

Changing Patterns of
Noncompliance Among Sole
Proprietors: 1988-2001
A Comparison of TY88
TCMP and TY01 NRP
Results

Katie Fox, Janice Hu, and Peter Adelsheim
Internal Revenue Service

Background

**Gross Tax Gap
\$345 Billion**

**Individuals
\$293 Billion**

**Business Individuals
\$243 Billion**

Individuals with Business Income account for more than 70% of the total tax gap

Study Objective

To explore the pattern of noncompliance with the Federal Income Tax among Sole Proprietors

Areas of Focus

- ❑ Changes in line items most often misreported by sole proprietors
- ❑ Changes in magnitude of the misreporting
- ❑ Differences between the non-Schedule C line items misreported by sole proprietors and by other individual taxpayers
- ❑ Changes in line items of errors made in the government's favor

Sole Proprietors

Market Segment

Individual taxpayers with business income from a Schedule C.

Size of Population

1988: 13.3 million (12.7% of the population)

2001: 18.2 million (14.4% of the population)

Definition

A taxpayer who should have filed a Schedule C (whether one was filed or not) based on the outcome of the audit.

Research Approach

- Analyze errors taxpayers make on individual line items and on aggregates of certain line items.
- Provide estimates of the total number of errors made, of errors that understate tax, of errors that overstate tax, and of the magnitude of errors made.

NOTE: We defined a line item change as an error, regardless of size.

Audit Methodology

	TCMP	NRP
Examination Approach	Examiners evaluated every line item on the return	Returns guided through a classification process to identify mandatory issues for examination
	All audits conducted face-to-face	Audits conducted both by correspondence & face-to-face examinations
Data Collection	Manual calculation and entry of adjustments to line items on a paper checksheet	Electronic data capture in the Reports Generation Software (RGS) system

Data Limitations & Caveats

- ❑ Measurement differences
- ❑ Individual line item analysis
- ❑ NRP reported values ('per return' data)
- ❑ Zeros vs. Missing Data

Groups of Analysis

- 1. Sole Proprietors - Form 1040**
1988 and 2001
- 2. Sole Proprietors - Schedule C**
1988 and 2001
- 3. Sole Proprietors and Others**
2001

Error Rate = Count of taxpayers who made an error / count of taxpayers who had the chance to make an error

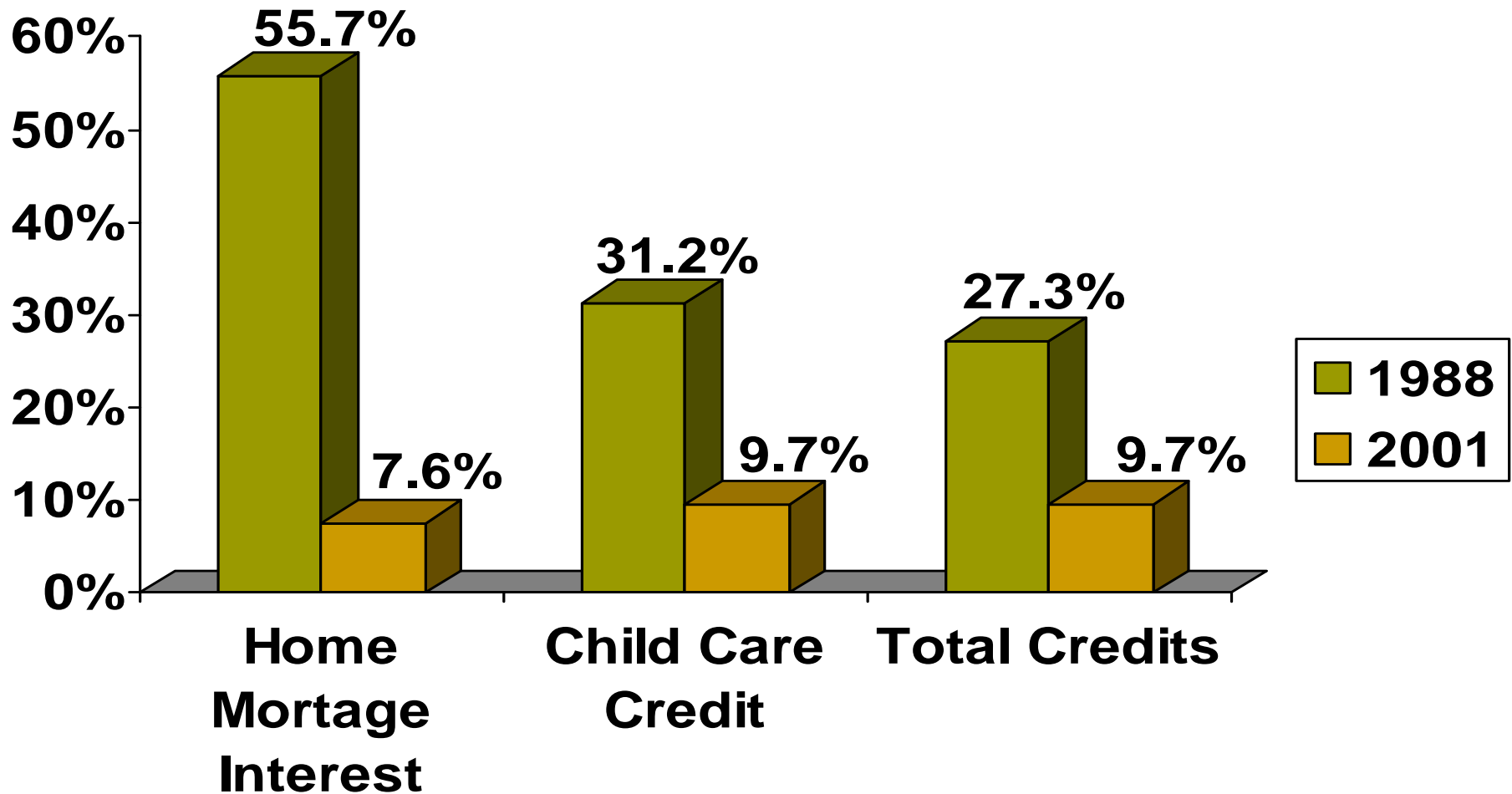
Group 1: Sole Proprietors – Form 1040

Overall Error Rates

Highest Overall Error Rates in 1988		Highest Overall Error Rates in 2001	
1. Total Income	85.6%	1. Total Tax	79.8%
2. Home Mortgage Interest	85.2%	2. Total Income	78.6%
3. Total Tax	84.5%	3. Adjustments to Income	68.5%
4. Child Care Credit	47.3%	4. Total Credits	44.3%
5. Total Credits	46.2%	5. Social Security Income	43.6%

Group 1: Sole Proprietors – Form 1040 Errors that Understate Tax

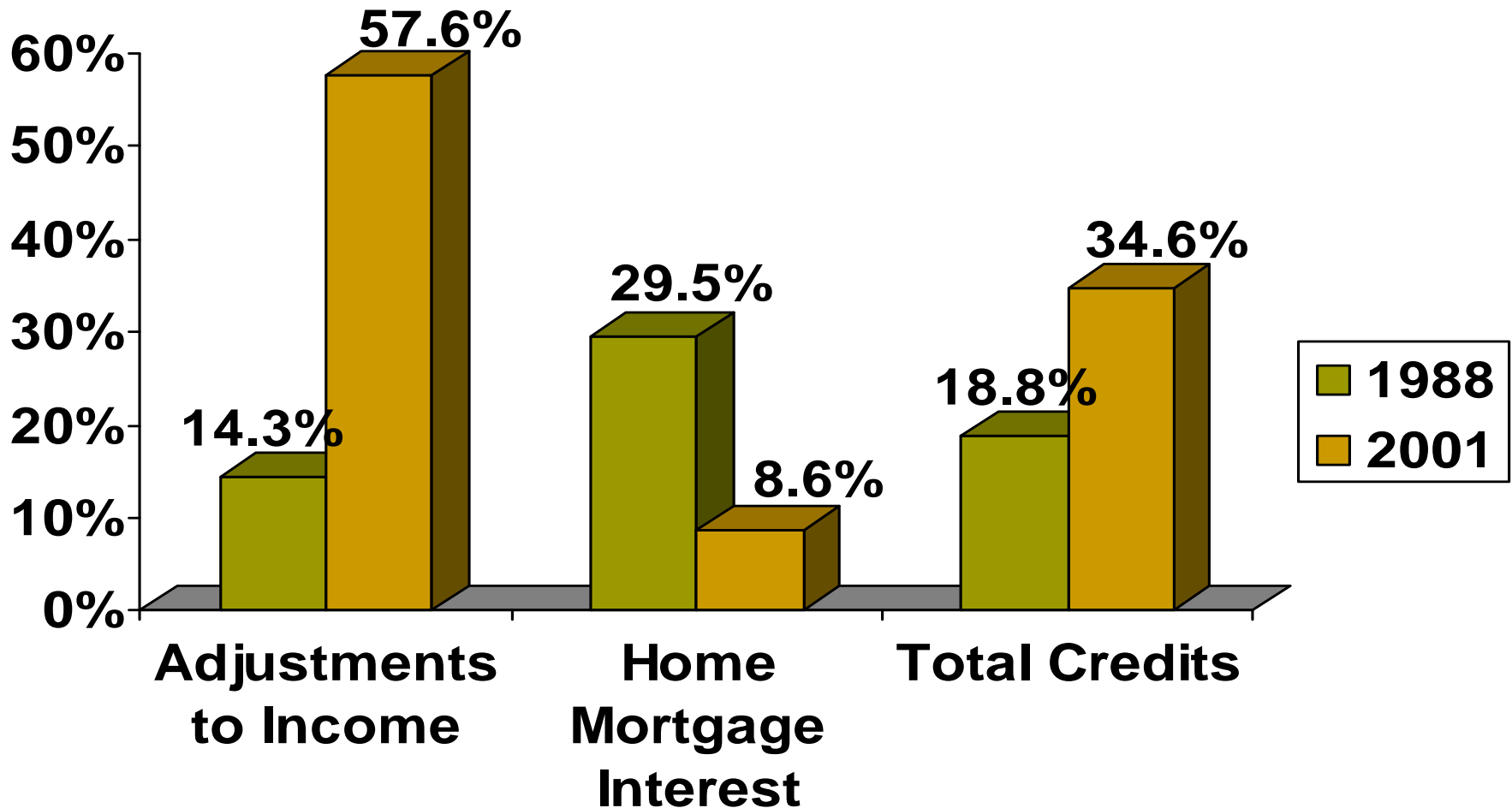
Largest Differences Between 1988 and 2001



Group 1: Sole Proprietors – Form 1040

Errors that Overstate Tax

Largest Differences Between 1988 and 2001

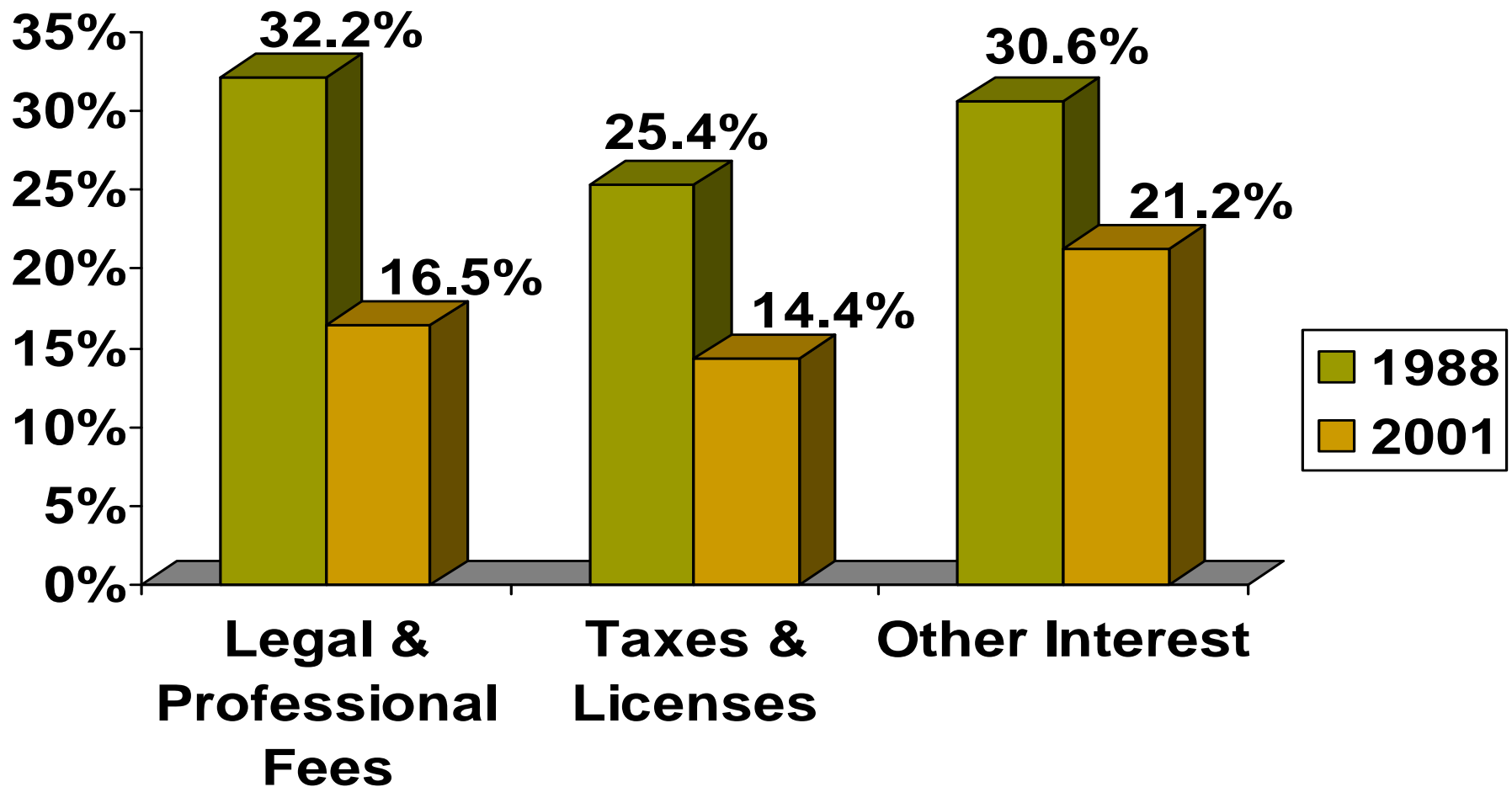


Group 2: Sole Proprietors – Schedule C Overall Error Rates

Highest Overall Error Rates in 1988		Highest Overall Error Rates in 2001	
1. Total Expenses	78.3%	1. Net Profit/Loss	69.4%
2. Net Profit/Loss	75.1%	2. Total Expenses	67.9%
3. Depreciation	47.8%	3. Bad Debt	48.0%
4. Cost of Goods Sold	47.0%	4. Cost of Goods Sold	47.2%
5. Bad Debt	43.8%	5. Depreciation	37.5%

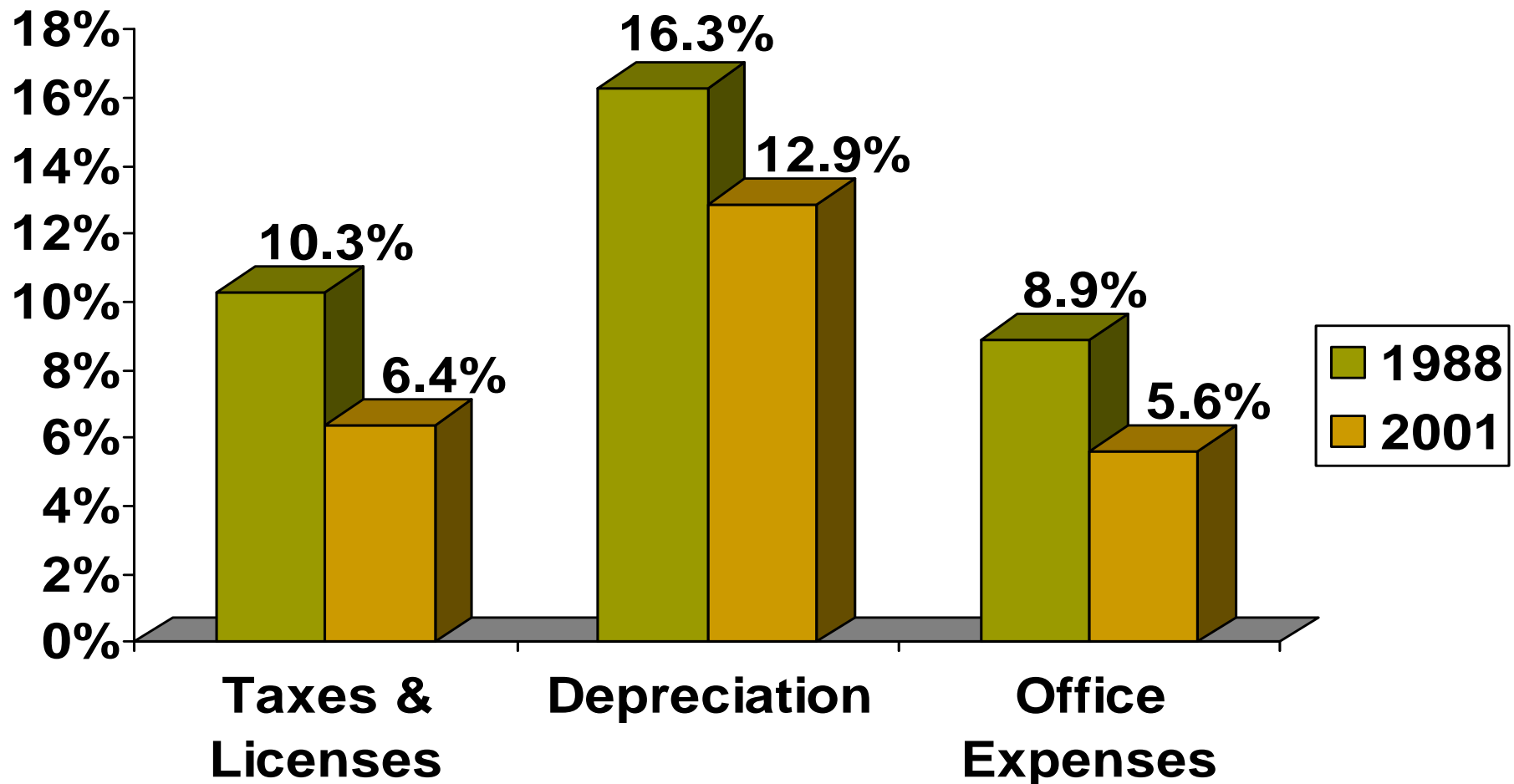
Group 2: Sole Proprietors – Schedule C Errors that Understate Tax

Largest Differences Between 1988 and 2001



Group 2: Sole Proprietors – Schedule C Errors that Overstate Tax

Largest Differences Between 1988 and 2001

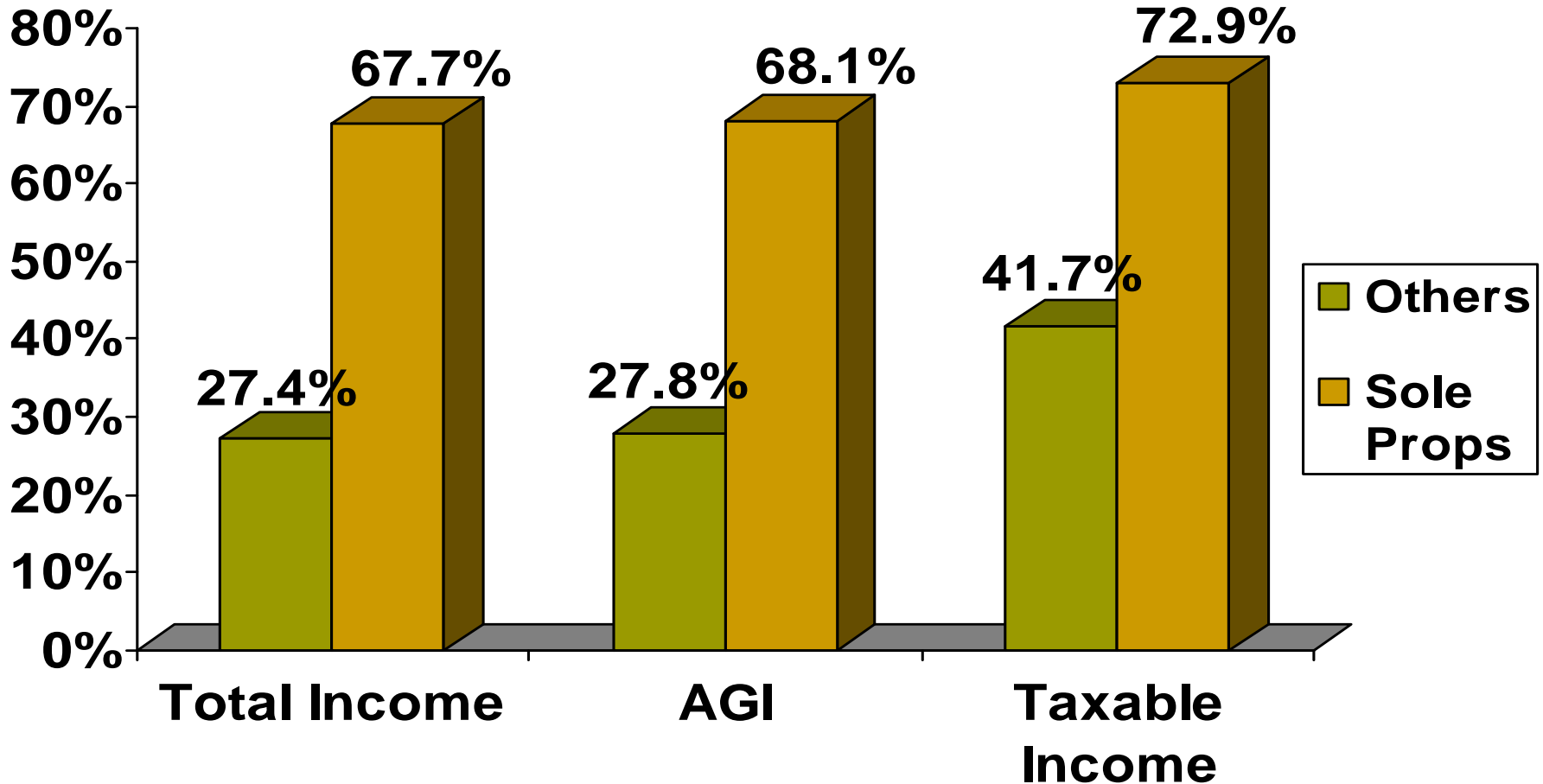


Group 3: Sole Proprietors & Others - Form 1040 Overall Error Rates

Other Individual Taxpayers		Sole Proprietors	
1. Taxable Income	51.9%	1. Taxable Income	85.3%
2. Total Tax	48.1%	2. AGI	80.2%
3. Earned Income Credit	45.1%	3. Total Tax	79.8%
4. Tentative Tax	44.0%	4. Total Income	78.6%
5. AGI	35.2%	5. Tentative Tax	78.3%

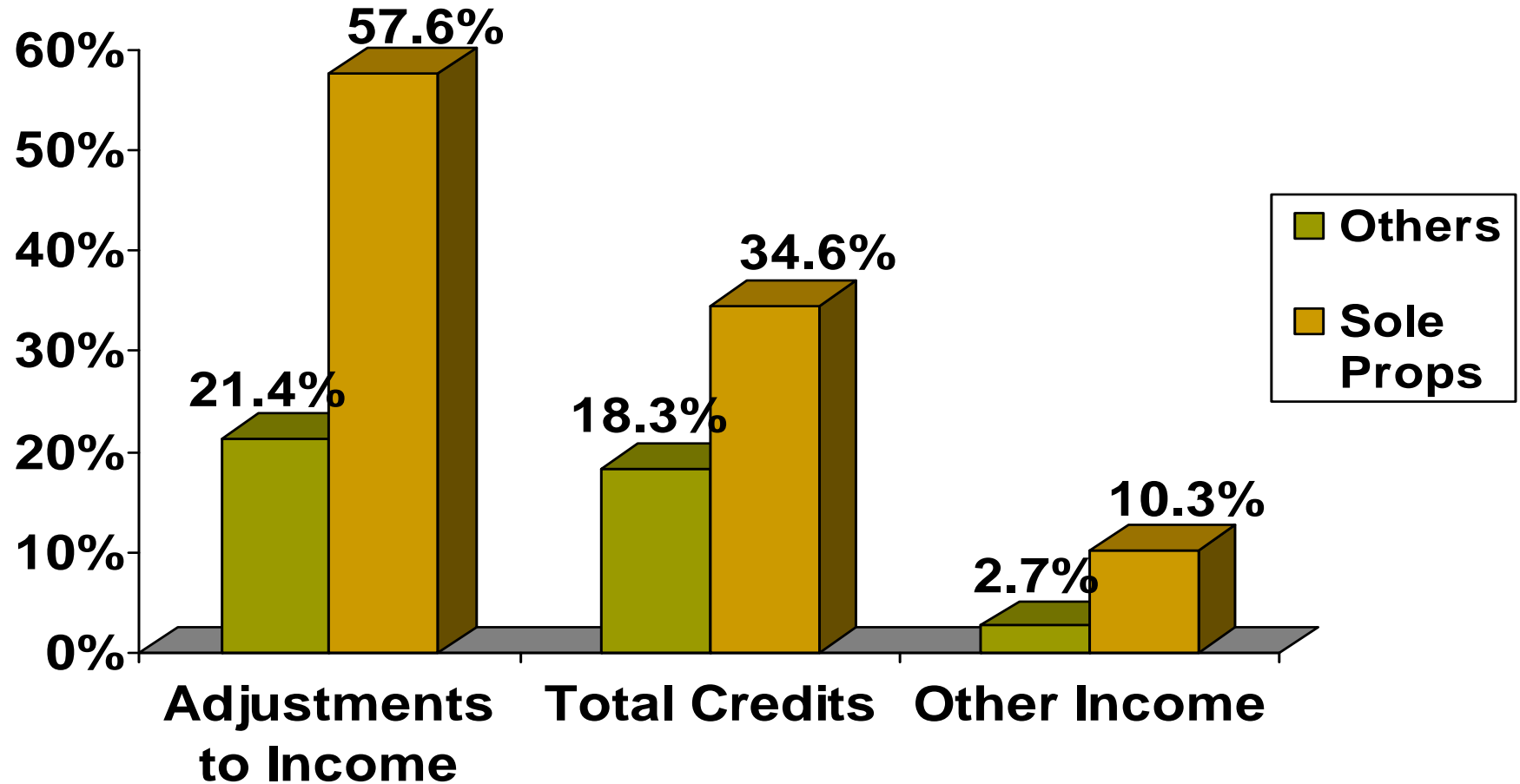
Group 3: Sole Proprietors & Others – Form 1040 Errors that Understate Tax

Largest Differences Between Sole Proprietors and Other Individual Taxpayers



Group 3: Sole Proprietors & Others – Form 1040 Errors that Overstate Tax

Largest Differences Between Sole Proprietors and Other Individual Taxpayers



Summary

- ❑ Overall error rates are generally higher for sole proprietors in 1988 than in 2001.
- ❑ Schedule C line items with the highest error rates were the same in 1988 and 2001.
- ❑ Sole proprietors had higher overall error rates than other individual taxpayers on most Form 1040 line items in 2001.

Considerations

- ❑ Role & influence of tax practitioners
- ❑ Increasing complexity of the tax law
- ❑ Perceived fairness of the tax system
- ❑ Increased visibility of the IRS through media campaigns, outreach activities, and audit coverage rates
- ❑ Legal issues rooted in the Restructuring and Reform Act of 1998 (RRA98)

Future Research

- Analyze subgroups of the data
- Set a \$100 tolerance amount as the definition of an error
- Analyze the data in terms of dollars