur through correspondence. In any case, IRS's correspondence tax examiners, the lowest-graded examiners, do not have the training to examine many Schedule C issues, such as business depreciation or accounting methods.

Schedule C tax issues typically must be addressed in field examinations. Field examinations took 20 hours on average to complete in fiscal year 2006. Furthermore, field examinations of returns with Schedule C forms took about 50 percent longer per return (7.2 hours more) to complete than those not categorized as Schedule C returns in that year.

Among field examinations, the recommended additional tax assessed for examinations of returns with attached Schedule C forms tended to be smaller than for other types of examinations. For example, the average recommended assessment for revenue agents examining returns with attached Schedule C forms (the employees most likely to do these examinations) was $24,000 in fiscal year 2006. This was $3,800 less than examinations of returns without Schedule C attachments and was less than the average dollars per return for 18 other types of returns without Schedule C attachments, such as tax-shelter program cases.

The relatively higher costs and lower yields for Schedule C examinations do not necessarily mean than Schedule C examinations are not cost-effective. The statistics reported above include only the additional taxes expected from the taxpayer who was examined. Examinations may have a deterrent effect on other taxpayers and increase the rate of voluntary compliance.[25] Because the rate of noncompliance is so high for sole

[24]IRS Examination data treat a minority of Schedule C returns it receives as business returns. This section deals only with returns IRS has categorized as Schedule C business returns for Examination purposes and will be referred to as returns with an attached Schedule C.

[25]GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C.: July 26, 2006).

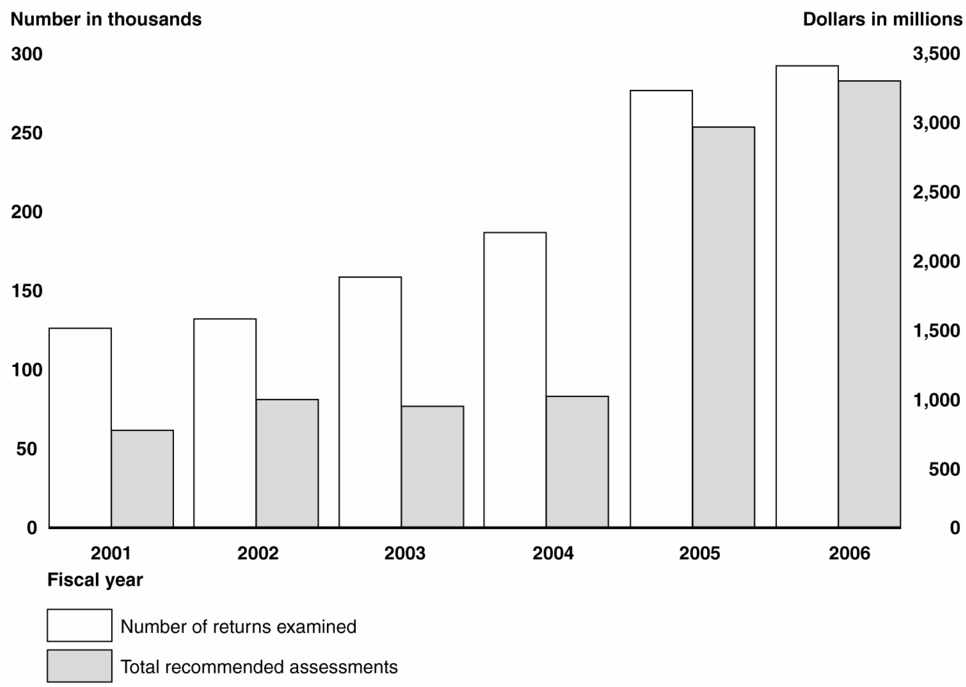
proprietors, any change in their voluntary compliance from doing more examinations could result in significant revenue increases.

IRS has been examining more tax returns with attached Schedule C forms, resulting in billions of dollars in recommended tax assessments. From fiscal years 2001 through 2006, the number of examinations of returns that IRS categorized as Schedule C returns increased by 132 percent, from 128,062 to 297,626, as shown in figure 7.[26] In fiscal year 2006, IRS examined about 3 percent of the Schedule C categorized returns. Recommendations of additional tax assessments also increased each year. The large increase in these assessments in 2005 was primarily for returns reporting income greater than $100,000. IRS officials also cited Son of Boss fraud cases from fiscal years 2005 and 2006 and increased examination efficiency as causes for the upward trends.[27] Assessments do not reflect amounts actually collected. Amounts ultimately collected are not yet known from the examinations closed in 2005 and 2006.

[26]IRS provided us examination data that did not differentiate between examinations of returns that have Schedule C forms attached and those that actually audited Schedule C issues. For example, a real estate agent filing a Schedule C may also own rental real estate and file a Schedule E. IRS may audit the real estate losses reported on the Schedule E, but nothing on the Schedule C. Therefore, IRS's data may overstate the number and amount of time that IRS spends auditing Schedule C returns.

[27]Son of Boss was an abusive transaction aggressively marketed in the late 1990s and 2000 primarily to wealthy individuals. IRS's settlement initiative regarding Son of Boss required taxpayers to concede 100 percent of the claimed tax losses and pay a penalty of either 10 percent or 20 percent unless they previously disclosed the transactions to IRS. We did not verify whether examinations were more efficient in 2005 and 2006.

Figure 7: Examinations of Returns with Schedule C Attachments and Recommended Tax Assessments, Fiscal Years 2001-2006



Source: GAO analysis of IRS data.

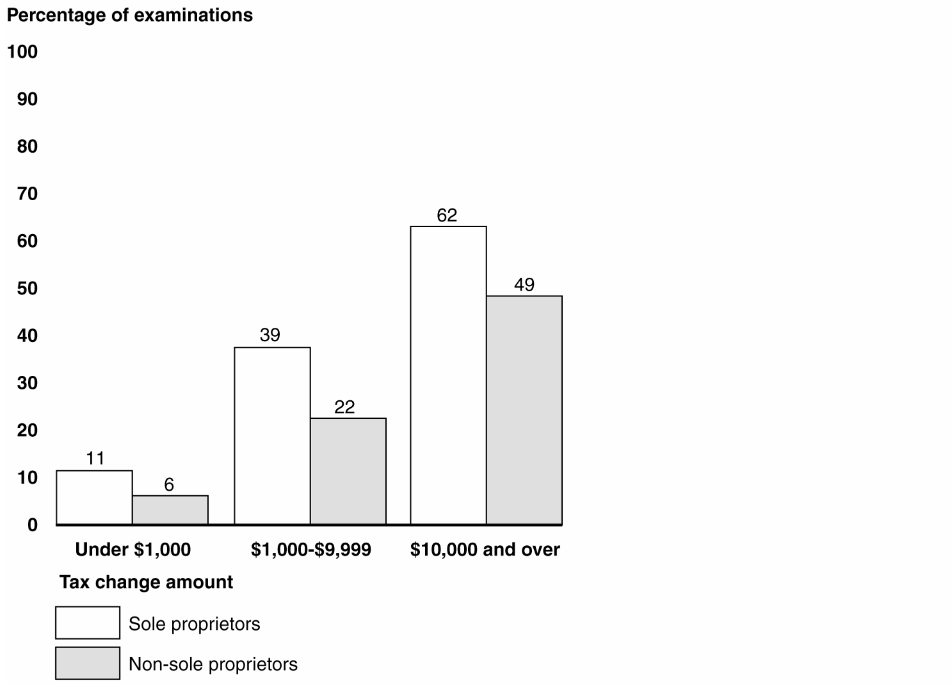
IRS Did Not Always Apply Negligence Penalties during NRP

IRS did not apply negligence penalties in a substantial portion of NRP cases with a tax change. IRS uses negligence penalties[28] to encourage compliance and to assure compliant taxpayers that the tax system is fair.

Although sole proprietors were more frequently penalized than non-sole proprietors, just 62 percent of the sole proprietors who had a 100 percent or more tax change in their tax liability after the NRP examination and had a tax change of $10,000 or more were penalized. For smaller tax changes, the percentage penalized was lower. Figure 8 summarizes the penalty results from the NRP examinations for tax returns with a 100 percent or more change for sole proprietors and non-sole proprietors.

[28]The negligence penalties discussed in this section refer to those in I.R.C. § 6662(b)(1).

Figure 8: Recommended Penalties for Sole Proprietors and Non-Sole Proprietors in NRP Examinations with a 100 Percent or Greater Recommended Tax Change by Dollar Value of Tax Change in Tax Year 2001



Source: GAO analysis of IRS information.

Our NRP case file review provided some examples in which penalties were not assessed at all or seemed to be assessed inconsistently.

- A sole proprietor reported AGI of about $10,000 and zero tax liability on the return. An examiner proposed total adjustments of about $3,000, which included unreported Schedule C receipts and overstated expenses resulting in additional tax of about $450. The examiner proposed a negligence penalty of about $90, explaining that the taxpayer did not take reasonable care in preparing the tax return, which was done by a tax preparer.
- A sole proprietor reported AGI of about $90,000 and a tax liability of about $16,000. An examiner proposed total adjustments of about $35,000, based on unreported Schedule C receipts and overstated expenses, and a tax increase of $15,000. The examination workpapers explained that no negligence penalty was proposed since the tax preparer was responsible for most of the adjustments.

The differences in individual cases might be caused in part by IRS procedures that give revenue agents discretion on whether to pursue a penalty, even when the tax change is substantial.[29] Recommended penalties must be reviewed by the examiner's manager. Explanations ranging from a lack of knowledge to reliance on a paid preparer can lead some examiners to mitigate a penalty but not others.

IRS officials said the application of penalties in NRP cases should be similar to that for operational examinations because NRP examiners were required to follow IRS's standard guidance for penalties. We have started work on a study that will more fully analyze the use of penalties in IRS's operational examinations.

Current Treasury Tax Gap Strategy Discusses Neither Sole Proprietor Noncompliance nor the Many Options That Could Address It

The tax gap strategy issued by Treasury in September 2006 does not discuss sole proprietor noncompliance or specific options to address it. A number of options to improve sole proprietor compliance exist and could be considered as part of the overall tax gap strategy. Each option has both pros (such as improved compliance) and cons (such as burdens on taxpayers or third parties).

Tax Gap Strategy Does Not Specifically Discuss Sole Proprietor Noncompliance

Treasury's tax gap strategy does not discuss specific options to address the tax gap overall or sole proprietor noncompliance in particular. As we discussed in February 2007 testimony,[30] the strategy generally does not identify specific steps that Treasury and IRS[31] will undertake to reduce the

[29]We used a statistical model to assess whether various factors are related to the recommended assessment of penalties. Controlling for other factors, we found that the dollar value of the tax change and the percentage tax change are related to the recommendation to assess a penalty. The relationship raises questions because the guidance about assessing penalties does not provide a basis for considering the percentage error or the dollar amount of the error, above a threshold, when deciding to assess a penalty. App. I describes the model we used, our analysis of the penalty-related data, and results.

[30]GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-488T (Washington, D.C.: Feb. 16, 2007).

[31]IRS is part Treasury, which is responsible for tax policy analysis and formulation.

tax gap, the related time frames for such steps, or explanations of how much the tax gap would be reduced. Rather, the strategy broadly discusses opportunities for tax evasion and the preventive role of tax research, information technology, compliance activities, taxpayer service, tax law simplification, and working with stakeholders. For example, the portion on improving compliance activities generally discusses initiatives on expanded information reporting, improved document matching, refined detection programs, and increased examinations in selected areas. However, no specifics are provided. Without specifics, the strategy does not include actions that potentially would reduce the tax gap.

Since the mid-1990s, we have reported on the need for a strategy to address the federal tax gap as well as sole proprietor noncompliance. In May 1994, we summarized many ideas on reducing the tax gap, including ideas on information reporting, tax withholding, and tax simplification.[32] In August 1994, we reported on the lack of a comprehensive linkage between IRS's compliance strategy and compliance efforts for sole proprietors and on the need for better systems to identify the causes of noncompliance and target enforcement resources.[33] More recently, in July 2005, we reported that IRS needed a results-oriented approach to reduce the tax gap based on long-term, quantitative voluntary compliance goals and performance measures to determine the success of its strategies and adjust as necessary.[34] In April 2006, we testified that IRS had established such compliance goals but lacked a data-based plan for achieving the goals.[35] In February 2007, we testified on the need for multiple approaches to reduce the tax gap, including improved taxpayer services, tax code simplification, more information reporting, and an appropriate level of

[32]GAO, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

[33]GAO, *Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors*, GAO/GGD-94-175 (Washington, D.C.: Aug. 2, 1994).

[34]GAO, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005).

[35]GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-615T (Washington, D.C.: Apr. 6, 2006).

resources for tax enforcement.[36] Our products related to the tax gap are listed in the Related GAO Products section at the end of this report.

IRS is not without some of the elements of a tax gap strategy. IRS's management continually makes decisions about reallocating resources and has taken steps that demonstrate an understanding of the value of a more strategic approach. One important step is NRP, which gives IRS management more information about the nature of noncompliance and is being used to better target examinations on noncompliant taxpayers. IRS's annual budget requests include specific compliance program proposals. For example, the fiscal year 2008 budget submission had 16 legislative proposals on tax gap reduction. Some of these proposals related to sole proprietors, such as those requiring information reporting on certain government payments made for the procurement of property and services and on merchant card payment reimbursements. Several IRS and Treasury experts, and other knowledgeable individuals also commented that many of these options would be applicable to any small business regardless of its organizational form (such as partnerships, limited liability companies, and corporations). However, these elements do not make up the type of long-term, comprehensive strategy, described above, that provides an overall rationale and specific steps, time frames, and predicted impact on the tax gap.

Many Options for Improving Sole Proprietor Compliance Exist and Could Be Considered for the Tax Gap Strategy, But All Have Trade-offs

Many options exist that could help reduce sole proprietor noncompliance. These options range from enhancing IRS's assistance to taxpayers to instituting tax withholding on payments made to all or certain types of sole proprietors. Each option has pros and cons.

We identified options and their pros and cons by reviewing our reports and the reports of others on sole proprietor compliance as well as through extensive conversations with experts and knowledgeable individuals inside and outside of IRS. Consistent with our previous reports, we tried to identify options that represented a range of approaches, such as improving taxpayer service, more information reporting, and various enforcement actions. Many of the options are directed at the specific sole proprietor compliance problems and IRS program limitations described earlier in this report. We placed the options into broad categories of problems, such as

[36] GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-391T (Washington, D.C.: Jan. 23, 2007).

poor recordkeeping, unreported business income, and overstated business expenses. Our list, in table 2, is not exhaustive and not ranked in any order. Appendix II contains a longer description of each option, including pros and cons.

Table 2: Options to Improve Sole Proprietor Tax Compliance

A. Recordkeeping and complexity
1. Work with small business representatives to improve instructions for keeping records and completing the Schedule C.
2. Provide assistance to first-time Schedule C filers. a. Target outreach to sole proprietors filing their first Schedule C—IRS could provide guidance to help them keep records and report accurately on their Schedule C forms. b. Notify first time Schedule C filers who did not use a paid tax preparer and who reported on certain Schedule C lines known to generate more noncompliance about guidance on IRS's Web site.
3. Separate business and personal records and transactions. a. Require sole proprietors to include all business transactions in a financial account or accounts used only for business purposes. b. Require sole proprietors to obtain TINs for business transactions in lieu of using their Social Security numbers.
4. Repeal certain limitations in section 530 of the Budget Act of 1978 involving guidance on rules on classifying workers.
B. Burdens and problems for third parties in filing information returns
5. Clarify Schedule C instructions to indicate that an information return may be required from sole proprietors who are deducting expenses for wages, fees, and commissions.
6. Ensure that IRS's Web-based system for filing information returns can accommodate those filing information returns on payments made to sole proprietors.
7. Create a new Form 1099-NEC to segregate the NEC from the various boxes on the existing Form 1099-MISC.
C. Unreported sole proprietor income
8. Expand gross receipts reporting on the Schedule C.
9. Close gaps in existing information reporting on payments made to sole proprietors, for example, by requiring information reporting on annual service payments that are a. made to all corporations or to some subset, such as small corporations, non-publicly held corporations, or noncompliant corporations, or b. less than $600, which is the current trigger for information reporting.
10. Require new information reporting by organizations on payments to sole proprietors. a. Require businesses that process credit (and debit) card payments to report on the amount of payments made to sole proprietors for a tax year. b. Require federal, state, and local governments to file information returns on all nonwage payments made to procure property and services from businesses. c. Require financial institutions to file information returns on business deposits and withdrawals by sole proprietors.
11. Require new information reporting on consumer payments to sole proprietors for property owners who pay contractors for improvements, if the payments will be used to adjust the basis of the property.
D. Overstated deductions for sole proprietor expenses
12. Expand expense reporting on the Schedule C.

13. Match information returns filed by sole proprietors with related expenses on their Schedule C forms.
14. Expand information reporting on the expenses of sole proprietors under two options. a. Require businesses that receive certain types of payments from sole proprietors in large amounts (i.e., thousands of dollars) to file information returns to report those amounts. b. Require businesses that process credit (and debit) card payments to report information on the amount of payments by sole proprietors for each tax year.
15. Verify additional expenses claimed to offset unreported income.
E. Nonpayment of tax
16. Deny benefits/payments until tax obligations are met, for example, by requiring that a. sole proprietors pay their self-employment tax obligations in order to receive credit for Social Security benefits and b. federal agencies do a tax compliance check with IRS before providing a government benefit to a sole proprietor.
17. Withhold tax to encourage compliance through situational or universal means by requiring those who are to file information returns on payments made to sole proprietors to a. withhold a small amount from payments until the sole proprietor's TIN is certified through an IRS system that is quick and accurate and b. withhold a very small percentage of the payments made to sole proprietors in all cases or in limited situations, such as when the sole proprietor voluntarily consents.
F. IRS management of limited resources
18. Improve IRS's audit selection of sole proprietor tax returns in at least two ways. a. Use more advanced automated systems to update the current manual system. b. Improve the ability of AUR to refer cases for audit.
19. Enhance data sharing with the states.
20. Use informational notices to encourage compliance.
21. Revise the rules for penalties to improve consistency and compliance under two options. a. Simplify the process for assessing penalties and develop standards on using penalties. b. Increase the penalty for subsequent failures to file required information returns.

Source: GAO analysis and interviews with tax experts and knowledgeable individuals.

All the options have pros and cons. Because the options are presented as concepts, rather than as detailed plans ready for implementation, the pros and cons could vary with such detail. In most cases, pros and cons are described qualitatively and are not intended to be exhaustive; additional analysis might find others. In general, the pros include helping sole proprietors to comply voluntarily, helping IRS detect and prevent underreporting of income and understatement of taxes, and reducing the burden on taxpayers or third parties for filing tax returns and information returns. The cons include the costs and burdens imposed on sole proprietors, third parties, and IRS.

We are not recommending particular options for a number of reasons:

- Trade-offs. IRS has other compliance objectives in addition to sole proprietor compliance. Devoting more IRS staff and other resources to close the sole proprietor tax gap means that fewer resources are available for combating other types of noncompliance, such as corporate, individual, or tax-exempt entity noncompliance. Forgoing enforcement revenue elsewhere is an opportunity cost of devoting more resources to sole proprietor noncompliance. Also, the resources and management capacity devoted to sole proprietor noncompliance may not be sufficient to implement all the options. Priorities would need to be established.
- Interaction between options. Some of the options may be substitutes for each other. Others may be complements. Improving assistance to taxpayers might reduce the need for some enforcement actions. Some of the options may reinforce each other—such as expanded information reporting and more convenient filing options—making it desirable to package them together.
- Policy judgments. Some of the options involve policy judgments about how the options would affect different groups of people. For example, information reporting invariably imposes some costs on the third parties required to report, but no objective criteria exist for assessing when third-party costs are excessive. In many cases, quantitative information about the effects is not available. Judgments would have to be made based on qualitative information.

For all of these reasons, we are not ranking or otherwise making recommendations on the value of each option, nor are we opining on which options should be packaged together and in what manner. The options could be considered as part of an overall Treasury and IRS tax gap strategy. For most options, Treasury and IRS would need to develop the details on how the options would work both singly and as part of a coordinated strategy. Issues that could be considered in an overall strategy include how much emphasis should be placed on

- sole proprietor noncompliance versus other types of noncompliance,
- efforts to help sole proprietors voluntarily comply versus efforts to help IRS detect noncompliance after it occurs,
- the reporting requirements and added burden placed on sole proprietors versus the reporting requirements and burden placed on third parties, and
- legislative changes versus administrative changes at IRS.

Conclusions

The tens of billions of dollars in tax revenue lost annually because sole proprietors underreport over half of their aggregate net income contribute to the nation's long-term fiscal challenge. This underreporting is also unfair to compliant taxpayers. Because underreporting is spread among more than 12 million sole proprietors, much of it in small amounts, because the underreporting is for both gross income and expenses, and because IRS's enforcement programs are limited and costly, the sole proprietor tax gap cannot be closed by IRS enforcement alone. As we have said before, improving compliance will require a variety of new approaches.

Many options exist for improving sole proprietor compliance; however, they all have individual pros and cons, some may be substitutes for each other and some may reinforce each other. Trade-offs also exist at a broader level. Devoting more IRS resources to sole proprietor compliance must be judged relative to what those resources could accomplish in IRS's other programs. Furthermore, IRS's resources are not the only ones devoted to tax administration. Taxpayers and third parties spend their time and money to make our tax system work. For these reasons, the options are best considered as part of an overall strategy. Such a strategy would provide more assurance that taxpayer, third party, and IRS resources are being used efficiently to promote compliance.

Recommendation for Executive Action

We recommend that the Secretary of the Treasury ensure that the tax gap strategy includes (1) a segment on improving sole proprietor compliance that is coordinated with broader tax gap reduction efforts and (2) specific proposals, such as the options we identified, that constitute an integrated package.

Agency Comments and Our Evaluation

We requested written comments from the Secretary of the Treasury and received comments on behalf of the Treasury from its Tax Legislative Counsel (see app. VI). In commenting on a draft of this report, the Treasury said that although not addressed specifically, the seven elements of the department's strategy are intended to apply broadly to all types of businesses and individual taxpayers, including sole proprietorships. Treasury also stated that this report provides valuable insight for applying the strategy to the tax gap. IRS and Treasury also provided technical comments on a draft of this report, which we incorporated as appropriate. IRS did not provide written comments.

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

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

James R. White
Director, Tax Issues
Strategic Issues

Appendix I: Scope and Methodology

To describe the nature and extent of the noncompliance associated with sole proprietors, we analyzed the Internal Revenue Service's (IRS) National Research Program (NRP) results, tax gap estimates, and Statistics of Income (SOI) data, and interviewed IRS officials. The NRP data are IRS estimates of individual tax reporting compliance based on reviews and examinations of filed tax returns. IRS randomly selected the returns for tax year 2001, which were filed with IRS during calendar year 2002. To compute the percentage of returns with an understatement or overstatement on a Schedule C line and the net misreported amounts, IRS used the following definitions, including related limitations:

Percentage of returns with an error: This ratio is the weighted number of taxpayers that have a non-zero net misreported amount divided by the weighted number of returns that should have reported the amount. For some items, taxpayers may have errors that exactly offset each other resulting in no net tax change. For example, a taxpayer may have reported a transaction as an "office expense," but an examiner reclassified the same amount as "repairs and maintenance." NRP did not consider these offsetting changes as errors for those line items.

Net misreported amounts (NMA): The NMA is the sum of all amounts underreported minus the sum of all amounts overreported for an item. The NMA does not include adjustments between schedules of the return. For example, the NRP examiner may disallow reported amounts for expense deductions on Schedule C that should have been reported on Schedule A and increase the deductions on Schedule A by the same amounts. Neither adjustment would be in IRS's NMA. However, the adjustments would be included in IRS's definition of the amounts that should have been reported, which are reflected in the denominator of the net misreporting percentage. The NMA does not include adjustments that were made because the taxpayer used the wrong form or line item.

Because the percentage of returns with an error and the NMA are derived from samples, table 3 lists the confidence intervals for each amount. IRS did not compute confidence intervals for its estimates. When we calculated confidence intervals, we got slightly different point estimates than IRS. The difference appears to arise from varying definitions of sole proprietors. We are 95 percent confident that the percentages and amounts reported are between the low estimate and the high estimate. In the body of this report, we present IRS's point estimates.

Table 3: Confidence Intervals for Summary of Schedule C Misreporting for Tax Year 2001

Dollars in billions

	Percentage of returns with an error				Net misreported amount			
Schedule C line	Low estimate	GAO calculated percentage	High estimate	IRS percentage reported	Low estimate	GAO calculated amount	High estimate	IRS reported amount
Gross income, line 7	38	40	42	39	$52.8	$56.8	$60.8	$52.6
Car and truck expenses, line 10	44	46	48	50	6.9	7.5	8.1	7.8
Depreciation and section 179 expense deduction, line 13	36	38	41	42	2.0	2.4	2.8	2.7
Supplies, line 22	34	36	38	41	2.4	2.8	3.2	2.9
Other expenses, line 27	50	52	54	55	7.2	8.5	9.8	9.0
Total expenses, line 28	67	69	71	73	36.4	38.6	40.8	40.4
Net profit or loss, line 31	68	70	72	70	91.7	95.8	99.9	93.6

Source: GAO analysis of IRS data.

Estimated understated tax amounts, as shown in figure 4, were derived from NRP sample data. Table 4 lists the estimated percentile amount and confidence intervals for each percentile. We are 95 percent confident that the percentages and amounts reported are between the low and high estimates.

Table 4: Confidence Intervals for Estimated Understated Tax Amounts by Percentile for Individual Income Tax Returns with Schedule Cs Attached, Tax Year 2001.

Percentile	Percentile lower confidence interval amount	Estimated percentile amount	Percentile upper confidence interval amount
25th	$255	$273	$294
50th	859	903	956
75th	2,422	2,527	2,674
90th	5,976	6,210	6,766
95th	10,635	11,081	12,353
98th	19,631	20,387	64,075

Source: GAO analysis of IRS data.

Estimated cumulative understated tax amounts, as shown in figure 5, were derived from NRP sample data. Table 5 lists the estimated percentile amount and confidence intervals for each percentile. We are 95 percent confident that the percentages and amounts reported are between the low and high estimates.

Table 5: Confidence Intervals for Estimated Cumulative Understated Taxes by Percentile for Individual Income Tax Returns with Schedule Cs Attached, Tax Year 2001

Dollars in billions

Percentile	Percentile lower confidence interval amount	Estimated percentile amount	Percentile upper confidence interval amount
25th	0.30	0.36	0.44
50th	1.84	2.05	2.35
75th	6.31	6.93	7.65
90th	13.47	14.26	15.64
95th	18.24	19.37	21.08
98th	23.68	24.91	33.06
100th	34.77	36.86	38.95

Source: GAO analysis of IRS data.

According to IRS Research officials, NRP results are not tax gap-related estimates since they do not account for misreporting that the auditors did not detect. Typically, the undetected misreporting of Schedule C net income likely takes the form of understated gross receipts and overstated expenses, for which IRS did not prepare separate tax gap estimates. Overstated expenses tend to be detected since the burden of proof is on the taxpayer to justify them. However, when taxpayers intentionally understate gross receipts, they may also understate expenses to hide the gross-receipt underreporting from IRS. Also, NRP includes estimates of some net business income that is not reported on Schedule C. These amounts are not added to the line-item detail and are not included in the analyses for this report. We could not estimate the amount of tax change that would result from NRP's examinations of Schedule C income because it must be combined with the taxpayer's filing status, exemptions, other types of income, deductions, credits, and other taxes.

To analyze the extent to which IRS's enforcement programs address the types of sole proprietor noncompliance found by IRS's most recent research, we used several data sources. We reviewed instructions for tax and information returns and filing guidance as well as program procedures. We analyzed program results data collected from the Automated Underreporter Program (AUR) and Examination officials, and interviewed IRS staff on the operations and results of AUR and the correspondence, office and field examination programs. We reviewed examination plans and *Internal Revenue Manual* procedures and other instructions to IRS staff describing program procedures. We analyzed data on examination results and numbers of Schedule C forms filed from the IRS Data Book, and data on paper Form 1099-MISC returns published by IRS's Office of Research for 2006. We did not analyze IRS's math error program since all NRP-examined returns were reviewed by this program, which is an integral part of IRS's returns processing function.

To calculate the percentage of noncompliant sole proprietors on which AUR and Examination made recommended assessments, we first multiplied the percentage of noncompliant sole proprietors found in NRP data by the number of Schedule C returns for the most recent years that we had available from the IRS Data Book that matched the most recent years for which we had complete AUR and Examination data (tax year 2003 for AUR and tax year 2004 returns for work Examination did in fiscal year 2005). Then we divided the number of recommended assessments made in each program by the number of noncompliant sole proprietors to arrive at the percentage of noncompliant sole proprietors on which the programs made recommended assessments.

We reviewed a sample of completed NRP examination case files to understand the types of sole proprietor noncompliance being detected. We selected the sample using the NRP case results database to identify all NRP cases with adjustments to Schedule C items for sole proprietor tax returns. We then selected a nonestimation sample of NRP examination cases with adjustments to gross receipts or sales, total expenses, net profit or loss on the Schedule C, and the business income line on the Form 1040 return, because these lines summarize the sole proprietor's operations. We also randomly selected some Schedule C adjustment cases.

We also used NRP data and the NRP case file sample to analyze IRS's use of penalties in NRP examinations. The analysis describes the proportion of NRP cases closed with adjustments and the proportion closed with a penalty recommended by the NRP examination. Because the cases with adjustments and penalties were not drawn from the population of all individual returns, they cannot be used to estimate a penalty assessment rate and other characteristics for all individual taxpayers. Even with these limitations, this analysis provides useful information on the outcome of the NRP sample.

To estimate the percentage of reported Schedule C receipts that were on a Form 1099-MISC, we compared amounts reported on the Form 1099-MISC and on Schedule C (line 1 total gross receipts or sales). This analysis used SOI data on individual tax returns for tax year 2001, which included a sample of information returns. We found that three Form 1099-MISC items could be reported on a Schedule C, including nonemployee compensation (NEC), medical payments, and fish sales. According to IRS, these Form 1099-MISC items could also be reported on two other IRS forms—Schedule F, Profit and Loss From Farming, and Form 4835, Farm Rental Income and Expenses—other than the Schedule C. We found that about 4 percent of the amounts reported on the Form 1099-MISC were reported on Schedule F or Form 4835. This difference was not material to our computation. Further, our analysis did not consider several sources of noncompliance that could affect the computation, such as the nonfiling of the required Schedule C or Form 1099-MISC or the underreporting of Schedule C or Form 1099-MISC amounts.

To estimate the percentage of Form 1099-MISC returns where the payer and the payee have the same address, we used an SOI data file with tax year 2001 individual income tax return information. We compared the postal codes and the numeric portion of street addresses reported by the payer and payee to identify whether they had the same address. For those who did, we reviewed a sample to verify that the addresses were the same. We also reviewed 55 Form 1099-MISC filings at the Ogden, Utah, campus, which provided 8 examples in which a payer and payee had similar addresses or names. We did not review other IRS records to determine whether these Form 1099-MISC filers were related parties.

To assess the likelihood of being assessed a penalty, controlling for other factors, we used logistic regression analysis, an econometric method appropriate for analyzing variables with dichotomous outcomes. We used the deciles of the continuous variables as the independent variables in the model. We did not weight the NRP returns or incorporate the NRP stratification because penalties are a function of the audit and the NRP returns are not representative of audited returns.

Controlling for use of a paid preparer, adjusted gross income, Schedule C amount, and total tax as reported by the taxpayer, a logistic regression was used to predict a penalty based on the absolute value of the difference between the total tax reported on the Form 1040 and the total tax after the NRP audit and the percentage of tax change (the difference in total tax divided by the total tax reported on the Form 1040). We found a significant effect of the percentage change in tax owed and the absolute value of the tax change on the likelihood of receiving a penalty. That is, individuals in higher deciles (5th through 10th deciles) of the percentage increase in tax were generally more likely than those in the lowest decile to be recommended for a penalty. Additionally, taxpayers in higher deciles of the absolute value of the tax change (4th through 10th deciles) were more likely than those in the lowest decile to be recommended for a penalty controlling for other factors. We also found that the odds of a penalty decreased with each decile increase in the taxpayer's reported total tax liability.

Although we did not test for interactions that could mitigate this effect, we found our results to be robust across a variety of model specifications. We did not control for other potentially relevant variables, such as differences among examiners, and did not test for whether the case was abated.

We used several approaches to identify options to close the tax gap related to sole proprietors that could be included in the tax gap strategy being developed by the Department of the Treasury (Treasury). First, we sought ways to address the gaps between the nature of sole proprietor tax noncompliance and existing IRS programs. Second, we reviewed various research publications on sole proprietors and our recommendations, as well as those from the President's Budget, President's Advisory Panel on Federal Tax Reform, Treasury Inspector General for Tax Administration, IRS's Taxpayer Advocate, and IRS advisory group reports. Third, we identified and discussed options and their the pros and cons with experts and knowledgeable individuals on sole proprietor compliance issues, including former Commissioners of Internal Revenue; persons who have experience with IRS or other federal programs related to sole proprietors; representatives for various national organizations representing sole proprietors, tax return preparers, or tax lawyers; tax staff working for Congress; and relevant staff at IRS and Treasury. All of the national organizations representing sole proprietors had large memberships and we contacted each organization's committee which focuses on small business issues. From this work, we consolidated the list of options and pros and cons. We excluded a few options that were raised near the end of our work, lacked details, or generated comments or questions from experts and knowledgeable individuals on how the options would work.

The list of options is not exhaustive and has limitations. Since data did not exist for analyzing the effect on the tax gap, taxpayers, or IRS for each option, we could not independently validate or weigh the pros or cons suggested by our experts and knowledgeable individuals. Because the experts and knowledgeable individuals had competing interests on questions of tax policy and administration, we did not seek consensus on the “best” options or on the pros and cons. Experts had limited time to discuss all the options and pros and cons. Thus, we did not discuss each option in detail in each interview, but overall, the interviews provided enough details for the options in our report. As a result of such limitations, we did not try to rank the options. Instead we described the options based on input from the literature and experts. More detailed proposals could raise other pros or cons not listed in our report.

We used several approaches to assess data reliability. We assessed whether the examination results and data contained in the NRP database were sufficiently reliable for the purposes of our review. For this assessment, we interviewed IRS officials about the data, collected and reviewed documentation about the data and the system used to capture the data, and completed testing of relevant data fields for obvious errors in accuracy and completeness. We completed analytic testing to ensure that tax return items that should logically be equal were equal. For example, the net profit and loss line on Schedule C should be accurately transferred and equal to the similar line on the individual income tax return. We also compared the information we collected through our case file review to corresponding information in the NRP database to identify inconsistencies. This testing found that the NRP results for Form 1040 returns with Schedule C forms were sufficiently reliable for our review.

The tax gap, SOI, AUR, and Examination data are all from sources that we used in previous reports. Based on assessments done for those reports, the fact that the sources are public and widely used, and additional testing we did to ensure that we were properly interpreting individual data elements, the data were sufficiently reliable for our review.

We conducted our review at IRS Headquarters in Washington, D.C., and at IRS’s Ogden, Utah, campus from July 2006 through June 2007 in accordance with generally accepted government auditing standards.

Appendix II: Options to Address Problems with the Tax Compliance of Sole Proprietors

We have developed a list of options for reducing the tax gap for sole proprietors by reviewing our past reports as well as other related literature and by talking to experts and knowledgeable persons about sole proprietors' tax compliance. As we built the list of options, we discussed the options and the related pros and cons with these experts, including past and current IRS and Treasury staff; former IRS Commissioners; congressional staff; representatives of organizations representing sole proprietors, tax preparers, and tax lawyers; and others who have working knowledge of tax compliance and IRS programs.

This list is not exhaustive nor is the list of the pros and cons associated with each option. Many of the options are concepts rather than fully developed proposals with details of how they would be implemented. Additional detail could bring more pros and cons to light. The pros and cons are not weighted, and options should not be judged by the number of pros and cons. We are not making recommendations about the options or ranking their desirability. Rather, we have aligned these options with a series of known problems with sole proprietor tax compliance. Some of the options overlap, covering more than one problem while other options only deal with specific aspects of a problem.

A. Recordkeeping and Complexity

For our system of voluntary compliance to work, taxpayers must keep appropriate records. Our work on sole proprietors has raised issues about incomplete or inaccurate recordkeeping by sole proprietors as well as about the difficulties they face in dealing with complex tax rules. The options in this section look for ways to improve recordkeeping, simplify some of the rules, or provide more guidance and education to sole proprietors to reduce their burden.

1. Work with small business representatives on their ideas for improving the instructions for keeping records and meeting their Schedule C filing obligations.

More education and better guidance could help sole proprietors comply with the complex tax rules for reporting on the Schedule C. IRS could work with small business and trade representatives to determine whether and how specific changes to IRS's existing education and guidance would help those filing the Schedule C.

Pro:

- Helping educate sole proprietors on their recordkeeping requirements and filing obligations (Schedule C and information returns) could reduce noncompliance.

- The costs to update the instructions is probably minimal, while the cost for the education would not be.

Con:

- Getting specific ideas that would help sole proprietors might take some time and effort, depending on the extent to which IRS tests these ideas.
- It may be difficult to target the education and guidance and improve instructions for the sole proprietors who need them the most, that is, those who keep poor records or make errors on the Schedule C. These sole proprietors may not have the time or incentive to pay attention.
- Changes may not help those who rely on a paid tax return preparer or bookkeeper because of IRS's tendency to forward tax information to the taxpayer but not to the tax return preparer.
- Some education efforts could be costly to IRS, such as efforts to contact taxpayers individually.

2. Provide assistance to first-time Schedule C filers.

IRS could consider at least two broad approaches that would

a) specifically target outreach to sole proprietors filing their first Schedule C to inform them about the option to receive regular e-mails on topics of interest, the small business hotline, the resource guide, and other services specifically targeted to help small businesses and

b) automatically send computer-generated notices (i.e., soft notices) to first-time Schedule C filers who did not use a paid tax preparers (to reduce the number of notices) and who reported on certain Schedule C lines that involve more complexity or higher noncompliance (e.g., accounting method, depreciation, travel, or home office) about guidance on IRS's Web site on reporting such issues.

Pro:

- This would provide new sole proprietors with the specific information that they need to comply.
- It would also help new sole proprietors avoid “bad habits” before they become rooted.
- Using e-mail would reduce IRS's costs.
- Using automated screening and soft notices would increase IRS's “presence” without the costs of an enforcement contact (e.g., audit).

Con:

- There is no assurance that sole proprietors will read the information and comply.
- Some sole proprietors may not use e-mail or want to provide an e-mail address to IRS.
- IRS would incur some costs for the outreach and notices.
- Soft notices may not boost compliance if they are too vague or if sole proprietors perceive that IRS will not follow up in future tax years on the soft notices.
- Waiting to act until after the first Schedule C filing may be too late to change the behavior of some sole proprietors.

3. Separate business and personal records and transactions.

Two requirements could help sole proprietors distinguish their business transactions and records from personal ones. Details would need to be worked out on any exceptions or tolerances; on offering incentives rather than requirements; and on enforcing and penalizing any noncompliance with the requirements, which follow.

a) Require sole proprietors to include all business transactions in a business bank account or accounts used only for business purposes. Such transactions would include deposits of business receipts and payments of business expenses. Receipts or expenses generated outside of the business would not be part of these business accounts. Further, financial institutions could provide sole proprietors with an annual summary of inflows and outflows for the business account(s).

b) Require each sole proprietor to obtain a taxpayer identification number (TIN) for a business. Currently, sole proprietors generally are required to obtain business TINs, known as employer identification numbers (EIN), when they have wage-earning employees for filing certain types of returns. In this option, sole proprietors could use EINs for their business transactions in lieu of using their Social Security numbers.

Pro:

- Recordkeeping could improve, which would reduce the time and burden of preparing returns and responding to IRS's inquiries.
- IRS could save money if its computer matching and audits could be done more quickly and with more certainty.
- Retroactively creating fictitious business expenses after the tax year would be easier to detect.

- Tax compliance would improve to the extent that sole proprietors would weed out personal expenses from their business expenses.

Con:

- Financial institutions may charge fees for separate business accounts and statements.
- Taxpayers who want to evade may not deposit all their income in the business accounts or still could run personal expenses through their business accounts.
- It might be unnecessary or burdensome for Schedule C filers who are not regularly operating a business but have intermittent Schedule C receipts and expenses.
- IRS may have difficulty enforcing such a requirement.

4. Repeal certain limitations in section 530 of the Budget Act of 1978 involving guidance on rules for classifying workers.

Lift the limitations on IRS issuing rules and guidance on the criteria to determine whether a worker is to be treated as an employee or an independent contractor for tax purposes as well as on the related safe harbors for employers that classified workers as independent contractors.

Pro:

- Guidance and rules might help clarify confusion in the myriad of employment relationships that have evolved since 1978.
- Clarification might help ensure that the correct amounts of taxes are being paid.

Con:

Some types of sole proprietors might prefer

- legislative clarification rather than trusting IRS to lead the efforts to clarify and
- living with the current confusion rather than opening the door to changes, particularly if they do not trust IRS to make equitable decisions about the proper classification or the existing safe harbors.

B. Burdens and Problems for Third Parties in Filing Information Returns

Information reporting offers a way to cover more of the income of sole proprietors who do not report all of their gross receipts. However, information reporting suffers when the information returns are not filed or are filed erroneously and late. Those filing the information returns may face difficulties or burdens in filing information returns on paper or when a sole proprietor does not provide a valid TIN. A number of options exist to better ensure that IRS receives the required information returns on payments made to sole proprietors while minimizing the burden of those filing these information returns.

5. Clarify Schedule C instructions to indicate that information returns may be required to be filed by sole proprietors who deduct expenses for wages, fees, and commissions.

Pro:

- To the extent more Forms 1099-MISC are filed, sole proprietors are likely to be more compliant in reporting business income.
- The instructions would provide another outlet for notifying taxpayers of their Form 1099-MISC reporting obligations at a minimal cost.

Con:

- If those who are to file the required information returns do not read or follow the instructions, the clearer instructions would not boost required filings.
- If IRS receives more information returns, its costs to process and use them would rise.

6. Change the IRS Web-based system for filing information returns to accommodate those filing information returns on payments made to sole proprietors, particularly those filing a smaller number of information returns.

Pro:

- To the extent more Forms 1099-MISC are filed, sole proprietors are likely to be more compliant in reporting business income.
- Web-based filing could reduce the costs, burdens, and errors for everyone compared to filing/processing paper information returns. IRS may be able to reduce its start-up costs by modifying its Filing Information Returns Electronically system.

Con:

- If those who are to file the required information returns are not comfortable filing information through the Web, do not have access to computers, or do not want to file them at all, more filings of the required returns may not occur.

- If IRS requires extensive registration steps in order to file on the Web, some filers might find those steps too burdensome.
- IRS would incur start-up costs to create a new form and a Web-based filing system.
- IRS would incur additional costs to process and use the information from a significant increase in the number of filed information returns.

7. Create a new Form 1099-NEC to segregate NEC from the various boxes on the existing Form 1099-MISC.

Although payment of NEC would trigger the requirement to file a Form 1099-NEC, IRS could request other summary information in the expanded space on this separate form about payments to sole proprietors, such as expenses reimbursed, noncash payments, type of services received, or payments for goods.

Pro:

- To the extent more information returns are filed with the new form and filed more clearly,

1. sole proprietors are likely to be more compliant in reporting business income,
2. filing would be less confusing,
3. IRS could refine its computer matching to minimize “false” leads that burden compliant taxpayers, and
4. IRS would have better data to improve its research and case selection for enforcement contacts to the extent that IRS requested other information.

Con:

- IRS has no assurance that a new form would reduce taxpayers’ burden enough to lead to more filings of the required information returns.
- IRS would incur additional costs if it has to process a significant increase in the number of filed information returns and if it has to expand its existing enforcement activities to check compliance in filing these types of required information returns.

C. Unreported Income for Sole Proprietors

For tax year 2001, about 70 percent of the sole proprietors misreported about 57 percent of their net business income. IRS's examinations are limited in number and scope and do not find much of the unreported income. Information reporting offers a way to cover more noncompliant sole proprietors and focus on unreported gross receipts. However, information reporting covered just a quarter of the gross receipts reported on Schedule Cs. One reason for the gap is that current information reporting focuses on payments for services and excludes certain payments, such as those totaling below a certain threshold and those to corporations. These options attempt to address these gaps in information reporting for sole proprietors.

8. Expand gross receipts reporting on the Schedule C.

Sole proprietors would break out their total gross receipts on the Schedule C to show the amount reported to them on information returns. Other information could be required, such as the number of information returns received and details on large payments.

Pro:

- Sole proprietors could be more sensitized to use the information returns received and thus more accurately report gross receipts.
- IRS could be more productive in detecting unreported gross receipts by matching the Schedule C and information returns filed or analyzing the ratio of total gross receipts reported on the Schedule C and information returns in audit selection.
- No additional burden would be placed on third parties.

Con:

- The reporting is unlikely to stop all businesses that wish to hide payments.
- If their records do not account for whether the income was reported on a Form 1099-MISC, sole proprietors may have an additional burden to report the information.
- IRS would incur some costs to process and use the additional data.

9. Close gaps in existing information reporting on payments made to sole proprietors.

Information returns are not required on all payments for services, creating gaps when matching information returns that are filed to determine if all the service payments received have been properly reported. Two options to address these gaps include requiring information reporting on annual service payments that (1) are made to all corporations or to some subset , such as small corporations, non-publicly held corporations, or noncompliant corporations (clear definitions of exclusions would be needed), and (2) total less than $600, which now triggers information reporting.

Pro:

- Sole proprietors who incorporate or receive payments below $600 should be more likely to comply in reporting business income.
- Sole proprietors would be less likely to structure payment amounts to avoid information reporting.
- Businesses would not have to distinguish between incorporated and unincorporated businesses in determining whether to file information returns.
- IRS could improve the productivity of its computer matching for unreported income.

Con:

- Businesses that file more information returns could incur significant costs and burdens, particularly if they have to expand their recordkeeping or make distinctions between small and large corporations.
- IRS would incur costs to process and match more information returns, and might not be able to use all of the new data if the number filed increases significantly.
- The information returns would be unlikely to encourage larger corporations that provide services to comply or help IRS find unreported income among larger corporations.
- Those receiving payments that are less than $600 might not account for much of the unreported income or might not be more noncompliant than other sole proprietors.

10. Require new information reporting by organizations on payments to sole proprietors.

These options would offer a way to get new information from organizations about payments made to sole proprietors.

a) Require businesses that process credit card payments for merchants to report information on the amount of payments made to sole proprietors for a tax year. This reporting could be a summary or include details for payments above some specified amount.

b) Require federal, state, and local governments to file information returns on all nonwage payments made (or those above a threshold) for property and services from corporate and noncorporate businesses. Certain payments, such as those related to interest, real property, and tax-exempt entities, would be excluded.

c) Require financial institutions to file information returns on business deposits and withdrawals by sole proprietors, which would be facilitated to the extent that business transactions are segregated in business accounts under business TINs.

Pro:

- Sole proprietors covered by any of these options might be more compliant in voluntarily reporting more business income on their Schedule Cs.
- Each of the options would provide information that IRS could use to select better enforcement cases or to be more productive in its enforcement activities. For example, credit card reporting could allow IRS to develop a ratio of credit card receipts to all receipts reported by sole proprietors by type of industry, and knowing deposit and withdrawal activity could allow IRS to better identify sole proprietors' gross receipts through its bank deposit analysis method. Similarly, the information can be used to avoid selecting a company for audit if the information reports suggest that the taxpayer is compliant.

Con:

- Credit card companies and financial institutions would have some reporting costs.
- Governments would incur some reporting costs, but they already would have to incur similar costs to meet the tax withholding requirement that Congress approved for these payments starting in 2011, and federal agencies are already required to file some of these data with IRS for federal contracts.[1]
- IRS would incur some costs to analyze the information from all the options and to figure out its best uses to identify underreporters.
- IRS might find it hard to use the increased amount of information returns at all or productively.
- If some businesses that use credit cards want to underreport income, they might move more transactions to the cash economy.

[1]See section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, May 17, 2006.

- The information would not help identify unreported income among sole proprietors who do not use credit cards, do not have accounts with financial institutions, or do not contract with governments.
- To the extent that financial institutions are reporting deposits and withdrawals related to nonbusiness activities, or that sole proprietors move funds between multiple business accounts, the information could create false leads for IRS that burden compliant taxpayers.

11. Require new information reporting on consumer payments to sole proprietors.

This option envisions new information reporting by organizations but also by consumers. It would require property owners to report on payments made to contractors for improvements if the payments will be used to adjust the basis of the property for depreciation or sales purposes. Property owners would be required to report the contractors' TINs. Absent the information return in their records, the property owners could not adjust the basis for tax purposes.

Pro:

- Information reporting on such contracts could cover a substantial dollar value.
- Sole proprietors may be more likely to report the payments on their tax returns.
- The payment information could cover a larger portion of the gross receipts than just service payments.
- Consumers would not have to be burdened with distinguishing the type of business or type of payment in doing the reporting, and overall burden would be limited by how often they contract for improvements.
- Property owners would have some incentive to report the contractor payments and a defensible foundation for basis adjustments claimed in the future.

Con:

- The incentive for property owners may dissipate if their basis adjustments offer few tax benefits because they do not depreciate or are not expected to have a taxable gain when they are sold, or because property owners do not keep the information returns in their records in order to compute and justify adjustments to basis many years later.
- Property owners would have some burden to track and report the information and to deal with contractors that do not want to provide their TINs, for which some recourse would be needed.

- If contractors want to avoid having these payments reported to IRS, they could negotiate with property owners for a lower price in return for property owners not filing the information returns.
- IRS would have to spend some time and money sorting the information, particularly if the information is reported on paper rather than electronically, and then using the information for research or enforcement.
- IRS might find it hard to use all of the new information or to use it productively.
- Some may view disallowing a basis adjustment as a harsh penalty for failing to file an information return.

D. Overstated Deductions for Sole Proprietor Expenses

A portion of the $68 billion sole proprietor tax gap arises from overstating deductions for business expenses. Based on what NRP detected, IRS has estimated for 2001 that about 73 percent of the sole proprietors misreported about $40 billion in expense deductions. Although IRS auditors find it easier to check claims for expense deductions than to hunt for unreported income, IRS audits cover few of the noncompliant sole proprietors who overstate business deductions. And the information reporting system does not cover payments made by sole proprietors that could be deductible business expenses. The options in this section look to provide more information about expenses to allow IRS to match or otherwise use to find overstated deductions.

12. Expand expense reporting on the Schedule C.

Sole proprietors would break out the amount of payments made for services on the relevant expense lines of the Schedule C. Additional information could be required, such as for payments above a specified amount.

Pro:

- Sole proprietors might be more sensitized to the need to accurately claim expense deductions on the Schedule C and the need to also report them on required information returns.
- Tax preparers would have more incentive to check expense reporting compliance.
- If adequate, IRS could use the data to detect overstated expenses by matching amounts reported as expenses on the Schedule C lines with the amounts reported on information returns filed by the sole proprietor or by analyzing the ratio of total expenses to amounts reported on an information return’s audit selection.
- No additional burden would be placed on third parties.

Con:

- IRS might have difficulties processing and matching all of the new expense data.
- IRS would incur difficulties, such as extra costs, to process and use the additional data.
- If their records are incomplete on their expenses and information returns or their accounting systems do not break out expenses by the services provided, sole proprietors may have an additional burden to report the information.
- This would not stop all reporting noncompliance.

13. Match information returns filed by sole proprietors with related expenses on their Schedule Cs.

IRS would match the existing information returns filed by sole proprietors to report their payments made for wages, services, and so forth to the related lines of the Schedule C in order to see whether the expenses claimed are consistent with the amounts reported on the information returns. As with any computer match, IRS would need to develop rules for doing the match and tolerances for contacting the sole proprietors about discrepancies.

Pro:

- Such reverse matching could help identify excess deductions, especially for wages, without incurring the costs of audits.
- If sole proprietors learn about the reverse matching, they may become more compliant in reporting expenses
- This matching would not impose any new burdens on third parties and little burden on compliant sole proprietors if the matching criteria are effective.

Con:

- Beyond wages and possibly some types of nonemployee compensation, IRS may find it difficult to effectively match expenses in order to avoid contacting compliant sole proprietors.
- If sole proprietors want to overstate deductions and know that IRS can use the information returns they file to look for overstated deductions, some of them may file fictitious information returns.

14. Expand information reporting on the expenses of sole proprietors.

The expanded information reporting to cover expenses claimed on the Schedule C could include two options:

a) Businesses receiving certain types of payments from sole proprietors in large amounts (i.e., thousands of dollars) would file information returns to report those amounts by type of expense. Beyond limiting such reporting to large dollar amounts (which would need to be set), the reporting also could be limited to certain types of payments that are easier to report or that tend to be overstated as expenses on the Schedule C (e.g., rents, fees, insurance, and travel).

b) Businesses that process credit (and debit) card payments would be required to report information on the amount of payments by sole proprietors for each tax year. This reporting could be a summary total or include more details for payments above some specified amount. IRS would need to decide how it would use this information to check for overstated expenses on the Schedule C.

Pro:

- Having the data might help IRS detect certain overstated expenses without incurring the costs of an audit. Otherwise, IRS would have more information on the expenses of sole proprietors for use in selecting cases for auditing.
- Sole proprietors might report their expenses more accurately with third-party data.

Con:

- Third-party businesses doing the reporting would have additional costs to file the information returns or burdens to know whether the payments are personal or business related.
- Some businesses might not want to report to IRS about payments they receive from sole proprietors, particularly if those payments account for most of their gross receipts and they underreport those payments on their tax returns.
- Sole proprietors wishing to avoid the credit reporting may use more cash purchases.
- If IRS were to use the information in a matching program, it would incur costs to process and match it in order to avoid contacting compliant sole proprietors and to identify personal expenses mixed in with business expenses.

15. Verify additional expenses claimed to offset unreported income.

Through some form of review or audit of documentation, IRS could verify additional business expenses in those cases where sole proprietors claim additional expenses after IRS informs them that it has discovered unreported business income.

Pro:

- IRS could improve the effectiveness of its AUR matching to the extent that it stops sole proprietors from claiming unverified expense offsets.

Con:

- If AUR staff do the verification, IRS would incur costs to train them to do the verification and find additional staff to keep up the volume of AUR contacts.
- If audit staff do the verification, IRS would have to make sure that the return on investment justifies allocating more expensive, better-trained staff to do the verification.
- If IRS develops some other verification program, it would incur start-up and operational costs.

E. Nonpayment of Tax

In addition to misreporting business income and expenses, the noncompliant sole proprietors do not pay their tax liabilities. Even so, they can receive government benefits, such as contract payments and Social Security credits. And they are not subject to a proven tax compliance technique for many individual taxpayers—tax withholding. This section lists options that could help induce sole proprietors to meet their tax obligations to receive benefits or avoid tax withholding.

16. Deny benefits/payments until tax obligations are met.

One way to induce sole proprietors to pay their taxes owed is to deny them government benefits unless they have paid the taxes. Federal agencies that provide the benefits would need to check for tax compliance with IRS, and the prohibitions against disclosing tax data would need to be revised to ensure that the authority exists. Two options for checking tax compliance before providing government benefits are to

a) require that sole proprietors pay their self-employment tax obligations in order to receive credit for Social Security benefits or

b) require federal agencies to do a tax compliance check with IRS before making a contract payment or otherwise providing a government benefit (certain loans or grants) to a sole proprietor (either all or just contractors). At a minimum, a check would be made to see whether the sole proprietor has unfiled tax returns or unpaid tax liabilities.

Pro:

- Sole proprietors would have an incentive to meet their tax obligations.
- This would help ensure that compliant sole proprietors' competitors pay their taxes.

Con:

- To the extent that sole proprietors are not motivated by the loss of Social Security credits or government benefits, some of them may continue to not pay their taxes.
- Sole proprietors could be unjustly denied credits or benefits because of a systemic/human error and thus would need some venue for seeking an administrative remedy.
- Federal agencies would incur costs to check compliance and might incur some contracting delays if the compliance checks take a lot of time.
- Denying some types of loans/grants (e.g., for disaster or poverty) may be seen as harsh.

17. Withhold tax to encourage tax compliance.

Another way to induce sole proprietors to pay their taxes owed is to require situational or universal tax withholding from the payments made to them. Two basic options would require those who are to file information returns (e.g., government and business entities) on payments made to sole proprietors to do tax withholding:

a) Withhold a small amount from payments until the sole proprietor's TIN is certified. This up-front withholding would replace "backup withholding" in those cases where, over a year or more later, IRS informs the sole proprietor that the TIN provided is invalid. IRS would need a system for quickly and accurately certifying TINs, which can be either EINs or Social Security numbers. Also, decisions would be needed on how much to withhold and on what to do with the withheld amounts (e.g., paid to the sole proprietor once the TIN is certified or remitted to IRS and reconciled when the tax return is filed).

b) Withhold a small percentage of the payments made to sole proprietors for services either in all cases or in limited situations, such as when sole proprietors (1) voluntarily consent or (2) have a recent history of tax noncompliance and IRS has not annually certified that they are now tax compliant.

Pro:

- Sole proprietors would be more motivated to provide TINs that can be certified, file their returns, report their income, and pay their taxes.
- Those paying sole proprietors would probably have fewer burdens from withholding the taxes up front compared to doing backup withholding over a year later.
- Using a low rate could get the sole proprietors into the system without necessarily creating an undue burden on their business operations.
- IRS would have fewer information returns with erroneous TINs that it spends resources trying to correct or that cannot be used in its computer matching programs.

Con:

- Withholding would create an added burden for those doing business with the sole proprietor, especially if they do not have systems for doing withholding or periodically remitting tax amounts to IRS, or if they would not have had to do backup withholding.
- Business relationships or operations might be disrupted if IRS's system for validating TINs is slow or burdensome, or generates errors, while some businesses may refuse to validate the TINs or to withhold payments if requested to do so by the sole proprietor that they want to use.
- Even with one low withholding rate, some sole proprietors may be burdened if, for example, they operate on thin profit margins or have limited working capital.
- If multiple, withholding rates or exceptions for withholding were created by industry, location, years in business, compliance history, and so forth to minimize the negative business impacts on sole proprietors, questions might arise about complexity, equity, and opportunities for "gaming" the system to have a lower or no withholding rate.
- If withholding were limited to sole proprietors, some could incorporate or claim to be a corporation to avoid withholding.

F. IRS Management of Limited Resources

Following up on AUR mismatches and conducting examinations are costly. Furthermore, some of IRS's compliance and enforcement actions mistakenly select compliant, rather than noncompliant, taxpayers. This section discusses options for more effectively using IRS's limited resources by better using data and other tools.

18. Improve audit selection of sole proprietor tax returns.

IRS could explore opportunities for improving its selection of sole proprietor tax returns and tax issues to be audited in at least two ways.

a) IRS would use advanced automated selection systems to update the current manual classification system to better select returns and tax issues for audit.

b) IRS would improve the ability of AUR to refer cases for audit, such as when unverified (e.g., oral) claims about income and expenses are made. AUR is limited in pursuing such cases, and IRS Examination already has selected many cases for audit by the time the referrals are made.

Pro:

- IRS could select returns with a higher likelihood of tax changes at a lower cost and with lower burden on compliant sole proprietors.
- More automation could free a number of experienced audit staff who help select these returns and these tax issues for audit to do more audits.
- IRS might be able to increase the dollar yield from finding unreported income and denying unjustified claims for offsetting deductions.

Con:

- IRS would incur costs to collect and test enough data to create an effective automated system.
- IRS is likely to still need some manual intervention to account for location-specific issues that cannot be programmed into the automated system
- IRS might find that these AUR cases are still less productive than other audit cases.

19. Enhance data sharing with the states.

IRS would seek to improve data-sharing arrangements with the states. State data could include using business licensing, ownership of real estate or other large assets, sales receipts, and tax compliance data to identify unfiled returns and underreported income.

Pro:

- IRS could cost effectively identify noncompliance, especially nonfilers, that it otherwise would miss.

Con:

- State data may be difficult to match with federal data because states impose different taxes than the federal government, may use a different taxable base, and may report the data in a format that IRS cannot easily use.

20. Use informational notices to encourage compliance.

IRS would send notices (soft notices) to Schedule C filers when it sees potential compliance issues that it does not have the resources to audit. These notices notify and educate the filers about a potential problem with a tax reporting obligation, and suggest that they either recheck their filed tax returns or change their reporting on future returns.

Pro:

- IRS can expand its presence/education and sensitize sole proprietors about tax obligations without the costs of enforcement contacts.
- Some sole proprietors may become more compliant voluntarily.

Con:

- Some sole proprietors will ignore the soft notices, particularly if they are received years after a return was filed or if IRS will not take follow-up action regardless of what they do.

21. Revise the rules for applying penalties to improve consistency and compliance

One tool to increase compliance is to punish improper behavior with penalties. Two options to remedy the inconsistent application of penalties are to

- simplify the process for assessing penalties and develop standards to ensure the consistency of their application to sole proprietor errors and misconduct and
- make information return penalties scalable by increasing the dollar amount of penalties for subsequent failures to file required information returns (e.g., the penalty for the tenth failure to file an information return may be significantly higher than the first).

Pro:

- Sole proprietors who are significantly noncompliant would be penalized, and the equity and consistency of penalty application might improve.

- Some sole proprietors might become more compliant if they are certain that penalties will be applied.
- If IRS applies the penalties more consistently, fewer sole proprietors may need to incur the burden of seeking abatements for unnecessary penalties.
- IRS could receive more required information returns that are accurate and timely.

Con:

- If the process becomes too rigid, some sole proprietors might resent the perceived inequities. Some sole proprietors might have equity concerns if IRS cannot reduce higher penalties caused by a systemic glitch for many information returns (e.g., a computer error that occurred over and over).
- If revised penalty rules go too far in accounting for inadvertent actions, hardships, and other reasonable causes, the penalty consistency may be hard to achieve.
- If many sole proprietors are required to file only a few information returns, scaling penalties would have little impact, and if only a small dollar amount of penalties is at stake, IRS procedures are likely to continue authorizing abatement of the penalties.

Appendix III: IRS Form 1040 Schedule C, Tax Year 2001

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2001

Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see page C-1 of the instructions) | **B Enter code from pages C-7 & 8** ▶

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN), if any**

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2001? If "No," see page C-2 for limit on losses . ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2001, check here . . . ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here ▶ ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8	**19**	Pension and profit-sharing plans	19	
9	Bad debts from sales or services (see page C-3)	9	**20**	Rent or lease (see page C-4):		
			a	Vehicles, machinery, and equipment	20a	
10	Car and truck expenses (see page C-3)	10	**b**	Other business property	20b	
11	Commissions and fees	11	**21**	Repairs and maintenance	21	
12	Depletion	12	**22**	Supplies (not included in Part III)	22	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	**23**	Taxes and licenses	23	
			24	Travel, meals, and entertainment:		
			a	Travel	24a	
14	Employee benefit programs (other than on line 19)	14	**b**	Meals and entertainment		
15	Insurance (other than health)	15	**c**	Enter nondeductible amount included on line 24b (see page C-5)		
16	Interest:					
a	Mortgage (paid to banks, etc.)	16a	**d**	Subtract line 24c from line 24b	24d	
b	Other	16b	**25**	Utilities	25	
17	Legal and professional services	17	**26**	Wages (less employment credits)	26	
18	Office expense	18	**27**	Other expenses (from line 48 on page 2)	27	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	
29	Tentative profit (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity (see page C-6). • If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you **must** attach **Form 6198.**	**32a** ☐ All investment is at risk. **32b** ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 2001**

Source: IRS.

Schedule C (Form 1040) 2001 Page **2**

Part III **Cost of Goods Sold** (see page C-6)

33 Method(s) used to value closing inventory: **a** ☐ Cost **b** ☐ Lower of cost or market **c** ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ **Yes** ☐ **No**

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36 Purchases less cost of items withdrawn for personal use	36	
37 Cost of labor. Do not include any amounts paid to yourself	37	
38 Materials and supplies	38	
39 Other costs	39	
40 Add lines 35 through 39	40	
41 Inventory at end of year	41	
42 **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-3 to find out if you must file.

43 When did you place your vehicle in service for business purposes? (month, day, year) ► ____/____/____ .

44 Of the total number of miles you drove your vehicle during 2001, enter the number of miles you used your vehicle for:

a Business ____________ **b** Commuting ____________ **c** Other ____________

45 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ **Yes** ☐ **No**

46 Was your vehicle available for personal use during off-duty hours? . . . ☐ **Yes** ☐ **No**

47a Do you have evidence to support your deduction? . . . ☐ **Yes** ☐ **No**

b If "Yes," is the evidence written? . . . ☐ **Yes** ☐ **No**

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

48 **Total other expenses.** Enter here and on page 1, line 27	48	

Schedule C (Form 1040) 2001

Source: IRS.

Appendix IV: Independent Contractors and Section 530 of the Revenue Act of 1978

With increased IRS enforcement of the employment tax laws beginning in the late 1960s, controversies developed over whether employers had correctly classified certain workers as independent contractors rather than as employees. In some instances when IRS prevailed in reclassifying workers as employees, the employers became liable for portions of employees' Social Security and income tax liabilities (that the employers had failed to withhold and remit), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 (Pub. L. No. 95-600). That provision generally allows an employer who meets certain requirements (such as filing required information returns) to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Under section 530, a reasonable basis is considered to exist if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, (3) long-standing recognized practices in the industry of which the taxpayer is a member, or (4) any other reasonable basis for treating a worker as an independent contractor. Section 530 also prohibits the issuance of Treasury regulations and revenue rulings on common-law employment status.[1] Congress intended that this moratorium to be temporary until more workable rules were established but the moratorium continues to this day. The provision was extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.[2]

The rules to classify a worker as an employee or an independent contractor are still complex and often difficult to apply. The determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the worker is subject to the control of the employer, not only as to the nature of the work performed but the circumstances under which it is performed. In general, the determination of whether an employer-employee relationship exists for federal tax purposes is made under a common-law test.

[1]A taxpayer may, however, request and obtain a written determination from IRS regarding the status of a particular worker as an employee or independent contractor.

[2]Pub. L. No. 97-248, September 3, 1982.

IRS has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. The 20 factors were developed by IRS based on an examination of cases and rulings considering whether a worker is an employee.[3] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed.[4]

Misclassification of workers can be either inadvertent or deliberate. Because the determination of classification is factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently. The prohibition on issuance of general guidance by IRS may make the likelihood of classification errors greater; IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement.

A significant issue is the potential revenue loss to the federal government when employees are misclassified as independent contractors. An IRS survey of 1984 employment tax returns found that nearly 15 percent of employers misclassified employees as independent contractors. When employers classified workers as employees, more than 99 percent of wage and salary income was reported. When workers were misclassified as independent contractors, 77 percent of income was reported when a Form 1099-MISC was filed and only 29 percent was reported when no Form 1099-MISC was filed.

[3]IRS has also developed three categories of evidence that may be relevant in determining whether a worker is a contractor or employee under the common-law test. The three categories are behavioral control, financial control, and type of relationship.

[4]For a list of the 20 factors and a discussion of their application, see GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

Appendix V: Backup Withholding Rules

Persons (payers) making certain types of payments must withhold and pay to IRS a specified percentage of those payments under certain conditions. Related to sole proprietors, for example, both (1) the commissions, fees, or other payments for work as an independent contractor and (2) payments by fishing boat operators, but only the part that is in money and that represents a share of the proceeds of the catch, are reported on Form 1099-MISC. Other payments are not subject to backup withholding, including wages, real estate transactions, foreclosures and abandonments, and canceled debts. Also corporations, governmental entities, and foreign governments generally are exempt from backup withholding.

For backup withholding to be initiated on payments to sole proprietors, a payment must be reportable and the payee must fail to furnish a correct TIN.[1] If an incorrect TIN is provided, IRS is to notify the payer regarding the missing, incorrect, or not currently issued payee TIN. At that time the payer is required to compare the listing with his or her records and send a notice to the payee, asking for the correct TIN. Under tax rules, if the payee refuses to provide a TIN, the payer is required to immediately begin withholding 28 percent of the amount of the payment and remit that amount to IRS. IRS procedures describe how the payer is to verify the TIN and request that the payee provide a correct TIN. The payer must make up to three solicitations for the TIN (initial, first annual, and second annual) to avoid a penalty for failing to include a TIN on the information return. If the payer files an information return with a missing TIN or with an incorrect name and TIN combination, or does not follow the procedure to correct the TIN, the payer may be subject to a $50 penalty for each incorrect return filed.

[1]Backup withholding also applies when the payee fails to certify, under penalties of perjury, that the TIN provided is correct for interest, dividend, and broker and barter exchange accounts opened or instruments acquired after 1983.

Appendix VI: Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 10, 2007

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

Dear Mr. White:

We appreciate the opportunity to review and provide comments on the draft report titled "Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance (GAO-07-1014)."

In addition to specific technical comments that we provided to your staff, we would like to respond to the report's recommendation that "the Secretary of the Treasury ensure that the tax gap strategy includes (1) a segment on improving sole proprietor compliance that is coordinated with broader tax gap reduction efforts and (2) specific proposals such as the options, such we identified, that constitute an integrated package." Although not addressed specifically, the seven elements of the Treasury Department's strategy are intended to apply broadly to all types of business and individual taxpayers, including sole proprietorships. As we continue to consider application of the strategy to the most significant elements of the tax gap, your report will provide valuable insight.

Thank you for your analysis and suggestions on this important issue.

Sincerely,

Michael Desmond

Michael J. Desmond
Tax Legislative Counsel

Appendix VII: GAO Contact and Staff Acknowledgments

GAO Contact

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

Acknowledgments

In addition to the contact named above, Tom Short, Assistant Director; Evan Gilman; Eric Gorman; Leon Green; George Guttman; Shirley Jones; Donna Miller; Karen O'Conor; Anna Maria Ortiz; and Sam Scrutchins made key contributions to this report.

Related GAO Products

Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap. GAO-07-488T. Washington, D.C.: February 16, 2007.

Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap. GAO-07-391T. Washington, D.C.: January 23, 2007.

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