

**The Internal Revenue Service Is Making
Progress in Addressing Compliance Among
Small Businesses Engaged in Electronic
Commerce**

November 2004

Reference Number: 2005-30-010

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 26, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Making
Progress in Addressing Compliance Among Small Businesses
Engaged in Electronic Commerce (Audit # 200330036)

This report presents the results of our review of small businesses engaged in electronic commerce. Electronic commerce is the sale or exchange of goods or services over the Internet. The overall objective of this review was to evaluate the Small Business/Self-Employed (SB/SE) Division's approach in addressing reporting compliance among small businesses that are doing business over the Internet.

In summary, in March 2004, the SB/SE Division estimated that the tax gap¹ among small businesses that are doing business over the Internet may be as high as \$1 billion. The SB/SE Division also noted in a March 2004 report² that global electronic commerce is projected to increase to \$12.8 trillion by 2006, from its current level of \$1.2 trillion. To address this gap, the SB/SE Division has taken a number of proactive steps to provide education and outreach and has developed plans to begin a detailed evaluation of electronic commerce reporting compliance beginning in 2005.

Specifically, the SB/SE Division has established general tax information sharing partnerships with Internet-related trade associations and Internet service providers. The SB/SE Division also implemented a focused outreach effort designed to improve the

¹ The gross tax gap is defined as the amount of tax liability for a given year that is not paid voluntarily and timely.

² Electronic Business Compliance: *A Report on the Impact of E-Business on SB/SE Compliance and the Status of E-Business Compliance Activities*, SB/SE Reporting Compliance, E-Business, (Whitepaper), March 22, 2004

reporting compliance of online bartering exchanges³ that did not file Proceeds From Broker and Barter Exchange Transactions (Form 1099-B).

Gathering reliable compliance information on small businesses engaged in electronic commerce presents a significant challenge for the Internal Revenue Service (IRS). It is presently impossible to identify income attributable to electronic commerce activity from the information maintained in the IRS databases or from a review of the information on filed tax returns. Similarly, information presently collected regarding examination-related adjustments does not contain sufficient specificity to isolate electronic commerce activity. As a result, the only reliable method of gathering compliance trend information regarding small businesses engaged in electronic commerce is through the examination of selected taxpayers.

The SB/SE Division's progress in gathering compliance measurement and trend information regarding small businesses engaged in electronic commerce has generally been slow. However, the SB/SE Division has developed preliminary plans to perform a detailed evaluation of electronic commerce compliance beginning in 2005. This effort will involve approximately 1,800 examinations to be performed in Fiscal Years 2005 through 2007 via a series of Compliance Improvement Projects (CIP)⁴ focusing on small businesses engaged in electronic commerce. This approach, if implemented as planned, should provide the SB/SE Division with significant data regarding small business taxpayer compliance levels. The SB/SE Division is also working with the National Research Program (NRP) project office in an effort to ensure detailed information is gathered regarding electronic commerce-related compliance during the upcoming evaluation of partnerships and small corporations.

While the SB/SE Division has made progress in preparing for the approximately 1,800 examinations to be performed in Fiscal Years 2005 through 2007, additional planning would help ensure the uniformity of the data gathered and improve the overall efficiency of this effort. For example, although each market segment CIP is supported by its own detailed activity plan, an overall methodology for accumulating and analyzing all of the information gathered during the examinations has not been developed.

We recommended the Director, Examination, SB/SE Division, continue with current plans to use CIPs to collect detailed compliance data on small businesses that are doing business over the Internet. The Director, Examination, SB/SE Division, should also consider the feasibility of gathering electronic commerce compliance data using general examination program examinations. Additionally, the Director, Examination, SB/SE Division, should develop an overall methodology for accumulating and analyzing all of the information gathered during the planned CIPs. Finally, the Director, Examination, SB/SE Division, should continue to coordinate with the NRP project office to ensure electronic commerce-related information is gathered during the upcoming

³ An Internet bartering exchange facilitates the exchange of one good or service for another and earns a profit by charging a fee on each transaction.

⁴ A CIP is any activity involving contact with specific taxpayers within a group to identify potential areas of noncompliance.

evaluation of partnerships and small corporations. Due to limited resources, in the past the IRS has not fully addressed initiatives that are not one of its seven priority area issues.⁵ Electronic commerce is not one of the priority areas; however, it is important that this initiative be completed due to the volume of potential noncompliance and increased use of electronic commerce activity.

Management's Response: IRS management agreed with the recommendations presented in our report and indicated it has already begun implementing corrective actions. Specifically, management will continue to acquire data and develop measurements on Electronic Business (E-Business) Compliance issues through CIPs and other techniques as outlined in the E-Business Compliance Strategy. Management is also currently reviewing options for the gathering of electronic commerce income adjustment information as part of general examination program examinations. Additionally, management is developing a database for the storage of acquired information, along with a standardization of data gathering sources for individual CIPs. Finally, management is currently coordinating with the NRP project office to determine the extent of information to be gathered during the upcoming evaluation of partnerships and small corporations. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to IRS officials who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

⁵ In July 2002, the IRS Commissioner presented seven new compliance priority examination areas as a priority-based approach for the assignment of new income tax examination workload.

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The Internal Revenue Service Is Making Progress in Addressing Compliance Among Small Businesses Engaged in Electronic Commerce

Background

Electronic commerce is the sale or exchange of goods or services over the Internet. Global electronic commerce is projected to increase to \$12.8 trillion by 2006, from its current level of \$1.2 trillion. This is equivalent to about 18 percent of the world's gross domestic product. In 2001, the United States accounted for approximately 71 percent of total electronic commerce sales.¹

In October 2000, the Internal Revenue Service (IRS) completed a research study that analyzed the tax compliance risks associated with electronic commerce.² The study indicated an income tax gap³ of \$6.2 million in 1997 for the 426 commercial web sites selected. Most of the tax gap identified was due to the understatement of taxable income. In addition, 10 percent of the selected commercial web site owners failed to file their 1997 tax returns and 12 percent could not be identified, so their filing status is unknown. The study included retail and wholesale businesses, financial services, business services, Internet service providers, computer sales/services businesses, and adult entertainment businesses. In March 2004, the Small Business/Self-Employed (SB/SE) Division estimated that the total tax gap among small businesses that are doing business over the Internet may be as high \$1 billion.

To help focus and coordinate its compliance efforts regarding small businesses engaged in electronic commerce, in October 2000, the SB/SE Division established a small electronic commerce compliance team within the Compliance Policy function. This team was realigned as a separate unit within the Reporting Enforcement area in October 2003. Similarly, an Electronic Business (E-Business) unit was established within the SB/SE Division Taxpayer Education and Communication

¹ Electronic Business Compliance: *A Report on the Impact of E-Business on SB/SE Compliance and the Status of E-Business Compliance Activities*, SB/SE Reporting Compliance, E-Business, (Whitepaper), March 22, 2004.

² Electronic Commerce: *Challenges and Opportunities*, Research and Analysis Division, Upstate New York District, October 2000.

³ The gross tax gap is defined as the amount of tax liability for a given year that is not paid voluntarily and timely.

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organization in June 2002 to focus education and outreach efforts on small businesses engaged in electronic commerce.

This review was performed at the SB/SE Division Headquarters in New Carrollton, Maryland, and at the Reporting Compliance E-Business unit in Dallas, Texas, during the period August 2003 through June 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

A Number of Proactive Steps Have Been Taken to Provide Education and Outreach to Small Businesses Engaged in Electronic Commerce

The SB/SE Division has established tax information sharing partnerships with numerous web site owners, Internet-related trade associations, and Internet service providers. These partnerships have a number of benefits, including increasing ways by which the IRS can provide tax law information to small business taxpayers. In addition, the SB/SE Division established a web site in March 2003 dedicated to providing tax law information and assistance to small businesses engaged in electronic commerce.

The SB/SE Division also implemented a focused outreach effort designed to improve the reporting compliance of online bartering exchanges.⁴ This outreach was performed in coordination with a Compliance Improvement Project (CIP),⁵ which identified that 758 of the 1,695 bartering exchanges sampled did not file Proceeds From Broker and Barter Exchange Transactions (Form 1099-B) in 2002.⁶ Bartering exchanges are required to annually file a Form 1099-B on bartering transactions and to collect the exchange member's Taxpayer Identification Number.

In October 2003, informational letters concerning Form 1099-B filing requirements were sent to bartering exchanges that did not file Forms 1099-B. A follow-up

⁴ An Internet bartering exchange facilitates the exchange of one good or service for another and earns a profit by charging a fee on each transaction.

⁵ A CIP is any activity involving contact with specific taxpayers within a group to identify potential areas of noncompliance.

⁶ Compliance Improvement Project: Internet Bartering Exchanges, approved April 17, 2003.

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Preliminary Plans Provide for a Detailed Evaluation of Electronic Commerce Compliance Beginning in 2005

analysis is presently in progress to determine what percentage of the exchanges that received the letters complied and filed Form 1099-B in 2004 for Tax Year 2003. General tax information regarding filing requirements was also placed on the IRS web site (IRS.gov) and a bartering association web site.

Gathering information on compliance among small businesses engaged in electronic commerce presents a significant challenge for the IRS. It is presently impossible to identify income attributable to electronic commerce activity from the information maintained in the IRS databases or from a review of the information on filed tax returns. Similarly, when tax returns are examined by the IRS, information is not collected to specifically identify and isolate electronic commerce activity. Gathering these types of data would require revising existing examination procedures and adding additional elements to the data collected regarding examination adjustments. The only reliable method of gathering compliance trend information regarding small businesses engaged in electronic commerce is through the examination of selected taxpayers.

Overall, the SB/SE Division's progress in gathering detailed measurement and trend information regarding small businesses engaged in electronic commerce compliance has been slow. Although the study of 1997 tax returns indicated there was noncompliance among businesses engaged in electronic commerce, the only tax compliance data subsequently gathered by the SB/SE Division regarding electronic commerce was obtained from the narrowly focused review on Internet bartering exchanges initiated in 2003. Management informed us that a number of other efforts to gather additional data through the examination of small businesses engaged in electronic commerce were previously rejected because they were not directly related to an examination priority area.⁷

⁷ In July 2002, the IRS Commissioner presented seven new compliance priority examination areas as a priority-based approach for the assignment of new income tax examination workload.

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Although progress has been slow in addressing electronic commerce compliance, the SB/SE Division has developed preliminary plans to perform a detailed evaluation beginning in 2005. This effort will involve approximately 1,800 examinations to be performed in Fiscal Years 2005 through 2007 and will be comprised of a series of CIPs focusing on small businesses engaged in electronic commerce. Approximately 650 of the 1,800 examinations are planned to begin in 2005. The CIPs will each focus on a different market segment related to small businesses engaged in electronic commerce. The overall purpose of these projects will be to identify the level of tax compliance for each market segment and identify solutions to improve compliance levels and address compliance issues, as necessary.

This approach, if implemented as planned, should provide the SB/SE Division with significant data regarding small business taxpayer compliance levels. Gathering these types of data is essential to the evaluation of compliance trends, development of new compliance approaches, and identification of areas in which taxpayer education and outreach need to be enhanced. In addition, the ongoing collection and analysis of data is essential for effective decision making and is a critical component of program management.

While the SB/SE Division has made progress in preparing for this effort, additional planning would help ensure the uniformity of the data gathered and improve overall efficiency. For example, although each market segment CIP is supported by its own detailed activity plan, an overall methodology for accumulating and analyzing all of the information gathered during the examinations has not been developed. Development of a single overall methodology for data accumulation and analysis would help ensure data uniformity, improve comparability of results, and enhance the overall efficiency of this effort.

The SB/SE Division is also in the process of working with the National Research Program (NRP) project office in an effort to ensure detailed information is gathered regarding electronic commerce-related compliance during the upcoming evaluation of partnerships and small corporations.

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Information gathering proposed by the SB/SE Division includes the amounts of adjustments for income and expenses related to business-to-business and business-to-consumer sales made using the Internet and other web site income.

Recommendations

The Director, Examination, SB/SE Division, should:

1. Continue with current plans to collect compliance data using a series of CIPs focusing on small businesses engaged in electronic commerce. Due to limited resources, the IRS has not fully addressed initiatives that are not one of its seven priority area issues. Electronic commerce is not one of the priority areas; however, it is important that this initiative be completed due to the volume of potential noncompliance and increased use of electronic commerce activity.

Management's Response: The current Electronic Business (E-Business) Compliance Strategy includes steps to continue to acquire data and develop measurements on electronic commerce markets and E-Business Compliance issues. Project, tracking, and aging codes are being implemented on examination cases to capture the results. The CIPs are designed to provide compliance data on selected markets.

2. Evaluate the feasibility of developing a methodology to gather electronic commerce-related income adjustment information as part of general examination program examinations.

Management's Response: The SB/SE Division Examination area is currently reviewing options to gather this information. The nature of electronic commerce income and expenses is that it is merged with general income and expenses by established firms that enter into the electronic commerce market place. There are relatively few pure electronic commerce businesses in existence. The merger of income and expenses makes it cumbersome and resource expensive to gather electronic commerce information from examinations initiated under other priority examination efforts.

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3. Develop an overall methodology for accumulating and analyzing all of the information gathered during the planned examinations with an emphasis on ensuring data uniformity and comparability.

Management's Response: A database for acquired information is in the process of being developed. Data gathering sources are being standardized for the individual CIPs.

4. Continue to coordinate with the NRP project office to ensure detailed information is gathered regarding electronic commerce-related compliance during the upcoming evaluation of partnerships and small corporations.

Management's Response: Management is currently coordinating with the NRP project office to determine what levels of questions are practical and acceptable.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the Small Business/Self-Employed (SB/SE) Division's approach in addressing reporting compliance among small businesses that are doing business over the Internet. In accomplishing this review, we relied on information accumulated by the Internal Revenue Service in established reports and did not perform any specific testing to verify its accuracy. To accomplish our objective, we:

- I. Determined whether the SB/SE Division had taken effective steps to develop a measure of reporting compliance among small businesses that are doing business over the Internet.
 - A. Interviewed SB/SE Division personnel and evaluated steps taken/planned to develop an overall measure of electronic commerce reporting compliance.
 - B. Evaluated plans to include steps in the next phase of the National Research Program (Phase II – Partnerships and Small Corporations) regarding electronic commerce reporting compliance.
- II. Ascertained whether the electronic commerce strategy was consistent with the compliance trends identified in data gathered by the SB/SE Division's Research and Analysis function.
- III. Determined whether key action items related to the development of electronic business taxpayer education were reasonable and supported by measurable milestones.
- IV. Determined whether the SB/SE Division was providing effective oversight to ensure the successful implementation of an electronic commerce strategy.
 - A. Reviewed the methodology (e.g., periodic conference calls, status reports, or other similar means) used to monitor the progress of key action items.
 - B. Evaluated steps taken to address any delays/difficulties identified in implementing key action items.

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Appendix II

Major Contributors to This Report

Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

Parker F. Pearson, Director

Philip Shropshire, Director

Anthony J. Choma, Audit Manager

Philip Smith, Lead Auditor

Cristina Johnson, Auditor

Rashme Sawhney, Auditor

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:CL
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division
SE:S:T
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

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Appendix IV

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
NOV 18 2004

November 5, 2004

MEMORANDUM FOR TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

FROM:

K. M. Brown
Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – Progress in Addressing Compliance Among
Small Businesses Engaged in Electronic Commerce Is Improving
(Audit No. 200330036)

I have reviewed your report and I appreciate your recognition of the number of proactive steps we have taken to address compliance in the Electronic Commerce (E-Commerce) field by providing educational outreach and developing a plan to evaluate E-Commerce reporting. We agree with your recommendations and we have already started to implement some of your recommendations. Electronic Commerce is emerging as a significant component of the economy, with twenty-five percent of U.S. Businesses now estimated as either purchasing or selling over the Internet.

The Small Business/Self-Employed (SB/SE) Division has recognized this growth in E-Commerce and responded with the formation of E-Business units in both our Examination and Taxpayer Education & Communications (TEC) divisions. The SB/SE Business Plan has established objectives for E-Commerce since fiscal year 2003 and will once again include objectives for FY2005. An E-Business Strategy has been developed and is being implemented systematically within SB/SE. A Service-Wide E-Commerce Board has been established to discuss and coordinate significant E-Commerce issues that are common to each of the major operating divisions.

The SB/SE compliance efforts have grown in proportion to the growth of E-Commerce in the market place. Today SB/SE has sub-programs in place for the dominant five key E-Commerce markets (Bartering, Auctions, Adult Entertainment, Online Retail/Services, and Business-to-Business transactions). Examination, TEC, SB/SE Research, and Media resources are being coordinated to identify and address compliance issues for these markets. Potential compliance issues that arise from the Internet and cut across markets, such as the influx of new electronic payment providers are also being reviewed to determine their impact and develop appropriate strategies.

Our comments on the recommendations in this report are as follows:

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RECOMMENDATION 1

Continue with current plans to collect compliance data using a series of Compliance Improvement Projects (CIPs) focusing on small businesses engaged in electronic commerce. Due to limited resources, the IRS has not fully addressed initiatives that are not one of its seven priority area issues. Electronic commerce is not one of the priority areas; however, it is important that this initiative be completed due to the volume of potential noncompliance and increased use of electronic commerce activity.

CORRECTIVE ACTION

The current E-Business Compliance Strategy includes steps to continue to acquire data and develop measurements on E-Commerce markets and E-Business Compliance issues. Project, tracking, and aging codes are being implemented on examination cases to capture audit results. The CIPs are designed to provide compliance data on selected markets.

IMPLEMENTATION DATE

November 30, 2005

RESPONSIBLE OFFICIAL(S)

Director, Examination, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, E-Business & Emerging Issues will advise the Director, Examination of any corrective action delays.

RECOMMENDATION 2

Evaluate the feasibility of developing a methodology to gather electronic commerce-related income adjustment information as part of general examination program examinations.

CORRECTIVE ACTION

SB/SE Examination area is currently reviewing options to gather this information. The nature of E-Commerce income and expenses is that it is merged with general income and expenses by established firms that enter into the E-Commerce market place. There are relatively few pure E-Commerce businesses in existence and they account for a very small percentage of E-Commerce. The merger of income and expenses makes it cumbersome and resource expensive to gather E-Commerce information from examinations initiated under other priority examination efforts.

IMPLEMENTATION DATE

July 31, 2005

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RESPONSIBLE OFFICIAL(S)

Director, Examination, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, E-Business & Emerging Issues will advise the Director, Examination of any corrective action delays.

RECOMMENDATION 3

Develop an overall methodology for accumulating and analyzing all of the information gathered during the planned examinations with an emphasis on ensuring data uniformity and comparability.

CORRECTIVE ACTION

A database for acquired information is in the process of being developed. Data gathering sources are being standardized for the individual CIPs.

IMPLEMENTATION DATE

November 30, 2005.

RESPONSIBLE OFFICIAL(S)

Director, Examination, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, E-Business & Emerging Issues will advise the Director, Examination of any corrective action delays.

RECOMMENDATION 4

Continue to coordinate with the NRP project office to ensure detailed information is gathered regarding electronic commerce-related compliance during the upcoming evaluation of partnerships and small corporations.

CORRECTIVE ACTION

We are currently coordinating with the NRP project office to determine what levels of questions are practical and acceptable.

IMPLEMENTATION DATE

November 30, 2005

RESPONSIBLE OFFICIAL(S)

Director, Examination

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CORRECTIVE ACTION MONITORING PLAN

The Program Manager, E-Business & Emerging Issues will advise the Director, Examination of any corrective action delays.

If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director Examination, Small Business/Self-Employed Division at 202-283-2170.