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The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Subject: Small Business Tax Compliance Burden

This letter responds to questions that you asked us to address following the Committee's April 12, 1999, hearings on the tax compliance burdens of small business taxpayers.[1] Specifically, we addressed (1) why IRS' compliance burden estimates are not reliable; (2) why the relationship of the no-change rates to audit rates for small businesses and other individuals is difficult to determine; and (3) why IRS has limited information on its interactions with small businesses.

Our comments are based on the work we did to prepare for the April 12, 1999, hearings, and our previous studies of tax administration issues.

IRS' COMPLIANCE BURDEN ESTIMATES ARE BASED ON OUTDATED INFORMATION AND QUESTIONABLE ASSUMPTIONS

In accordance with the Paperwork Reduction Act, IRS has attempted to estimate the time required for taxpayers to complete each tax form or schedule.[2] The estimates include components for recordkeeping; learning about the law or the form; preparing the form; and copying, assembling, and sending the form to IRS.

However, IRS' compliance burden estimates are unreliable for several reasons, including the fact that the model used to estimate burden is based on data collected from taxpayers in 1984.[3] Given the numerous changes in the tax law and associated requirements that have occurred since the model was developed, it is doubtful that the estimates derived from it provide useful information about burden today.

The model also incorporates questionable assumptions. For example, one of the model's assumptions is that the time for recordkeeping (which is a major component of IRS'

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[1] Small business (including farmers) are sole proprietorship, partnerships, S corporations, and corporations that reported less than $5 million in assets.

[2] The Paperwork Reduction Act (44 U.S.C. 3501 et seq.) requires executive branch agencies to justify and estimate the burden associated with the paperwork they require from the public.

[3] The formulas, developed for IRS by Arthur D. Little, Inc., were based on data derived from a survey of taxpayers and a study in which another group of taxpayers tracked the actual time they spent on certain tax activities.

estimates) to complete business-related forms is predicated solely on the number of line items on forms and associated worksheets. Yet, the number of line items (i.e., items that may require the taxpayer to enter a response) is not a good indicator of burden because it does not account for differences in the nature of the line items. In particular, the model assumes that adding a line item to a business form increases burden by the same amount regardless of whether the added line requires a simple "yes or no" response and little, if any, recordkeeping or whether it requires complex calculations and extensive recordkeeping. IRS' estimates of burden are also not comprehensive because they do not account for post-filing burden—that is, the burden imposed on taxpayers who are required to respond to IRS notices and audits. As noted in our April 12, 1999, testimony, for IRS to fully gauge the tax compliance burden taxpayers face, information on post-filing burden is needed.[4] While neither we nor IRS know the actual burden imposed on taxpayers, it can be significant, depending on the tax issues involved. For example, a bank deposit analysis can be very burdensome if the IRS auditor asks for records on many bank accounts and asks many questions about the deposits in those accounts.[5]

Further, IRS does not have estimates of compliance burden that distinguish business taxpayers based on size and type. The data IRS collected in 1984 was classified only according to business and individual taxpayer categories. Neither category distinguished small businesses from other taxpayers. Instead, the business category included all corporations, S corporations, and partnerships, and the individual category included an amalgam of nonbusiness individuals along with sole proprietors, farmers, and partners.

IRS is now working with a consultant on a multiyear project to develop better estimates of tax compliance burden. According to IRS officials, the estimates are to be based on a new burden model that better reflects taxpayer experiences, including post-filing requirements. IRS also plans to survey a random sample of small businesses to identify their unique burdens and needs in complying with the federal tax system. According to IRS, the results of the survey may be available by September 1999. However, as our prior work indicates, obtaining reliable data on burden will not be easy.[6] Businesses we surveyed said they generally did not need and did not track data on the time devoted to meeting their federal tax requirements.[7] They also noted that it would be difficult to separate recordkeeping for tax purposes from recordkeeping that would have been done anyway.

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[4] Small Business: Taxpayers Face Many Layers of Requirements (GAO/T-GGD-99-76, Apr. 12, 1999).

[5] Tax Administration: Taxpayer Rights and Burdens During Audits of Their Tax Returns (GAO/T-GGD-97-186, Sept. 26, 1997).

[6] Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators (GAO/GGD-98-37, Jan. 14, 1998) and Tax System: Issues in Tax Compliance Burden (GAO/T-GGD-96-100, Apr. 3, 1996).

[7] GAO/T-GGD-96-100.

RELATIONSHIP OF THE NO-CHANGE RATES TO AUDIT RATES IS DIFFICULT TO DETERMINE

IRS generally attempts to focus its audits on the returns deemed most likely to require significant adjustments to the reported tax liability. Some types of taxpayers, such as sole proprietorships and large corporations, are audited at a relatively high rate because IRS compliance data indicate that their returns are more likely to require such adjustments. Given this basis for audit selection, one might expect IRS to recommend adjustments to the reported tax liability at a higher rate in a taxpayer population that is audited at a higher rate.

Under this logic, IRS' data on audit rates and no-change rates shown in table 1 raise a question as to why IRS has been auditing some small businesses at a higher rate than individuals.[8] The no-change rate in audits of sole proprietorships—the most prevalent form of small business—has been generally similar to the rate for other individuals even though sole proprietorships are audited over twice as often as other individuals, as shown in table 1.[9]

Table 1: Comparison of Audit and No-change Rates for Sole Proprietors and Other Individuals[a]

		No-change rate	
Year and type of taxpayer	**Audit rate**	**District office**	**Service center**
1997			
Sole proprietors	3.2%	12.4%	23.3%
Other individuals	1.2	13.4	12.8
1996			
Sole proprietors	3.6	10.4	39.9
Other individuals	1.5	12.5	35.5
1995			
Sole proprietors	4.1	5.7	40.2
Other individuals	1.5	11.3	46.0

[a] Sole proprietors and other individuals in this table exclude farmers filing schedule F. The audit rates for farmers in these years were somewhat higher than for other individuals, e.g., 1.8 percent vs. 1.2 percent in 1997. No-change rates for farmers were generally similar to the rates for other individuals.

Source: GAO analysis of IRS data.

However, it is difficult to determine whether the no-change rates for sole proprietorships are a sign that some are being audited unnecessarily. This is because other factors account for why returns are selected and why audits of such returns might not culminate in the recommendation of additional tax assessments. For example, some data suggest that the higher audit rate for sole proprietorships may be supported by the size, rather than the frequency, of the errors identified in the audits. As a case in point, the average amount of additional tax and penalties recommended in audits of sole proprietorships was $10,278 compared to $4,596 for other individuals in 1997.

[8] The no-change rate is the proportion of audits resulting in no change to the reported tax liability and no adjustments deemed significant by IRS, such as those that could affect the taxpayer's liability in other years.

[9] The no-change rates for other types of small business are also similar to or higher than among comparable taxpayers; however, these businesses are not audited at a much higher rate than comparable taxpayers. In particular, the audit rate for small corporations is much lower than for larger corporations: 2.1 percent vs. 21.5 percent in 1997.

Even so, IRS has acknowledged that one of its key tools for selecting returns to be audited—its Discriminant Function (DIF)—is in need of revision to improve its accuracy. DIF is an automated system for scoring individual tax returns according to their audit potential. A key issue is that the DIF formulas IRS uses are based on compliance data collected more than 10 years ago through IRS' Taxpayer Compliance Maintenance Program (TCMP).[10] The TCMP data have provided IRS with its most comprehensive compliance information on sole proprietorships and other types of taxpayers.

ARCHAIC DATA SYSTEMS LIMIT THE AVAILABILITY OF INFORMATION ON SMALL BUSINESS INTERACTIONS WITH IRS

In general, IRS' numerous information systems do not collect or store data by taxpayer groups, such as small businesses. Even if IRS' information systems maintained data by taxpayer groups, obtaining complete account information for a taxpayer would not be easy because IRS' systems are not linked together. Rather, IRS' current data systems reflect the agency's stovepipe structure and transaction-based business approach.

Historically, IRS has operated through functions like Examination or Collection, and information about taxpayers tended to be developed to serve each functions' specific needs and its specific interactions with taxpayers rather than IRS' overall needs or taxpayers' needs. As a result, IRS' various databases provide information pertaining to certain transactions, such as seizures or the filing of income tax returns. The structure of IRS' information systems does not easily allow for a complete assessment of a small business taxpayer's interactions (from filing to post-filing) with IRS.

IRS stores information about individual and business taxpayers' filing and compliance history in two master files—the Individual Master File (IMF) and the Business Master File (BMF).[11] Neither of these files is coded to distinguish small businesses from other taxpayers. To further complicate matters, data on filings and payments by small businesses may be divided between the IMF and BMF. Data from Schedule C (sole proprietorship), Schedule E (partnership and S corporation shareholder), and Schedule F (farmer) are posted to the IMF. Data from Schedule 1120 for corporations, including S corporations, are posted to the BMF. In addition, all employment and excise tax data are posted to the BMF. As a result, certain small businesses may have data on both the IMF and BMF. A similar situation exists with post-filing data, such as examination and collection. The data are scattered across numerous information systems and are not coded to distinguish small businesses from other taxpayers.

The limitations in IRS' information systems prevented us from fully determining the extent to which small businesses actually filed various required forms and schedules and made

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[10]As part of this program, IRS conducted random audits to obtain statistically valid compliance information. However, TCMP audits have been discontinued due to concerns about their impact on IRS' resources and taxpayers' burden. The last TCMP audits were conducted on returns filed for tax year 1988.

[11]The master files are currently maintained in Martinsburg, WV.

deposits. The limitations also prevented us from fully determining the extent of small businesses' involvement in IRS' enforcement processes.

The first problem we encountered pertained to locating information that we needed. IRS has dozens of discrete databases—so many that it is difficult to determine what data are in them, what the data mean, how the files are structured, or even how many files there might be. As mentioned earlier, the databases are function-specific (e.g., Examination) and designed to reflect transactions at different points in the life of a return or information report—from its receipt to its disposition. As a consequence, IRS does not have any easy means to develop or access comprehensive information about taxpayers or their accounts.

Second, many of the IRS data systems do not allow for a detailed analysis of the information they contain. We were unable to separate small businesses from mid-size and large businesses in some of the data systems. For example, the Form 941 that employers are to use to file their employment taxes does not have information on business assets or gross receipts that would have allowed us to categorize employers by size. Without this information, our alternative was to use information from the BMF. Accessing the appropriate tax module in the BMF might have made it possible to capture information on assets.

However, extracting master file data is a time- and resource-intensive undertaking that is prone to errors and data reliability problems. It involves requesting IRS' Information Services to provide an extract from the master files, working with the files to validate them, and then melding the data from two files into one that would be suitable for analysis. IRS receives many internal and external requests for data, and each request must wait its turn in the queue. IRS' resources are limited, and the request could take many months for the agency to complete. Thus, we decided not to ask IRS to make the extractions to determine the extent of its interactions with small businesses.

Copies of this letter are being sent to the Honorable Robert E. Rubin, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; Senator John Kerry, Ranking Minority Member of your Committee; and other interested parties.

We appreciate the opportunity to assist you in your deliberations on the tax compliance burdens of small businesses. This letter was prepared under the direction of Charlie W. Daniel, Assistant Director. The other contributors were Robert R. Floren and Daniel J. Lynch. Please do not hesitate to call me or Mr. Daniel on (202) 512-9110 should you have any
Sincerely yours,

Margaret T. Wrightson

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