

Self-Employed Nonfilers, 1988

by Laura R. Rosage

For 1988, an estimated 1.7 million individuals having self-employment income failed to file their income tax returns with the Internal Revenue Service (IRS). Because most self-employment income is not subject to tax withholding, the net tax they owed was \$4.4 billion. Despite this large balance due, the average self-employed nonfiler's adjusted gross income (AGI) was only \$19,000, and nearly half of those who failed to file had an AGI of \$10,000 or less. The most common occupations among self-employed nonfilers were construction trades and real estate, insurance and securities sales. The majority were in their prime earning years, ages 31 to 50, and more than four in ten lived in non-metropolitan areas.

Background

Because the self-employed have sources of income generally not subject to information reporting (and tax withholding) there is a concern that the self-employed who fail to file required income tax returns may escape detection. (Information reporting is the process in which employers, or other financial entities, report wages and other monies paid out to taxpayers on Form W-2, *Wage and Tax Statement*, Form 1099-MISC, *Miscellaneous Income*, and the like. These "information returns" are sent to the payee for his or her records and tax return preparation and to the IRS for tax return verification.) For this study, an individual taxpayer was considered self-employed if he or she had an employer identification number (EIN) or reported self-employment tax (on a delinquent return), or, was identified as self-employed by an IRS revenue officer [1]

By matching the existing social security numbers (SSN's) of individuals against those of individuals who filed an income tax return for 1988, it was determined that there were approximately 100 million SSN's of individuals who were potential nonfilers for 1988. Of these, more than 3 million had self-employment income. This was the starting point. Based on contacts with a sample (see Data Sources and Limitations) of the individuals corresponding to the 100 million SSN's, it was concluded that an estimated 5 million were actually delinquent and were required to file an individual income tax return for Tax Year 1988 [2].

Three million of the 100 million potential nonfilers had self-employment income. Of these, 56 percent (1,697,081) were delinquent and were required to file an income tax return. (This is 35 percent of the estimated 5 million non-

filers for Tax Year 1988.) Another 10 percent of the 3 million potential nonfilers with self-employment income were not required to file a return. In addition, there were 29 percent who had previously filed a return, 4 percent who could not be found and were classified as "unable to locate" (UTL), and for 1 percent there was insufficient information for classification. For some, there was an indication of self-employment before investigation (Figure A). The indicator is based on the presence of a Schedule C, *Profit or Loss from Business (Sole Proprietorship)*, or Schedule F, *Profit or Loss from Farming*, attached to Form 1040 in previous years' records on the IRS Individual Master File of all taxpayers. This shows that only 13 percent of self-employed potential nonfilers who were required to file a return filed a Schedule C or Schedule F with their tax return in earlier years. Eighty-seven percent were not classified as self-employed until after the investigation.

Of the estimated 1,697,081 persons who were required to file, 88 percent (1,485,544) of their returns were secured; 10 percent (176,470) were sent for further IRS examination, criminal investigation or substitutes for returns were created; and only 2 percent (35,067) were not secured.

Classification of Nonfiler Cases

In normal operations, the IRS investigates those who have not filed a return based on the potential tax yield of the required returns, using information reported on such other returns as Form W-2 and Form 1099-INT, *Interest Income*. These cases are classified as "in the system."

In some cases, information returns show that taxpayers have income or transactions, but have not filed a return. Because it is not feasible to investigate all these potential nonfilers, criteria have been developed to exclude from follow-up those where available information indicates a potentially lower tax yield. Those cases eliminated by the screening process are classified as "dropped from the

Figure A

Identification and Disposition of Potential Self-Employed Nonfilers, 1988

Disposition	Total	Identified as self-employed before investigation	Identified as self-employed after investigation
	(1)	(2)	(3)
Required to file.....	1,697,081	220,635	1,476,446
Previously filed.....	889,868	48,358	841,510
Not required to file.....	308,746	15,526	293,220
Unable to locate.....	124,484	6,521	117,963
Insufficient information.....	34,295	778	33,517

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system.”

Finally, there are potential nonfilers for whom IRS has no information returns and no record of the individual on the Individual Master File. These persons are classified as “never in the system.” Although the IRS does receive and investigate informants’ allegations, and has special procedures to detect and secure delinquent returns, returns secured in this manner are not “in the system” because the IRS was not aware of the delinquent taxpayer prior to the allegation.

For the purposes of an accurate profile of the nonfiler population, an appropriate number of cases classified as “in the system,” “dropped from the system,” and “never in the system” were included in the sample used for this study. The results show that 5 percent were “in the system,” 49 percent were “dropped from the system,” and the remaining 46 percent were “never in the system.”

The criteria used to classify nonfiler cases into the three groups proved valid (Figure B). The system is designed to yield the most taxes, rather than the most tax returns. More than half of the self-employed nonfilers accounted for only one fifth of the net tax due. In normal IRS operations, the low tax yield expected from these cases would cause them to be dropped from follow-up so that resources could be focused on higher tax-yielding cases. More than 78 percent of the self-employed nonfiler tax due for 1988 was owed by those who were “in the system” (41 percent) and would be identified in normal operations. The 7 percent who were never in the system

accounted for only a small amount of tax due (actually, as a group, they were due a small refund). Despite the small amount of taxes owed by these taxpayers, future efforts will need to be developed to identify them and integrate them into the Federal tax system.

Characteristics of Self-Employed Nonfilers

Income

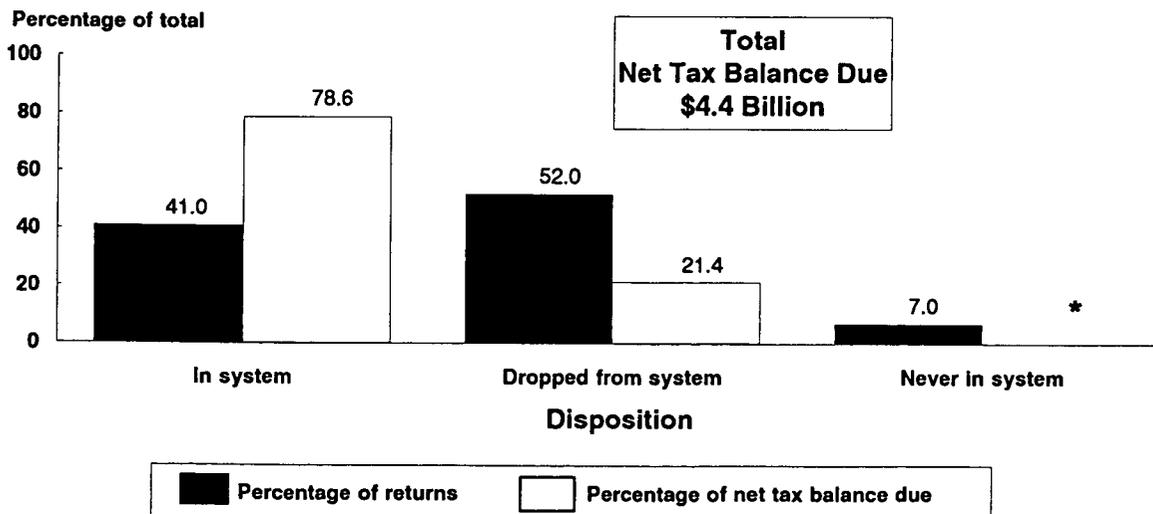
Although the average adjusted gross income (AGI) of self-employed nonfilers was almost \$19,000, AGI ranged from a negative \$867,000 to a positive \$5,200,000 (Figure C). However, the largest percentage of self-employed (41 percent) had income ranging from \$1,001 to \$10,000. Roughly one out of every sixteen had an AGI of \$1,000 or less. For one out of four the range was \$10,001 to \$20,000, and one in five had income between \$20,001 and \$50,000. Just one in fifteen had income above \$50,000.

Occupation

Several different construction trades, together, comprised the largest (15.2 percent) occupation group for 1988 self-employed nonfilers. The specific groups within this category least likely to comply were carpenters (5.0 percent); painters, paperhangers and plasterers (3.3 percent); and “other construction trades” (4.6 percent). The “miscellaneous occupations” category was the next largest, with 13.8 percent of the total. Within this category, occupations of those least likely to file included housewives (5.0 percent), children and students (4.0

Figure B

Ability of Present IRS System to Identify Self-Employed Nonfilers, 1988

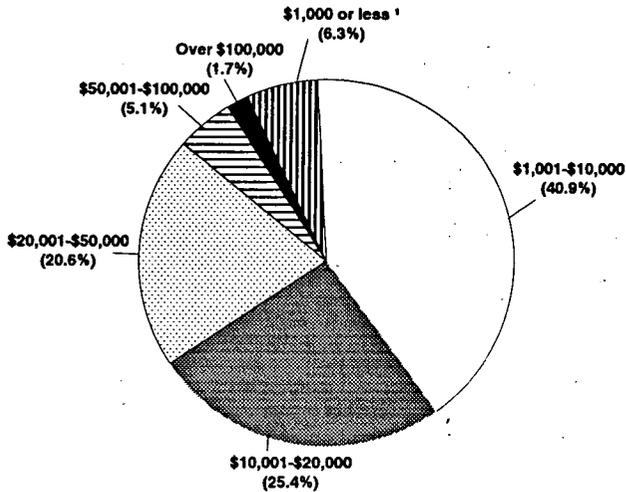


* The net tax balance due for returns never in the system was negative, i.e., a small refund.

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Figure C

Self-Employed Nonfilers, by Size of Adjusted Gross Income, 1988



¹ Includes adjusted gross deficit.

percent), and retired and disabled persons (4.0 percent), all of whom were self-employed in some capacity. In addition to these major categories, the single occupation of self-employed individuals least likely to file was in insurance, real estate and securities sales. These persons alone accounted for 5.5 percent of the total number of self-employed nonfilers. The ten major occupations of those least likely to file are listed in Figure D.

Many States or local jurisdictions require a license before a person can practice certain trades. Using listings of the licensed occupations and professions from the State of Minnesota and from Seminole and Brevard Counties in Florida (known for having strict licensing laws), 30 occupations were determined to have some licensing requirements. Based on the Minnesota and Florida experience, it is calculated that of the total estimated 1,697,000 self-employed nonfilers, only 268,000 (15.8 percent) had any sort of licensing requirement (Figure E).

This group of licensed taxpayers (268,000) was only responsible for \$634 million, or 14.5 percent, of the \$4.4 billion net tax balance due by self-employed nonfilers (Figure F). Further, 56 percent were "in the system," 34 percent were "dropped from the system," and only 10 percent were "never in the system." Those in the system with licensing requirements were responsible for \$373 million of tax due, more than half the total tax due (59 percent) by licensed self-employed persons who were required to file, and almost 9 percent of the total \$4.4

billion net tax balance due. Those "dropped from the system" accounted for only 5 percent (\$215 million) of the total tax balance outstanding, and those "never in the system" were responsible for only 1 percent (\$45 million).

Thus, current IRS procedures would ordinarily collect an estimated 59 percent of the tax due from of the licensed taxpayers. If additional procedures were instituted based on licensing, another \$261 million (or 6 percent) could be collected.

Age

An estimated 10 percent of the self-employed nonfilers were age 25 and under and only 9.0 percent were age 26 to 30. The majority of self-employed nonfilers were in their prime income-earning years: 12.4 percent were age 31 to 35, while 9.3 percent were age 36 to 40 and 15.2 percent, 41 to 50. While nearly 7 percent were age 51 to 60, only 6.5 percent were over 60 years of age. For 31.0 percent of the self-employed age was not determinable because the date of birth of the taxpayer was not available.

Place of Residence

Self-employed nonfilers were divided into four geographic segments based on their place of residence: urban, suburban, rural and unknown. The results show that over four in ten resided in non-metropolitan cities or towns with populations of 50,000 or less. Roughly three in ten resided in cities with populations over 50,000; and almost one in four lived in the suburbs of cities with populations over 50,000. Slightly over 4 percent of the self-employed nonfilers could not be classified because there was no address known for them (Figure G).

Figure D

Ten Most Frequent Occupations of Self-Employed Nonfilers, 1988

Occupation	Number of nonfilers	Percentage of total
All occupations.....	1,697,081	100.0
Insurance, real estate and securities sales ¹ ...	92,853	5.5
Carpenters and related workers.....	85,177	5.0
Housewives ²	84,452	5.0
Other construction trades.....	77,878	4.6
Miscellaneous manual occupations.....	69,877	4.1
Children and students ²	68,443	4.0
Retired and disabled persons ²	68,071	4.0
Painters, paperhangers and plasterers.....	56,065	3.3
Motor vehicle operators ¹	51,318	3.0
Vehicle and mobile equipment mechanics.....	44,759	2.6

¹ Includes only those with appropriate licenses.

² These "occupations" are not normally income-generating activities. However, these were the occupations reported on delinquent returns by taxpayers. Consequently, these taxpayers may not be full-time self-employed.

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Figure E

Number of Licensed and Non-Licensed Self-Employed Nonfilers, 1988

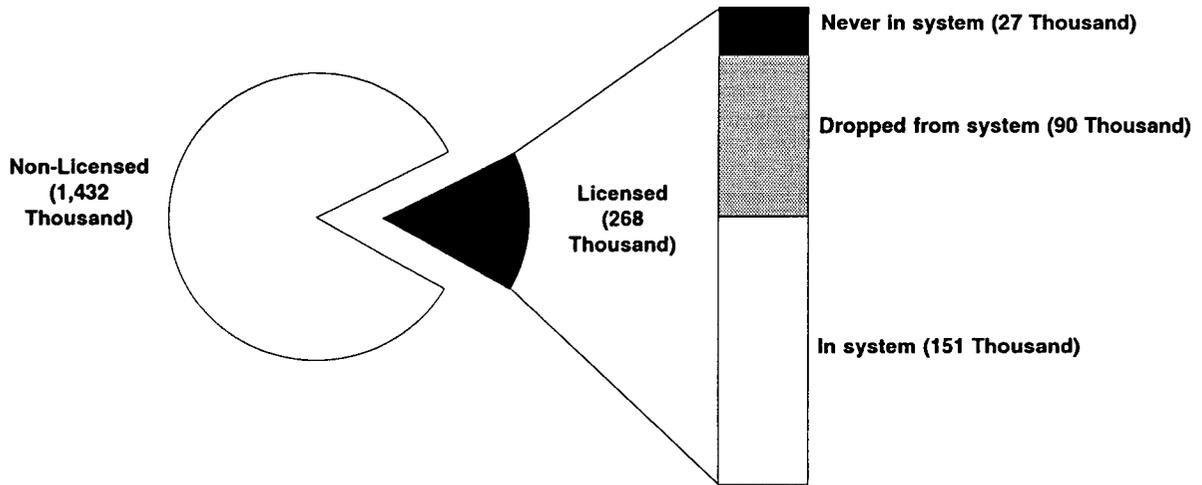
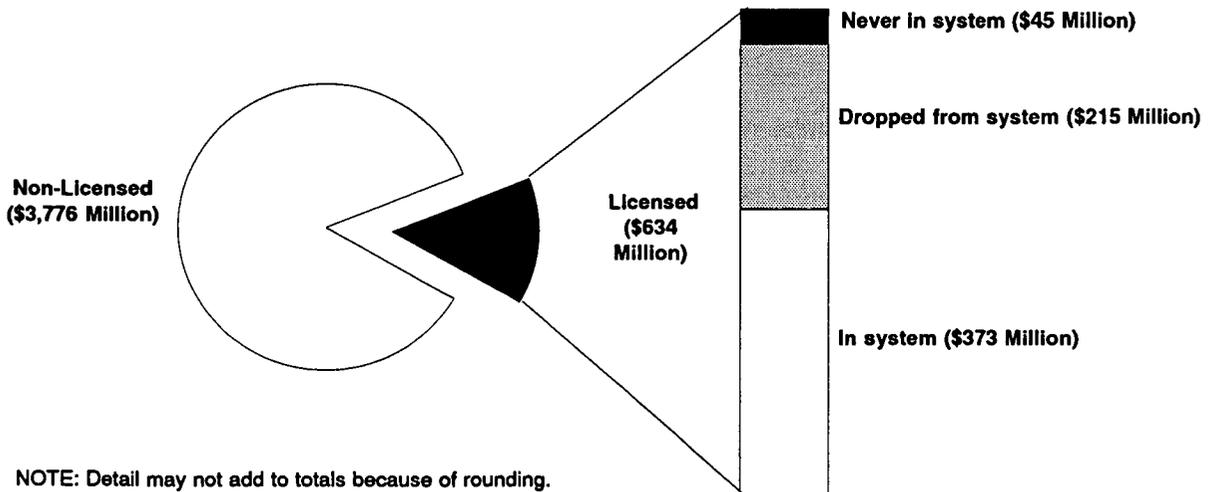


Figure F

Net Tax Balance Due, Licensed and Non-Licensed Self-Employed Nonfilers, 1988

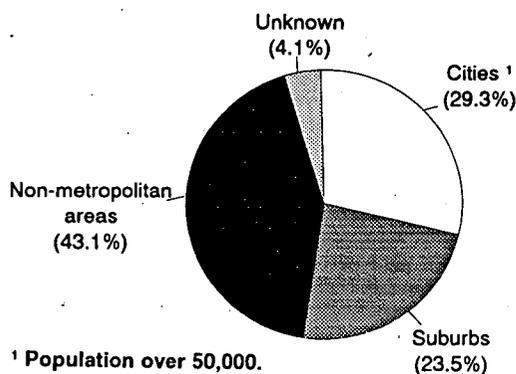


NOTE: Detail may not add to totals because of rounding.

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Figure G

Self-Employed Nonfilers, by Place of Residence, 1988



Type of Return

Of the estimated 1,697,081 self-employed nonfilers, returns would have been obtained through IRS enforcement contact for an estimated 1,485,544, or 88 percent. These returns would have been classified as "balance due" if the taxpayers owed taxes before any remittances with the returns were credited. Returns were classified as "refund" returns if prepayments (i.e., taxes withheld or estimated tax payments) and earned income credit exceeded the tax liabilities. Returns for which there were no tax liabilities or prepayments, or where prepayments exactly matched tax liabilities, were classified as "even."

Almost three out of every four returns obtained from self-employed nonfilers showed a balance due. The statistics show that only one in five was a refund return and 1 in 12 was "even." If all the estimated self-employed nonfilers were identified, the distribution of balance due and refund returns would result in an estimated total net balance due of nearly \$4.4 billion. The majority (78 percent) of this amount would be owed by those self-employed who are "in the system" and would be subject to enforcement activities under normal procedures.

For this study, balance due and refund amounts were further distributed as follows: \$1 to \$100; \$101 to \$500; \$501 to \$1,000; \$1,001 to \$5,000; \$5,001 to \$10,000; \$10,001 to \$20,000; \$20,001 to \$50,000; \$50,001 to \$100,000; and over \$100,000. Of those required to file with a balance due, the largest segment (37 percent, or 450,000), was in the \$1,001-to-\$5,000 range. Almost 28 percent (336,000) fell between \$101 and \$500, and nearly 15 percent (178,000) fell in the \$501 to \$1,000 range.

Although the number of self-employed nonfilers who would have gotten refunds was less than one-third of those with a balance due, the size distributions were somewhat similar. The largest (29 percent, or 98,000) was

also in the \$1,001 to \$5,000 class. However, almost 26 percent (87,000) were refund returns between \$1 and \$100, and 25 percent (85,000) were refund returns in the \$101 to \$500 class.

An analysis of balance due and refund returns with respect to known place of residence showed that over 44 percent of the balance due returns were attributable to self-employed nonfilers living in non-metropolitan areas. Thirty-three percent were attributable to taxpayers residing in cities, leaving only 22 percent attributable to those residing in suburbs. The distribution is similar for refund returns. The majority of refund returns, 40 percent, were for self-employed living in non-metropolitan areas. Slightly more than 36 percent would have been filed by taxpayers in cities, and 24 percent, by persons residing in suburbs.

Reason for Not Filing

The investigating IRS revenue officers were asked to categorize the reason for which they believed the sampled taxpayer did not file a return. A distribution of the reasons given shows procrastination was the primary factor of noncompliance for more than one in four (27 percent). Slightly more than 12 percent did not file because of inability to pay the tax and 11 percent, because they were unaware of the filing requirement. Nearly one in ten claimed to be missing vital information or documents, such as a Form W-2 or a Form 1099-INT. Some less frequent reasons were misinterpretation of the tax laws, not wanting to bother to file for a small refund, forgetting to mail the return, assuming a relative or spouse had filed the return, taxpayer was deceased, and nonfiler was a tax protestor.

Data Sources and Limitations

Sample

The Taxpayer Compliance Measurement Program (TCMP) measures the success of the IRS in its efforts to fulfill its mission. For this purpose, two nationwide surveys were conducted specifically to measure nonfiling of individual income tax returns. The most recent was a random stratified sample of approximately 24,000 individual apparent nonfilers for Tax Year 1988, which served as the basis for the statistics in this article [3].

This sample was constructed by matching a list of all existing social security numbers or SSN's (approximately 313 million), after subtracting SSN's of deceased taxpayers on the Death Master File (35 million), against all those who filed a tax return for 1988 [4]. The SSN's of those that matched were eliminated, leaving 100 million SSN's for which there was no matching return. These were the

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potential nonfilers. The sample was drawn to determine if these "potential" nonfilers had sufficient income to require filing. The 100 million potential nonfilers were then distributed according to criteria indicative of the source and amount of available income information. The sources of this information were the several IRS Master Files used for tax administration purposes: the Information Return Master File, the Individual Master File, and the Returns Transaction File. Each one of these is described in Explanation of Selected Terms. The categories created by the amount of information and sources are as follows:

Information Return Master File (IRMF) document present for 1988, income present: This category contains SSN's for which information documents (examples are Form W-2 or Form 1099-INT), were on the IRS Information Return Master File and income (wages, tips, interest, and the like) was recorded.

IRMF document present for 1988, income unknown or not present: This segment consists of SSN's on the IRMF due to the presence of information documents reporting transactions, such as real estate and stock sales, income from which was unknown or not indicated.

No IRMF document present for 1988: This division encompasses all those SSN's which were not on the IRMF because no information returns were associated with them.

Individual Master File (IMF) entity and 1987 Returns Transaction File (RTF) module: A social security number fell into this class if there was a name or address on the IMF for the entity, i.e., the individual, and there was a record of that person filing a return for 1987.

IMF entity and no 1987 RTF module: This category consists of SSN's where a name and address existed on the IMF, but there was no record of a return having been filed for 1987.

No IMF entity: A social security number fell into this category when there was no name and address on the IMF associated with that number.

These categories of information sources resulted in nine sampling classes (Figure H). The stratified sample (24,000) was designed to reflect the characteristics of all 100 million potential nonfilers.

In addition to the sample based on SSN's, the IRS had information on potential nonfilers where the SSN could not be processed, and therefore the information returns could not be included in the SSN sample. This information consisted of the following two categories:

Passport documents, domestic and foreign: This section of the sample consisted of persons with only

passport documents (no identifying income information was available). There were 246 individuals in the sample in this category.

Cases dropped from IRMF: This category was made up of individuals whose information returns were dropped from the IRMF for one of three reasons: the documents were filed late, the information returns were incorrect or the SSN on the information return did not match the SSN of anyone on the IMF. There were 370 individuals in the sample in this category.

This population is not necessarily distinct from the SSN sample. It does capture individuals who do not have SSN's, but it also includes those whose processed SSN was inaccurate, and therefore could not be matched against any other information on file. Because of this, some overlap was possible, but due to the small sample size, duplication was very limited.

Unable to Locate

Despite numerous sources and attempts, the IRS was "unable to locate" (UTL) or unable to contact approximately 4,700 of the 24,000 cases in the sample, which, when weighted, corresponded to 41 percent of the 100 million potential nonfilers (40,860,955). Almost 900 of these cases, 71 percent of the total estimated number of UTL nonfilers (28,960,000), fell into sample class 5D, a residual category, representing potential nonfilers for which the IRS had no more information (many times, less) than SSN, name and age. An important point is that for the 15.6 percent of the SSN's in this category where the

Figure H

Self-Employed Nonfiler Sample Classes, Based on Social Security Numbers, 1988

IRMF, IMF and RTF status; income status	Sample class	Number in sample class
IRMF document present for 1988 and income present:		
IMF entity and 1987 RTF module.....	1	3,272
IMF entity and no 1987 RTF module.....	2	3,181
No IMF entity.....	3	4,453
IRMF document present for 1988 and income unknown or not present:		
IMF entity and 1987 RTF module.....	4A	3,155
IMF entity and no 1987 RTF module.....	5A	1,491
No IMF entity.....	5B	1,483
No IRMF document present for 1988:		
IMF entity and 1987 RTF module.....	4B	3,992
IMF entity and no 1987 RTF module.....	5C	1,225
No IMF entity.....	5D	1,052

NOTE: IRMF is the acronym for the Information Return Master File, IMF is the Individual Master File, and RTF is the Returns Transaction File.

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Figure 1

Percentage of Self-Employed Nonfilers Located and Delinquency Rates, 1988

Sample class	Nonfilers not located	Nonfilers located	Percentage of located nonfilers actually delinquent
	(1)	(2)	(3)
1.....	16.1	83.9	27.8
2.....	19.0	81.0	24.5
3.....	13.8	86.2	4.6
4A.....	19.1	80.9	6.3
4B.....	20.7	79.3	5.0
5A.....	15.4	84.6	4.5
5B.....	10.6	89.4	1.3
5C.....	33.2	66.8	3.8
5D.....	84.4	15.6	3.1
6.....	22.6	77.4	7.4
7.....	24.9	75.1	3.7

taxpayer was located for the study, only 3.0 percent of the group was actually delinquent in filing. The actual delinquency rates of the taxpayers located are detailed for all the sample categories in Figure 1.

In addition, a number of SSN's classified as UTL corresponded to persons with multiple SSN's, or deceased individuals who were not listed on the Death Master File. As a result, many of the nonfiler leads designated UTL were generated by SSN's that were duplicative or should have been inactive because the person was deceased or because no such person existed. If all taxpayers designated UTL were located and the leads generated by erroneous SSN's eliminated, the percentage of potential nonfilers who were actually delinquent in filing would likely decrease.

Explanation of Selected Terms

Individual Master File (IMF).—This data file, housed at the IRS National Computing Center in Martinsburg, West Virginia, contains tax accounts for all individual taxpayers. Identifying information, such as name, address and social security number, as well as tax information, such as adjusted gross income or balance due, is recorded there. The file is updated periodically with changes to taxpayer accounts.

Information Returns Master File (IRMF).—This data file contains data from Forms W-2, Forms 1099-INT, and any other "information returns" issued to taxpayers for a given year. The IRS uses the file to verify the amount of income claimed on an individual's income tax return. This

file contains over one billion information returns annually.

Returns Transaction File (RTF).—This file contains taxpayer return information as transcribed directly from each income tax return. RTF files are created for each tax year. Unlike the IMF, they are not updated.

Substitute for Return (SFR).—When a taxpayer does not file a return, the IRS issues a series of reminder and delinquency notices. If the taxpayer continues to be delinquent, one option the IRS can choose is to file a "substitute for return". Using the standard deduction and income information available from Form W-2, *Wage and Tax Statement*, and other information returns, IRS computes the tax liability and penalties for the taxpayer. A bill for the outstanding amount is then issued. Because only the standard deduction is included in the calculation, for instance, the tax amount may be higher than if the taxpayer had filed directly.

Notes and References

- [1] The cases selected for this study were thoroughly investigated by IRS revenue officers during 1990 and 1991. Contrary to normal operations, cases where the estimated potential tax yield was low, or where there was a potential refund, were investigated as completely as those where the potential balance outstanding was very high. At the conclusion of the investigations, revenue officers completed detailed questionnaires, which served as the basis for the statistics in this article.
- [2] Graeber, Michael J., Nichols, Bonnie L. and Sparrow, D. Arthur, "Characteristics of Delinquent Returns," *The IRS Research Bulletin*, Internal Revenue Service, Department of the Treasury, 1992.
- [3] The first individual nonfiler Taxpayer Compliance Measurement Program survey was conducted for Tax Year 1979. Because the survey sample was limited to leads created by "information returns," it is believed that many nonfilers who were not subject to "information return" reporting were undetected and were not included in the estimate of 2.6 million nonfilers for that year.
- [4] The Death Master File and the list of existing social security numbers, with the corresponding names and ages, were obtained from the Social Security Administration and used for tax administration purposes. The Death Master File is an incomplete list of deceased individuals with SSN's.