United States Government Accountability Office

Report to Congressional Requesters

October 2023

SOLE PROPRIETOR COMPLIANCE

Treasury and IRS Have Opportunities to Reduce the Tax Gap

GAO-24-105281

October 2023

SOLE PROPRIETOR COMPLIANCE

Treasury and IRS Have Opportunities to Reduce the Tax Gap

GAO Highlights

Highlights of GAO-24-105281, a report to congressional requesters

Why GAO Did This Study

IRS attributes approximately $80 billion in unpaid taxes to sole proprietors underreporting income each year. This comprises 16 percent of the estimated annual $496 billion tax gap. In tax year 2019, roughly 27.8 million sole proprietors filed tax returns, which accounted for about 18 percent of all individual taxpayers.

GAO was asked to review the tax compliance of sole proprietors. This report (1) reviews options for IRS to close the tax gap by increasing sole proprietor compliance, (2) evaluates IRS efforts to assess the risk of sole proprietor noncompliance, and (3) assesses IRS efforts to conduct outreach to improve voluntary compliance among sole proprietors.

GAO reviewed literature and conducted a nongeneralizable survey of 25 experts and stakeholders on options to improve sole proprietor compliance. GAO also analyzed IRS tax gap and statistical data, reviewed agency documentation, and interviewed agency officials.

What GAO Recommends

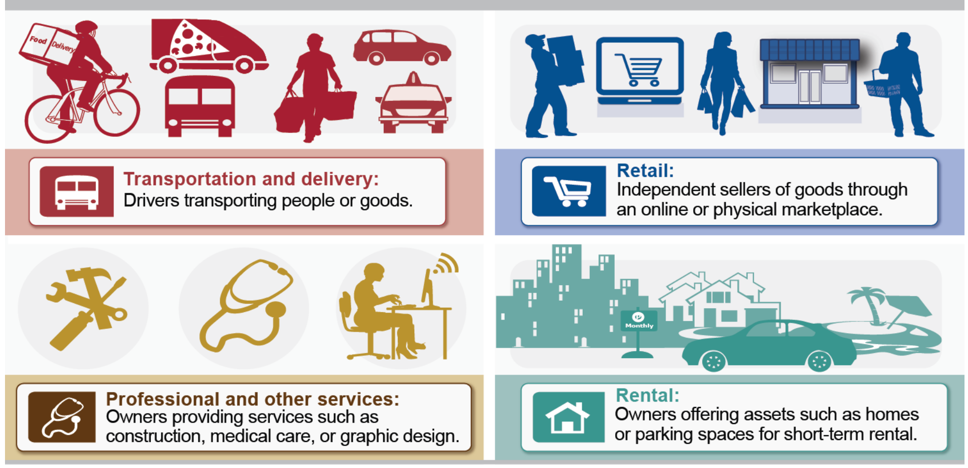
GAO is recommending that Congress consider requiring (1) Treasury to develop a tax gap strategy that includes efforts to improve sole proprietor compliance, and (2) IRS to implement voluntary withholding when both companies and sole proprietors would like to participate. GAO is also making three recommendations to IRS related to policies and practices that could improve sole proprietor compliance. IRS agreed with one recommendation and disagreed with two. GAO maintains that all the recommendations are valid, as discussed in the report.

View GAO-24-105281. For more information, contact James R. McTigue, Jr. at (202) 512-6806 or mctiguej@gao.gov.

What GAO Found

The Department of the Treasury and the Internal Revenue Service (IRS) have not developed an overall tax gap strategy that includes specific approaches to address sole proprietor noncompliance, as GAO recommended in July 2007. Sole proprietor underreporting is one of the largest segments of the tax gap (the difference between federal income taxes owed and the amount paid). Sole proprietors are individuals who own an unincorporated business by themselves.

Examples of Sole Proprietor Industries



Sources: GAO adaptation of graphics from the JPMorgan & Co. Institute report, "The Online Platform Economy in 2018: Drivers, Workers, Sellers, and Lessons," Anna/umar/tinica10/Adrian Hillman/Flatman vector 24/Ljupco Smokovski/stock.adobe.com and from analysis of literature and stakeholder interviews. | GAO-24-105281

GAO identifies 17 options to improve sole proprietor tax compliance. The options involve tradeoffs and would best be considered as part of an overall tax gap strategy. However, Treasury officials said they have no plans to develop a strategy. Also, IRS has not taken steps to allow for voluntary withholding on payments to independent contractors, including sole proprietors, as GAO recommended in May 2020. Without voluntary withholding, these workers may find making quarterly tax payments burdensome, which may reduce compliance.

IRS's strategic operating plan outlines its priorities for the coming years, but neither this plan nor other IRS documents provide an approach specifically to improve sole proprietor compliance. While IRS has some methods to assess noncompliance risk, they are not complete or specific to sole proprietors. A risk assessment would allow IRS to make strategic decisions related to enforcement and outreach priorities to help it reduce sole proprietors' share of the tax gap.

IRS has a communications plan for platform workers, who are one type of sole proprietor. However, it does not have a coordinated communications plan focused on informing the wide variety of sole proprietors about their tax and reporting responsibilities. Such a plan would help sole proprietors meet their tax obligations and navigate tax law changes. According to stakeholders GAO spoke with, some sole proprietors are unaware of their tax obligations on income earned through online platforms. Additionally, stakeholders told GAO that they found the existing guidance overly technical and difficult to understand.

Contents

Letter		1
	Background	3
	Treasury and IRS Have Not Implemented Two of Our Key Recommendations to Improve Sole Proprietor Compliance	12
	IRS Has Not Completed a Comprehensive Risk Assessment of Sole Proprietor Noncompliance to Inform a Compliance Strategy	20
	IRS's Lack of Strategy Limited Its Outreach Efforts to Sole Proprietors	28
	Conclusions	33
	Matters for Congressional Consideration	34
	Recommendations for Executive Action	34
	Agency Comments and Our Evaluation	35
Appendix I	Objectives, Scope, and Methodology	38
Appendix II	Small Business Traits and Tax Reporting Requirements	46
Appendix III	Options to Improve Sole Proprietor Compliance	47
Appendix IV	Sole Proprietors Vary Widely in Income Levels and Business Activities	56
Appendix V	Comments from the Internal Revenue Service	60
Appendix VI	GAO Contact and Staff Acknowledgments	65
Tables		
	Table 1: Options to Improve Sole Proprietor Compliance	17
	Table 2: Response Rates by Experts and Stakeholders for Survey on Options to Improve Sole Proprietor Compliance	41

Table 3: Number of Responses by Question for Survey on Options to Improve Sole Proprietor Compliance 41
Table 4: Examples of Business Traits and Tax Reporting Requirements of Selected Types of Small Businesses 46
Table 5: Details on Options to Improve Sole Proprietor Compliance 48

Figures

Figure 1: Examples of Sole Proprietor Industries 5
Figure 2: IRS Estimates $80 Billion of the $496 Billion Annual Tax Gap Is Due to Sole Proprietor Underreporting (Averages for Tax Years 2014 to 2016) 8
Figure 3: Online Platforms Required to Send IRS and Sole Proprietors Form 1099-K for Payments over $600, Starting Tax Year 2023 10
Figure 4: Overview of IRS's Process for Matching Information Returns 11
Figure 5: Key IRS Compliance Programs during and after Tax Return Processing 12
Figure 6: In the Absence of Voluntary Withholding, Some Sole Proprietors Are Required to Pay Quarterly Estimated Taxes 15
Figure 7: Average Expert and Stakeholder Ratings of Options to Improve Sole Proprietor Compliance 19
Figure 8: Availability of Third-Party Information Reporting Affects Misreporting of Income, Tax Years 2014 to 2016 21
Figure 9: Number of Sole Proprietors and Number of Closed Sole Proprietor Audits, Tax Years 2011 to 2017 23
Figure 10: IRS's General Process for Audits 25
Figure 11: Certain Scenarios in Which Taxpayers May Receive Form 1099-K 31
Figure 12: Same Payment May Be Reported on Multiple Information Returns 32
Figure 13: Distribution of Schedule C Filers and Their Total Adjusted Gross Income, Tax Year 2019 56
Figure 14: Percent of Schedule C Income Out of Adjusted Gross Income (or Losses), Tax Year 2019 58

Abbreviations

AGI	Adjusted gross income
AUR	Automated Underreporter Program
EITC	Earned Income Tax Credit
FAQ	Frequently asked question
IRA	Inflation Reduction Act of 2022
IRS	Internal Revenue Service
NMA	Net misreporting amount
NRP	National Research Program
RRP	Return Review Program
SB/SE	Small Business/Self-Employed Division
SOI	Statistics of Income
TPSO	Third-Party Settlement Organization

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

October 19, 2023

The Honorable Tom Carper
United States Senate

The Honorable Jon Ossoff
United States Senate

The Internal Revenue Service (IRS) estimates that the annual gross tax gap—the difference between federal taxes owed and the amount paid—is about $496 billion on average each year for tax years 2014 to 2016.[1] According to IRS, sole proprietors—individuals who own an unincorporated business by themselves—are one of the largest contributors to the tax gap. IRS attributes approximately $80 billion each year in unpaid individual income taxes to nonfarm sole proprietors underreporting their income. Sole proprietors include skilled trades and professions such as plumbers, gig workers, and social media influencers, among many others.

Noncompliance among sole proprietors has been a challenge because IRS has less third-party income and expense information about sole proprietors. In 2007, we recommended that the Department of the Treasury ensure that its strategy for reducing the tax gap includes options for improving the tax compliance of sole proprietors.[2] Treasury has not taken action on this recommendation, telling us it does not believe it needs to revise its efforts from 2006.[3]

[1]The gross federal tax gap is the difference between the amount that taxpayers owe and the amount they actually pay voluntarily and on time. In October 2022, IRS estimated the average gross tax gap was $496 billion each year from 2014 to 2016. Of that amount, IRS estimated $428 billion each year will never be collected through late payments or enforcement activities—this amount is the net tax gap. The gross tax gap consists of three categories—nonfiling ($39 billion), underreporting ($398 billion), and underpayment ($59 billion).

[2]GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

[3]U.S. Department of the Treasury, Office of Tax Policy *A Comprehensive Strategy for Reducing the Tax Gap* (September 2006).

You asked us to review sole proprietor noncompliance.[4] This report (1) reviews options for IRS to close the tax gap by increasing sole proprietor compliance, (2) evaluates IRS efforts to assess the risk of sole proprietor noncompliance, and (3) assesses IRS efforts to conduct outreach to improve voluntary compliance among sole proprietors.

To review options for IRS to close the tax gap by increasing sole proprietor compliance, we started with our 2007 report that listed potential policy options to improve sole proprietor compliance.[5] To update this list, we reviewed relevant publications from 2017 through 2021. Based on the information collected, we added new policy options and refined options, such as by including modern technology elements.

After updating the list of policy options, we surveyed subject matter experts and stakeholders for their views on the policy options. We selected experts who were knowledgeable about various issues affecting sole proprietors with experience in a range of sectors, as well as stakeholders representing a range of entities that would be affected by implementation of the options. We used the survey responses to further refine the list of potential options to improve sole proprietor compliance to the 17 we include in this report.

To evaluate IRS efforts to assess the risk of sole proprietor noncompliance, we reviewed IRS documents on the objectives, procedures, and processes for IRS compliance programs relevant to sole proprietors. We analyzed IRS's National Research Program data to describe misreporting and IRS's Statistics of Income (SOI) data to describe sole proprietors and related tax compliance issues. We assessed the reliability of these data by reviewing IRS's documentation about the data and interviewing knowledgeable IRS officials about any limitations. We determined that these data were sufficiently reliable for our purposes. We present SOI estimates in our report along with their margins of error or relative margins of error at the 95 percent confidence

[4]This work completes our response to Senator Tom Carper's request to review ways to reduce the tax gap. At the time of the request, Senator Carper was the Ranking Member of the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs in the 116th Congress. For other work responding to this request, see GAO, *Paid Tax Return Preparers: IRS Efforts to Oversee Refundable Credits Help Protect Taxpayers but Additional Actions and Authority Are Needed*, GAO-23-105217 (Washington, D.C.: Nov. 30, 2022) and *Management Report: IRS Should Test Videoconference Visits with Paid Preparers*, GAO-22-105978 (Washington, D.C.: July 14, 2022)

[5]GAO-07-1014.

level. We also interviewed IRS officials about these programs and data they collect relevant to sole proprietor noncompliance. We evaluated IRS's written procedures for implementing selected compliance programs relevant to sole proprietors against the applicable federal standards for internal control, particularly the risk assessment component.

To assess IRS efforts to conduct outreach to improve voluntary compliance among sole proprietors, we reviewed IRS documents and interviewed IRS officials and stakeholders in the tax industry. We compared IRS's efforts to IRS's Fiscal Year 2023-2031 Inflation Reduction Act Strategic Operating Plan and internal control standards for information, communication, and monitoring.

For each of our objectives, we reviewed our relevant prior reports. A more detailed discussion of our methodology is included in appendix I.

We conducted this performance audit from June 2021 through October 2023 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Sole Proprietors

A sole proprietorship is an unincorporated business with one owner. A sole proprietorship does not require legal action to form and generally exists when an individual earns income by providing goods or services with the intention of seeking a profit.[6] Because no legal action is required, some taxpayers may not realize they are sole proprietors. For purposes of this report, we consider individuals who filed or should have filed a Schedule C a sole proprietor.

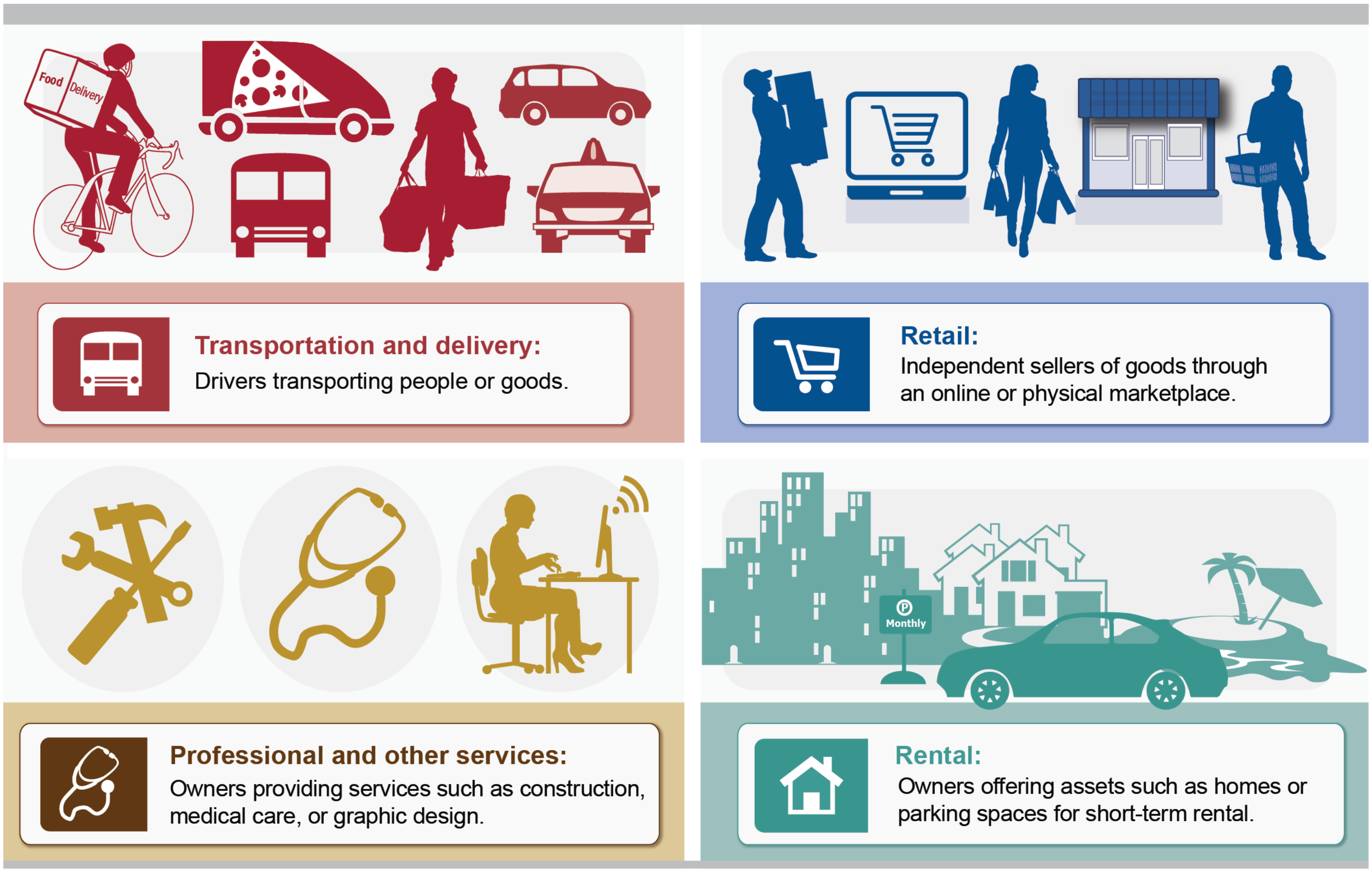
[6]Sole proprietorships contrast with corporations, which generally do require the formal legal step of incorporation, and partnerships, which involve more than one person or other entity. Although no action is required be a sole proprietorship, there are instances where a legal action is taken, but the result is still a sole proprietorship. For example, a member of a single-member Limited Liability Company may be treated as a sole proprietor unless it elects to be treated as a corporation. 26 C.F.R. §§ 301.7701-2(a); 301.7701-3(a).

In tax year 2019, an estimated 27.8 million sole proprietors filed tax returns, which accounted for about 18 percent of all individual taxpayers, according to IRS data.[7] Sole proprietors span a wide variety of industries from retail sellers to professional services, as shown in figure 1. They may have employees and may use a physical location, a virtual location, or online marketplaces or platforms to sell their goods or services.[8] They may work full or part time—for example as a freelancer, side gig, or platform worker. The sole proprietorship may account for all or part of an individual's income.

[7]The margin of error is less than +/- 1 percentage point.

[8]For the purpose of this report, we use the terms platform company for companies that generally facilitate the match, transaction, and payment between those seeking goods or services online and those providing them. Examples of platform companies include companies like Uber, Etsy, and Airbnb. We also use the term platform economy for business activity conducted through platform companies. For more information on related tax compliance issues, see GAO, Taxpayer Compliance: *More Income Reporting Needed for Taxpayers Working Through Online Platforms*, GAO-20-366 (Washington, D.C.: May 28, 2020).

Figure 1: Examples of Sole Proprietor Industries



Sources: GAO adaptation of graphics from the JPMorgan & Co. Institute report, "The Online Platform Economy in 2018: Drivers, Workers, Sellers, and Lessons," Anna/umar/tinica10/Adrian Hillman/Flatman vector 24/Ljupco Smokovski/stock.adobe.com and from analysis of literature and stakeholder interviews. | GAO-24-105281

Sole proprietors generally report their business-related profit or loss on their Schedule C, Profit or Loss from Business, which is filed as part of their individual income tax return, IRS Form 1040.[9] To compute the sole proprietor's overall individual tax liability, the proprietor's business profits

[9]Platform companies typically treat workers providing services as independent contractors. Generally, independent contractors, including those who are platform workers, must use Schedule C to report their self-employment revenues and expenses, and to calculate net income. For additional information on classification, see GAO, *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention*, GAO-09-717 (Washington, D.C.: Aug. 10, 2009).

or losses are combined with (1) income from other sources, and (2) tax deductions and credits reported on Form 1040.

In addition to income tax obligations, sole proprietors may have other tax obligations. Sole proprietors may be required to pay self-employment tax on their business income.[10] Self-employment tax includes Old-Age, Survivor, and Disability (Social Security) tax and hospital insurance (Medicare) tax on self-employment earnings.[11] If a sole proprietorship has employees, the sole proprietorship will have various employment tax obligations on wages paid to employees, such as the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and federal income tax withholding obligations. These include (1) paying the employer share of Social Security and Medicare taxes, (2) withholding and remitting amounts for employees' federal income taxes and the employee share of Social Security and Medicare taxes, and (3) paying federal unemployment tax.[12]

Unlike wage earners, sole proprietors generally do not have taxes withheld from their income as they earn it. To comply with the requirement to pay taxes as income is earned during the year, sole proprietors generally must make quarterly tax payments to IRS.[13] In addition, sole proprietors may earn income which third parties, such as businesses and financial institutions, are not required to report to IRS on forms such as the 1099-NEC, Nonemployee Compensation or 1099-MISC, Miscellaneous Information. Generally, third parties are not required to report income under a certain amount. This amount varies by form and payment type. For example, the requirement for certain third parties to report payments for goods or services does not apply when those payments do not total $600 or more over the course of a year.[14] Sole proprietors are still required to pay taxes on the income regardless of whether an information return is submitted.

[10] 26 U.S.C. §§ 1401–1402.

[11] 26 U.S.C. § 1401.

[12] 26 U.S.C. §§ 3102 (withholding for employees' share of Social Security and Medicare taxes), 3111 (employer share of Social Security and Medicare taxes), 3301 (unemployment tax on employers), 3402 (withholding of employee income tax at the source).

[13] 26 U.S.C. § 6654.

[14] 26 U.S.C. § 6041(a).

Selected Pass-through Entities

Partnerships. These group two or more individuals or entities—such as corporations or other partnerships—to carry on a business. Individuals, corporations, trusts, estates, tax-exempt entities, and other partnerships may all be partners.

S corporations. These may have between one and 100 shareholders. Individuals, certain trusts, estates, and certain tax-exempt entities may be S corporation shareholders. 26 U.S.C. § 1361.

Partnerships and S corporations must file tax returns (IRS Forms 1065 and 1120-S, respectively).

Source: GAO analysis of IRS documentation. | GAO-24-105281

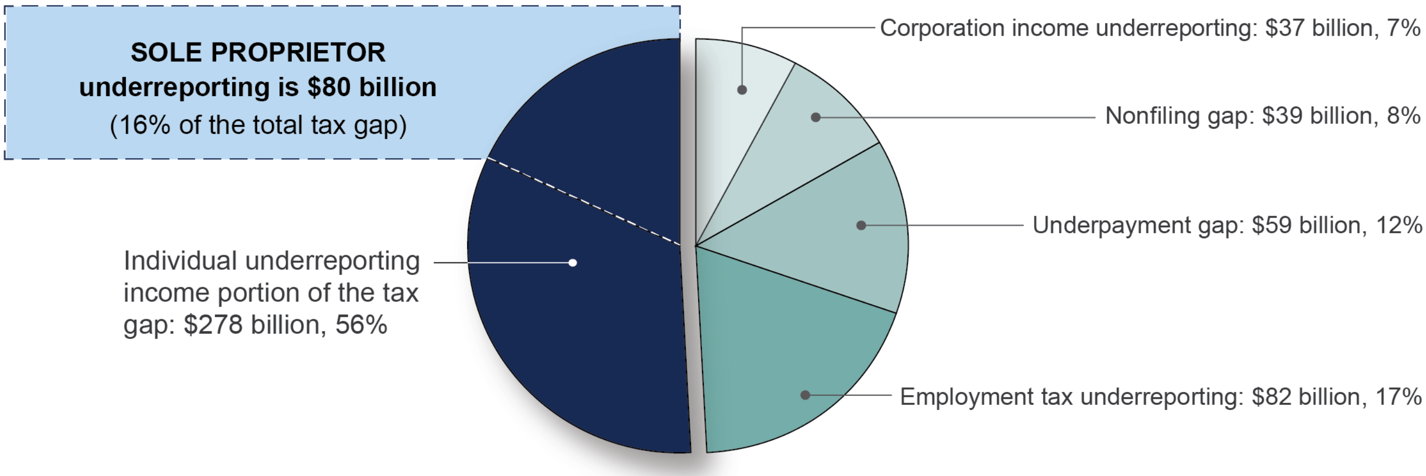
In recent decades, businesses have shifted toward organizing as sole proprietorships and pass-through entities (see sidebar) and away from corporations that are subject to the corporate income tax. Sole proprietorships and pass-through entities transfer income or losses to their owners, partners, and shareholders, who must include that income or loss on their individual income tax returns. Compared to sole proprietorships, pass-through entities such as partnerships have more complex business structures and tax reporting requirements, as shown in appendix II.[15]

Tax Gap

In October 2022, IRS estimated the annual gross tax gap to be $496 billion on average for tax years 2014 to 2016. The tax gap has been a persistent problem for decades. IRS estimated that $80 billion of the annual tax gap is caused by sole proprietors underreporting their net business income, which can stem from either understated receipts or overstated expenses. Further, sole proprietor underreporting accounted for the largest share of the individual underreporting income tax gap and 16 percent of the total tax gap, as shown in figure 2.

[15]For more information on tax compliance issues related to partnerships and S corporations, see GAO, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, GAO-14-453 (Washington, D.C.: May 14, 2014). See also GAO, *Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships*, GAO-23-106020 (Washington, D.C.: July 27, 2023), GAO, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency,* GAO-14-732 (Washington, D.C.: Sept. 18, 2014).

Figure 2: IRS Estimates $80 Billion of the $496 Billion Annual Tax Gap Is Due to Sole Proprietor Underreporting (Averages for Tax Years 2014 to 2016)



Source: GAO presentation of Internal Revenue Service (IRS) data. | GAO-24-105281

Notes: Estate tax underreporting was excluded because it is less than 0.5 percent of the tax gap ($1 billion). See IRS Publication 1415 (Rev. 10-2022) for a description of IRS's estimation methodology.

IRS uses several approaches to estimate the different components of the tax gap shown in the figure, but these approaches have various limitations. Estimates can have measurement and sampling error and can vary in the quality of information available.[16] Further, the estimates do not fully reflect all areas of the tax system. For example, foreign or illegal activities, digital assets, and some corporate income tax are not fully included because data are either not reliable or not available.

Information Reported to IRS

Information returns are forms filed by third parties, such as employers, businesses, and financial institutions, to provide information about taxable transactions to IRS and taxpayers (for wage earners, this is the Form W-2, Wage and Tax Statement). Taxpayers can use the information on the forms to complete their tax returns. IRS uses the forms to verify information reported by taxpayers on their tax returns.

[16]Sampling errors and non-sampling errors create uncertainty in IRS's estimates of the components of the tax gap. Sampling errors arise due to the selection of a probability sample rather than examining the entire population of tax returns. Non-sampling errors arise from other sources such as those due to data collection and processing procedures.

Sole proprietors may receive information returns on their business transactions and other payments. Some examples of information returns relevant for sole proprietors are:

- **Form 1099-MISC, Miscellaneous Information.** This form is used to report business payments unrelated to non-employee compensation, including royalties, rents, prizes and awards, and medical and health care payments.[17] Generally, a business is required to file the form when it pays a sole proprietor at least $10 in royalties or at least $600 in other miscellaneous payments in a year.
- **Form 1099-NEC, Non-employee Compensation.** Generally, a business must file this form to report $600 or more in total annual payments to a sole proprietor for their services. An exception is if the business uses a Third-Party Settlement Organization (TPSO) to pay the sole proprietor for their services, which is described below.[18]
- **Form 1099-K, Payment Card and Third-Party Network Transactions.** This form is filed for all payment card transactions (e.g., debit, credit, or stored-value cards) and for third party network transactions above the minimum reporting thresholds. TPSOs generally function as intermediaries between buyers and sellers of goods or services and charge a fee for serving as an intermediary. Examples of these types of entities include some online auction or marketplace services (such as eBay and Amazon), some gig economy platforms (such as Uber and Airbnb), some third-party payment applications (such as Cash App and Venmo) when used to facilitate purchase of goods or services, and some cryptocurrency processors (such as BitPay).

The American Rescue Plan Act of 2021 expanded the existing reporting requirements for payments made through TPSOs.[19] Under the law, TPSOs must file Form 1099-K to report payments made through their

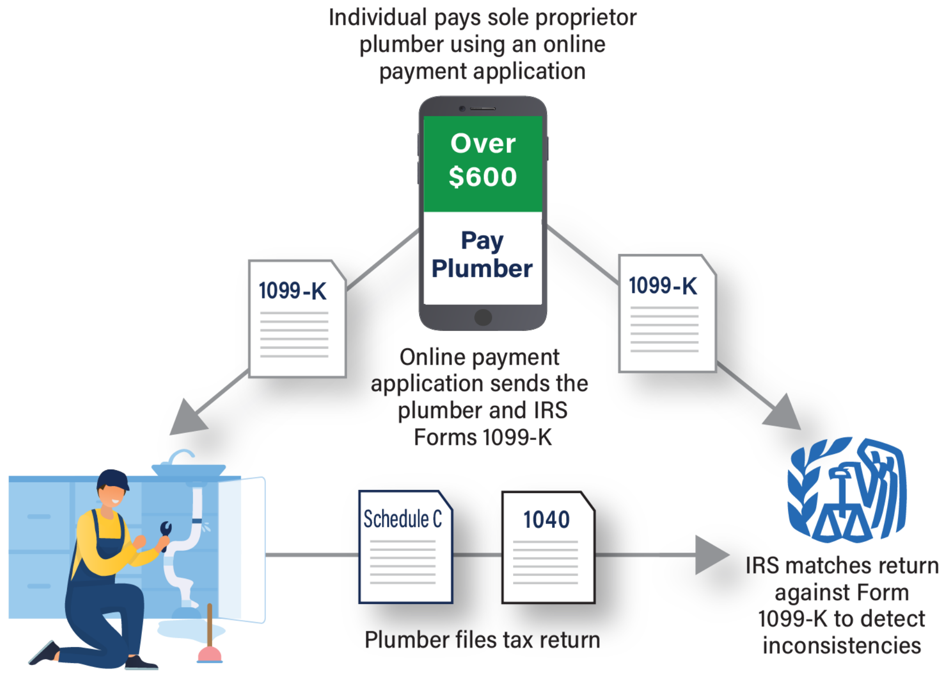
[17]26 U.S.C. § 6041; 26 C.F.R. § 1.6041-1. Beginning tax year 2020, IRS instituted a 1099-NEC form that split nonemployee compensation from Form 1099-MISC.

[18]A TPSO is a central organization which has the contractual obligation to make payments for third-party network transactions. 26 U.S.C. § 6050W(b)(3). A third-party network is any agreement which involves the establishment of accounts with a TPSO by a substantial number of persons who (1) are unrelated to the TPSO, (2) provide goods or services, and (3) settle transactions for providing the goods or services pursuant to the agreement. The agreement must provide standards and mechanisms for settling the transactions, and guarantee that the people providing the goods and services will be paid. 26 U.S.C. § 6050W(d)(3).

[19]Pub. L. No. 117-2, § 9674, 135 Stat. 4, 185 (2021), *codified at* 26 U.S.C. § 6050W(e).

payment networks that exceed $600 annually, regardless of the number of transactions (see fig. 3). Previously, TPSOs were not required to report payment information unless annual payments exceeded $20,000 and 200 transactions. The new requirements were to be effective at the beginning of 2022; however, in December 2022, IRS delayed implementation of this requirement until the beginning of 2023.[20]

Figure 3: Online Platforms Required to Send IRS and Sole Proprietors Form 1099-K for Payments over $600, Starting Tax Year 2023

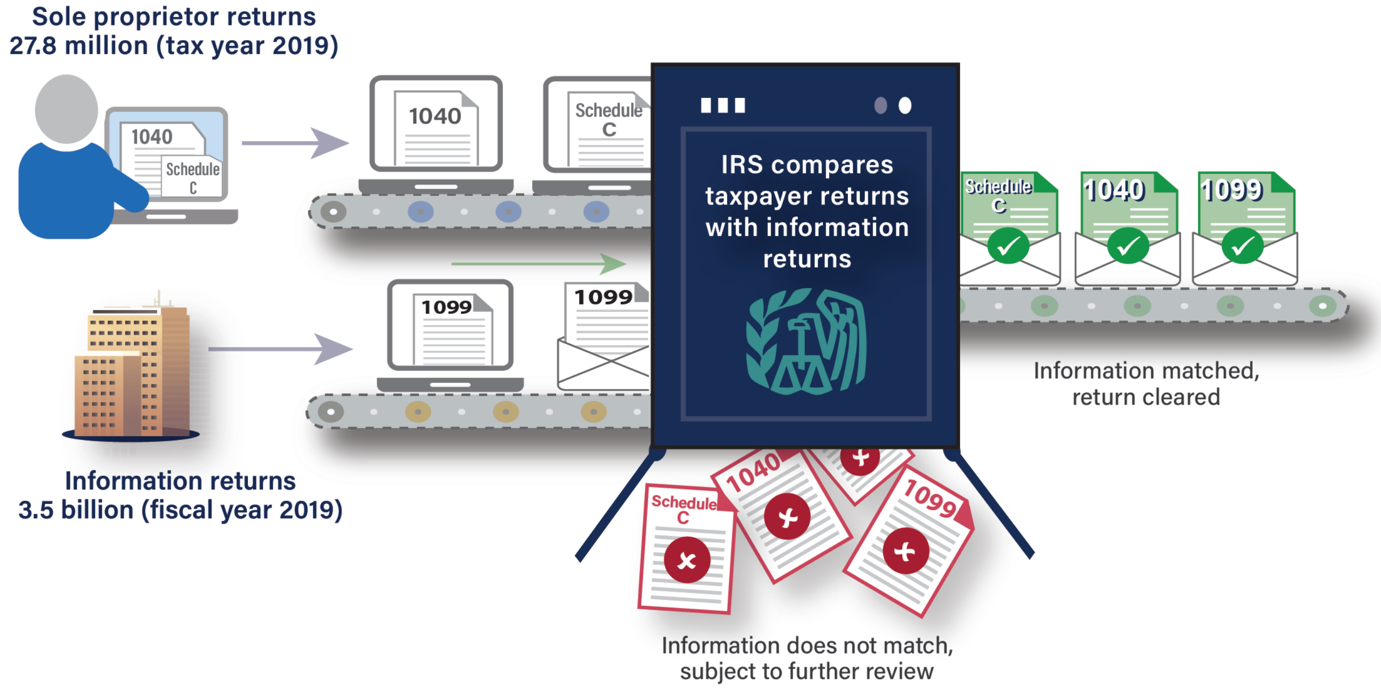


Sources: GAO analysis of Internal Revenue Service (IRS) information and Rudzhan/stock.adobe.com (icons). | GAO-24-105281

If IRS identifies mismatches between the information reported by third parties and information provided by taxpayers on their returns, it performs additional scrutiny on those returns (see fig. 4).

[20]IRS Notice 2023-10, 2023-3 I.R.B. 403.

Figure 4: Overview of IRS's Process for Matching Information Returns



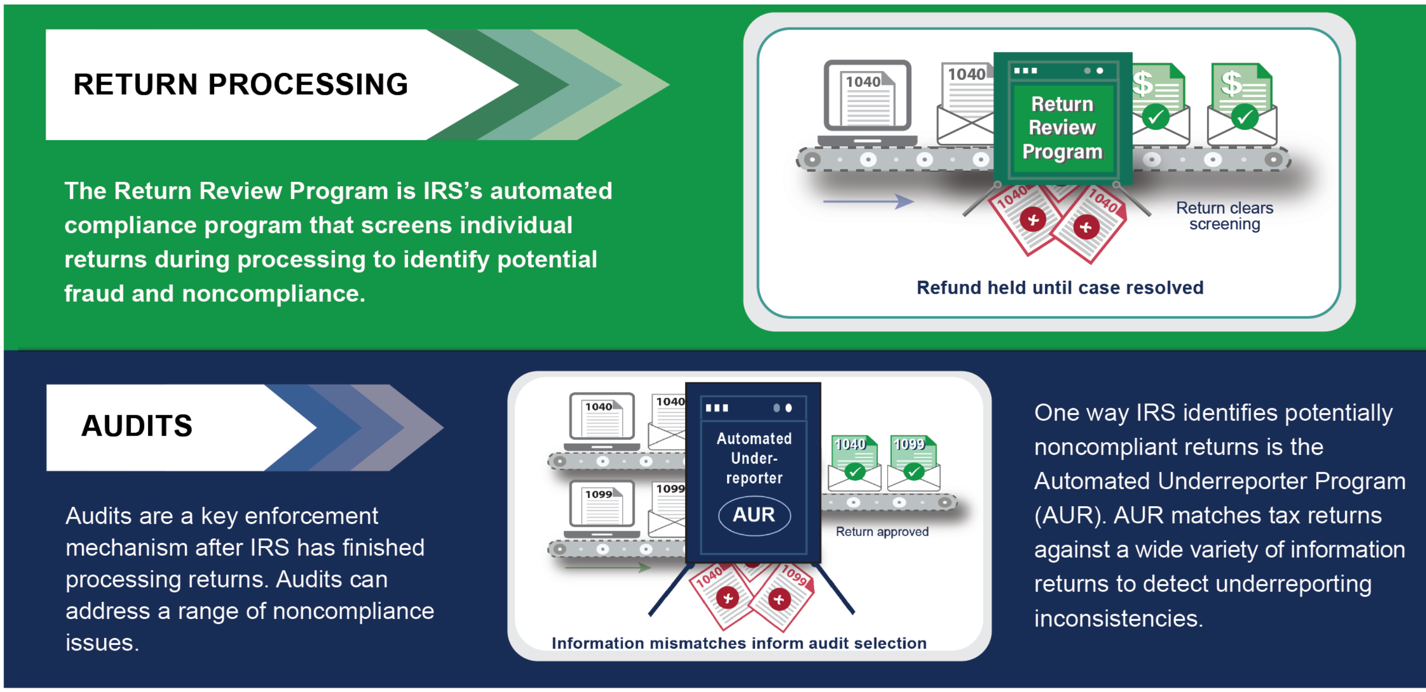
Source: GAO analysis of Internal Revenue Service (IRS) data and information and GAO (icons). | GAO-24-105281

Note: The margin of error for the number of sole proprietors is less than +/- 1 percentage point.

IRS Compliance Programs

Noncompliance can occur when individuals make unintentional errors as well as when individuals intentionally seek to evade taxes, such as by underreporting income, overreporting expenses, or engaging in frivolous tax schemes. Two of IRS's key programs for detecting and deterring tax noncompliance among taxpayers, including sole proprietors, are (1) the Return Review Program (RRP), and (2) audits, as shown in figure 5. During return processing, RRP aims to prevent the issuance of invalid refunds associated with suspicious returns. After IRS has finished processing returns, audits are a key enforcement mechanism. The Small Business/Self-Employed (SB/SE) Division of IRS oversees the compliance of sole proprietors, including auditing their tax returns and helping them understand and meet their tax obligations.

Figure 5: Key IRS Compliance Programs during and after Tax Return Processing



Source: GAO presentation of Internal Revenue Service (IRS) information and GAO (icons). | GAO-24-105281

Treasury and IRS Have Not Implemented Two of Our Key Recommendations to Improve Sole Proprietor Compliance

Treasury Has Not Yet Implemented Our 2007 Recommendation Regarding a Compliance Strategy

Treasury and IRS have not developed an overall tax gap strategy that includes specific approaches to address sole proprietor noncompliance, as we recommended in July 2007 and as we have reiterated in our

Duplication, Overlap, and Fragmentation work.[21] The most current tax gap strategy is from 2006.[22]

Since the mid-1990s, we have reported on the need for a strategy to address the overall tax gap as well as the significant portion that is due to sole proprietor noncompliance.[23] Released in April 2023, IRS's Inflation Reduction Act Strategic Operating Plan outlines IRS priorities for the coming years. It has goals aimed at narrowing the tax gap and addressing noncompliance; however, these are not specific to sole proprietors.[24] The plan does not address our original recommendation to incorporate (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.

Despite significant changes in the global economy, tax law, information technology, and consumer behavior, Treasury and IRS officials stated that they do not think a strategy for sole proprietor compliance is needed because they think their existing efforts are sufficient. Specifically, IRS officials stated that sole proprietors and small businesses are similar in that they are less likely to have controls in place to ensure compliance. However, there are significant differences between business types as well as among the types of sole proprietors that should be taken into account that could affect relevant compliance approaches. For example, as referenced earlier, some taxpayers may not realize they are sole proprietors. By not acknowledging the distinct challenges and differences of sole proprietors, IRS may be missing opportunities to improve voluntary compliance among sole proprietors. As we have stated earlier, sole proprietors make up the largest portion of the individual

[21]GAO-07-1014, GAO, *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-11-318SP (Washington, D.C.: Mar. 1, 2011), and our publicly accessible *Duplication and Cost Savings website*, which allows Congress, agencies, and the public to track the federal government's progress in addressing the issues we have identified.

[22]U.S. Department of the Treasury, *A Comprehensive Strategy for Reducing the Tax Gap* (Washington, D.C.: Sept. 26, 2006).

[23]See, for example, GAO, *Tax Gap: Multiple Strategies Are Needed to Reduce Noncompliance*, GAO-19-558T (Washington, D.C.: May 9, 2019); and *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

[24]Internal Revenue Service, *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan*, Publication 3744 (Rev. 4-2023) (Washington, D.C.: April 2023).

underreporting income tax gap. This includes comparing sole proprietors to other business types or income such as S corporations, partnerships, estates and trusts, rents and royalties, and farms.

Treasury and IRS officials also maintain that IRS's broader compliance efforts sufficiently address sole proprietors. Specifically, officials stated that compliance efforts are a matter of confirming income and expenses regardless of business type. However, as we discuss throughout this report, there are compliance issues and taxpayer burden concerns that may be unique to sole proprietors.

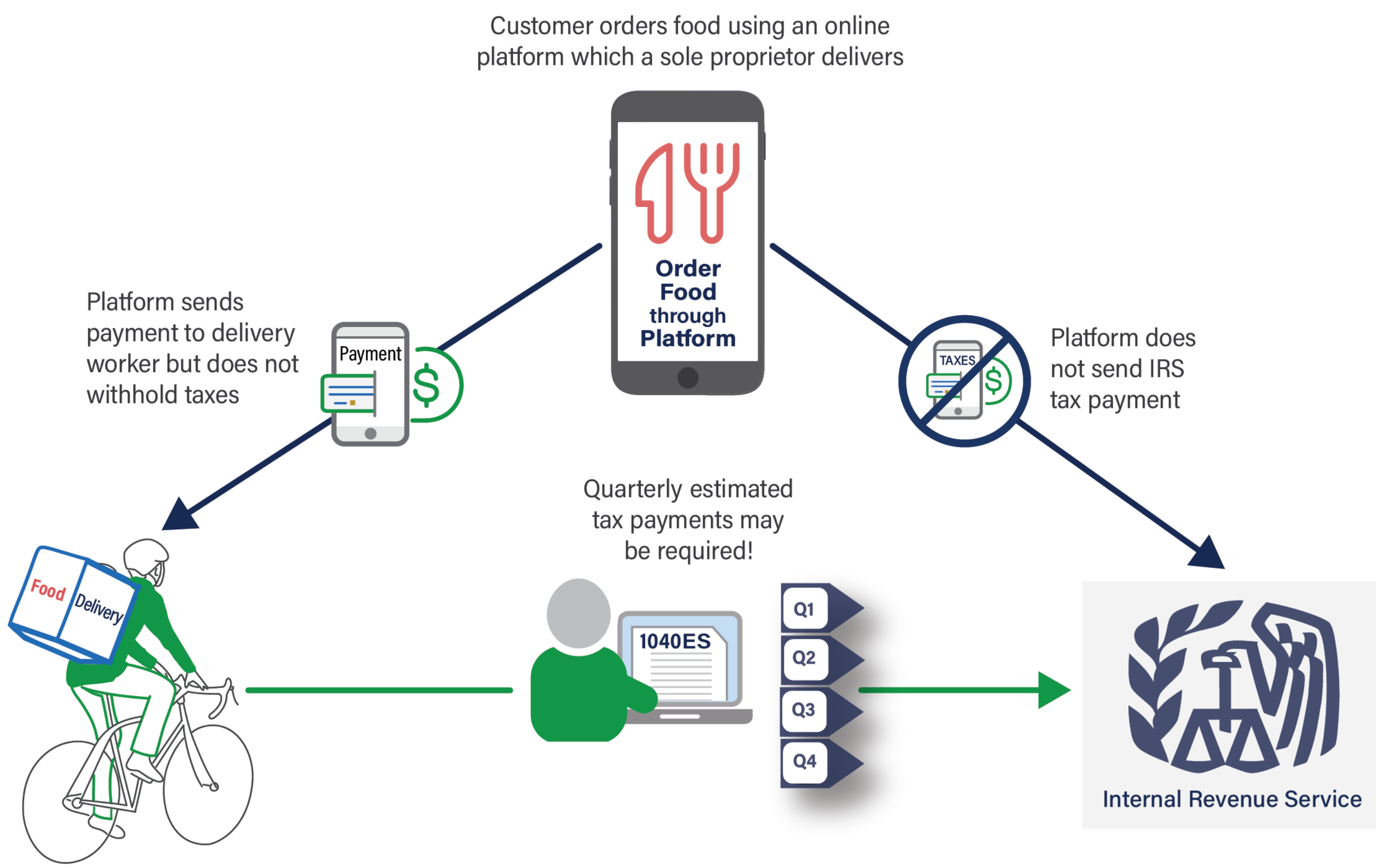
We stand by our conclusion from 2007 that having an up-to-date strategy to decrease the tax gap in general—and sole proprietor compliance in particular—can help IRS and Treasury reduce the tax gap.

Treasury and IRS Have Not Yet Implemented Our 2020 Recommendation to Allow Voluntary Withholding of Estimated Taxes for Certain Sole Proprietors

Treasury and IRS have not taken steps to allow for voluntary tax withholding on payments for services to platform workers and other independent contractors who may choose to participate. Some of these independent contractors are sole proprietors that may find estimating, saving, and remitting quarterly payments for income, Social Security, and Medicare taxes burdensome (see fig. 6). We previously found that voluntary withholding aligns with our previously reported criteria for a good tax system.[25]

[25]See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005), and GAO-20-366.

Figure 6: In the Absence of Voluntary Withholding, Some Sole Proprietors Are Required to Pay Quarterly Estimated Taxes



Sources: GAO presentation of Internal Revenue Service (IRS) information and Anna/stock.adobe.com (illustrations). | GAO-24-105281

In May 2020, we recommended that IRS work with Treasury to implement withholding that is voluntary for both the companies making payments for services and for workers who choose to have taxes withheld.[26] IRS disagreed and said that its role is to administer tax law rather than propose tax policy changes. As we discussed in that report, IRS has the authority to take this action if the Secretary of the Treasury agrees that the action would improve tax administration. We continue to believe that

[26]GAO-20-366.

voluntary withholding has potential to improve tax compliance and reduce taxpayer burden.

IRS Has Implemented Two Options We Previously Identified to Improve Sole Proprietor Compliance

In 2007, we reported on options to improve sole proprietor compliance.[27] In the years since our report, IRS has implemented two of these options.

- **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** (former option 5). IRS updated its Schedule C Form and Instructions for tax year 2011 requiring sole proprietors to indicate whether they made payments requiring them to file Form(s) 1099, and providing more information on these requirements. This additional prompt can help sole proprietors and IRS better account for payments they deduct as expenses.
- **Create a new Form 1099-NEC to segregate the NEC from the various boxes on the existing Form 1099-MISC** (former option 7). IRS implemented Form 1099-NEC and updated Form 1099-MISC beginning with tax year 2020. To the extent that more Forms 1099-NEC are filed, it can help sole proprietors be more compliant reporting business income and potentially reduce confusion. Further, IRS could use the information returns to refine its matching and audit selection.

Additional Options Have Been Proposed to Improve Compliance but All Have Tradeoffs

In this report, we have updated our 2007 list of options for reducing the tax gap for sole proprietors by reviewing recent literature and obtaining feedback from subject matter experts (such as academics and tax professionals), stakeholders affected by these policy options, and agencies responsible for implementing the options. As a result, we refined the list to 17 policy options. Appendix I provides more information about our methodology for identifying options. Appendix III lays out additional detail about the 17 options, including goals and key considerations.

Each option has pros and cons to consider, and could affect compliance differently for some sole proprietors compared to others. 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 resources expended on tax compliance. Taxpayers and third

[27] GAO-07-1014.

parties spend time and money to comply with various requirements of our tax system. In addition, some options may require legislative changes.

Table 1 summarizes these options and organizes them into four broad categories.

Table 1: Options to Improve Sole Proprietor Compliance

A	Conduct Education and Outreach	
A1	**Education**	Improve education and guidance for sole proprietors
A2	**New filers**	Identify sole proprietors filing a tax return for the first time and provide them with assistance
A3	**Worker classification**	Repeal legal limitations restricting IRS from issuing guidance for classifying workers
A4	**Informational notices**	Use more informational notices to encourage compliance
B	Implement Administrative Actions	
B1	**Separate accounts**	Require sole proprietors to use a business account for all business transactions
B2	**Form 1099-K**	Distinguish between gross and net income on Form 1099-K
B3	**Cash transactions**	Include direct questions about income from cash or cash equivalents on the Schedule C
B4	**Voluntary Withholding**	Withhold tax to encourage compliance
B5	**Standard deduction**	Offer a Standard Business Deduction
C	Leverage Data	
C1	**High-income earners**	Require information reporting on financial accounts of high-income sole proprietors
C2	**Gross receipts**	Expand gross receipts reporting on the Schedule C
C3	**Third-party data**	Collect additional information from third parties tracking platform workers' transactions
C4	**Expense reporting**	Expand expense reporting on the Schedule C
C5	**State data**	Enhance access to state data
D	Improve Technology	
D1	**Deduction matching**	Identify overstated deductions for expenses
D2	**Return Review Program**	Use the Return Review Program to detect underreported income early
D3	**Service**	Use technology to improve customer service

Source: GAO analysis of literature and survey data. | GAO-24-105281

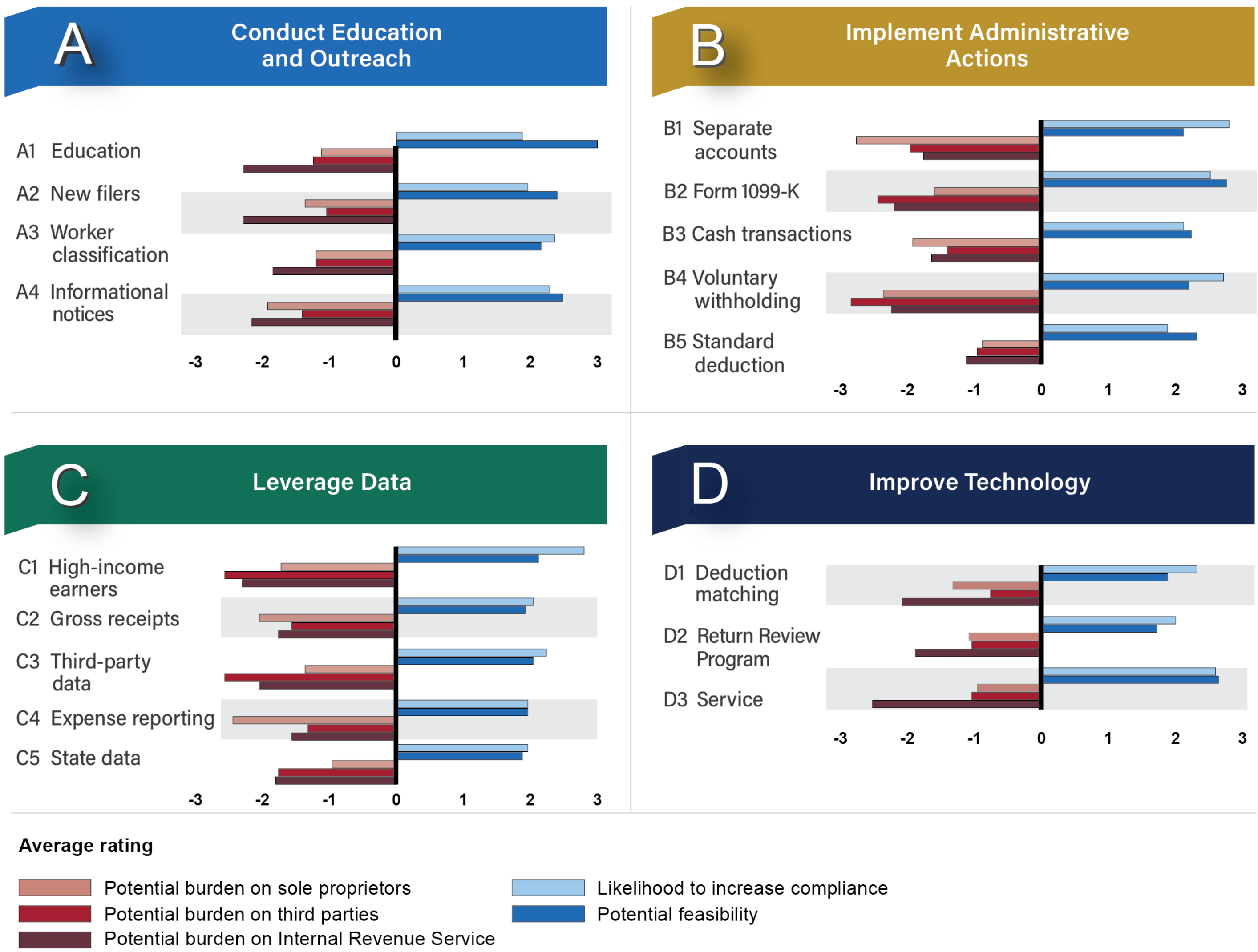
Note: Some options may require legislative changes to implement.

We identified these 17 options for Congress, Treasury, and IRS to consider for improving sole proprietor compliance as part of an overall strategy to promote taxpayer compliance and reduce the tax gap. Subject matter experts rated and commented on each option with respect to the following key factors:

- the likelihood of the option to improve tax compliance;
- the feasibility of implementing the option; and
- the potential burden of the option on sole proprietors, third parties, or IRS.

Figure 7 displays average ratings of each option based on these factors.

Figure 7: Average Expert and Stakeholder Ratings of Options to Improve Sole Proprietor Compliance



Source: GAO analysis of survey data. | GAO-23-105281

Note: We surveyed experts and stakeholders on a list of options for improving sole proprietor compliance and asked respondents to rate the options on a scale of 0 to 4, according to the specific factors listed in the figure. The figure shows average ratings, where a larger number indicates a higher likelihood or potential. We show the likelihood to improve compliance and potential feasibility on a positive scale and potential burden on a negative scale.

In addition to the factors listed above, there are a number of additional issues for Congress and IRS to weigh when considering these options. This includes tradeoffs between efforts to improve sole proprietor compliance and other compliance efforts, the potential interaction between options, variations in how options are developed and implemented, and policy judgments inherent in such decisions.

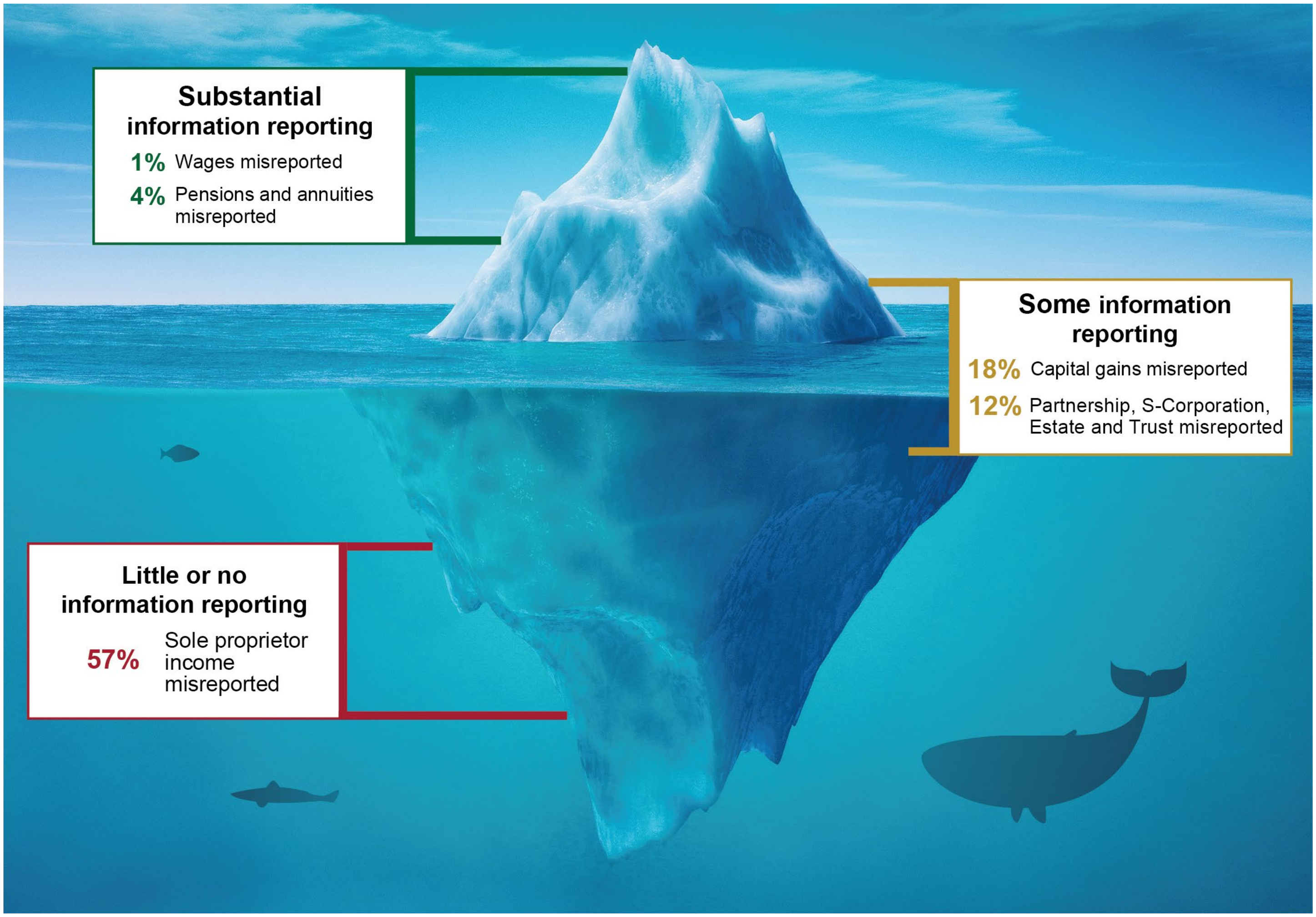
IRS Has Not Completed a Comprehensive Risk Assessment of Sole Proprietor Noncompliance to Inform a Compliance Strategy

Many Sole Proprietors Misreported Income or Expenses and Audits of Sole Proprietors Decreased

Schedule Cs have one of the highest rates of income and expense misreporting across all individual income tax forms. For example, misreporting of sole proprietor income is higher than misreporting of wages and pension income. Misreporting can be either intentional or unintentional. Some taxpayers may simply misunderstand the reporting requirements while others may be attempting to underreport their true tax liability. However, for Schedule C, IRS has less visibility into—and fewer means to confirm—the accuracy of reported taxable income. According to IRS research, taxpayers are more likely to misreport income when little or no third-party information reporting exists than when substantial reporting exists (see fig. 8).[28]

[28]GAO, *Tax Administration: Better Coordination Could Improve IRS's Use of Third-Party Information Reporting to Help Reduce the Tax Gap*, GAO-21-102 (Washington, D.C.: Dec. 15, 2020).

Figure 8: Availability of Third-Party Information Reporting Affects Misreporting of Income, Tax Years 2014 to 2016



Sources: GAO analysis of Internal Revenue Service data and Orlando Florin Rosu/stock.adobe.com (illustrations). | GAO-24-105281

Note: Net misreporting percentage estimates are based on sample data, and thus are subject to sampling error. However because sampling errors for these estimates were not available, we were unable to determine whether specific estimates were statistically significant from one another, or determine the lower and upper bounds for estimates. However, we found these data sufficiently reliable for reporting on broad-level line items. See appendix I of GAO-24-105281 for more information.

Sole proprietors can misreport their gross receipts and some or all of their expenses. Underreporting income or overreporting expenses, or both, lowers their reported taxable income and resulting tax liability. While IRS updated its estimate of the tax gap for tax years 2014 to 2016, its most current Schedule C misreporting line item data are from tax years 2013 to 2015.

> **What is the National Research Program?**
>
> IRS relies on its compliance research program—the National Research Program (NRP)—to estimate the tax gap caused by underreporting of individual income. IRS uses multiple years of NRP data along with statistical modeling to compute estimates of underreported income and taxes for the population of individual tax returns.
>
> In October 2017, we recommended, and IRS agreed, that the Commissioner of Internal Revenue should instruct the appropriate officials to develop and document a strategy that outlines how IRS will use the NRP data to update compliance strategies that could help address the tax gap. As of March 2023, IRS is redesigning the program and the outcome of the redesign will determine the scope of the information available from NRP in the future. See GAO-18-39.
>
> Source: GAO analysis of IRS documentation. | GAO-24-105281

- **Gross receipts.** For tax years 2013 to 2015, IRS estimated that 30 percent of sole proprietors misreported their gross receipts for a net misreported amount (NMA) of $101 billion on average per year.[29] This number reflects income that should have been reported and subject to taxes. It is distinct from the tax gap estimate because it does not reflect the amount of taxes owed. For example, if someone underreports their income by $100, the NMA is $100 but only the amount of unpaid taxes due on that $100 of income would be part of the tax gap.
- **Expenses.** According to IRS, for tax years 2013 to 2015, an estimated 76 percent of sole proprietors misreported their total expenses for an NMA of $92 billion on average per year. Based on IRS's National Research Program (NRP) analysis, some of the estimated top misreported expenses included: Schedule C-EZ total expenses, with about 62 percent misreporting total expenses on this form for an NMA of $1.3 billion on average per year;[30] car and truck expenses (58 percent); utilities (57 percent); travel (56 percent); and expenses for business use of home (53 percent).

Some sole proprietors may misreport their income or expenses to qualify for tax credits or deductions. Taxpayers may report false sole proprietor income to receive credits, such as the refundable Earned Income Tax Credit (EITC).[31] To claim EITC, taxpayers must have earned income, which can include income as a sole proprietor. According to IRS estimates, between 7.4 and 7.7 million sole proprietors claimed EITC in 2019.

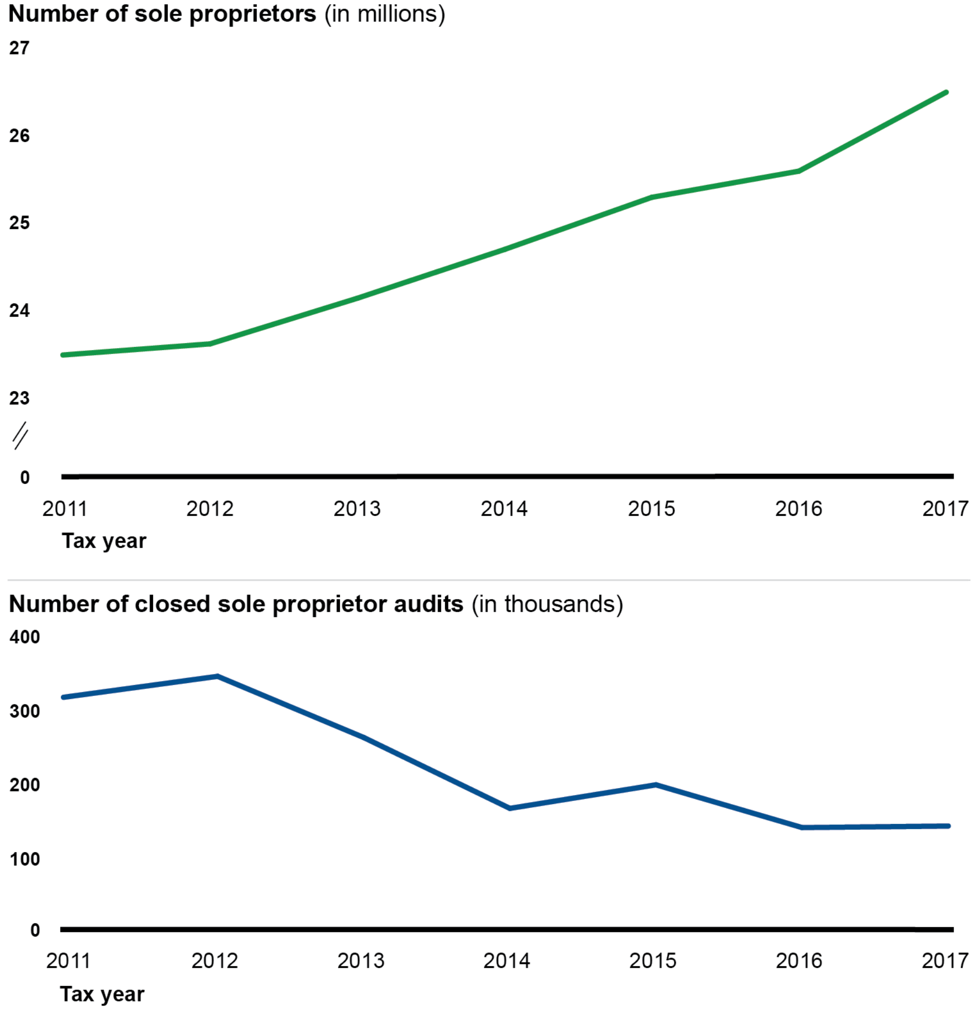
[29]IRS calculates NMA, which is the dollar amount of misreporting associated with a particular tax return or schedule line item. The word "net" in NMA refers to the offsetting of overstated and understated amounts and not the subtraction of enforced and other late payments. These data do not account for any noncompliance that the NRP audits did not detect. NMA estimates are based on sample data, and thus are subject to sampling error. However because sampling errors for these estimates were not available, we were unable to determine whether specific estimates were statistically significant or determine the lower and upper bounds for an estimate. However, we found these data sufficiently reliable for reporting on broad-level line items. See appendix I for more information.

[30]The Schedule C-EZ was a streamlined version of the Schedule C available for certain sole proprietors, such as those with business expenses of $5,000 or less and no employees. The Schedule C-EZ was last used for tax year 2018.

[31]26 U.S.C. § 32.

From tax year 2011 to 2017, the most current and complete data available at the time of our analysis, the estimated number of sole proprietors increased by about 13 percent. However, during the same period, IRS audits of sole proprietors decreased by about 56 percent (see fig. 9).[32]

Figure 9: Number of Sole Proprietors and Number of Closed Sole Proprietor Audits, Tax Years 2011 to 2017



Source: GAO analysis of Internal Revenue Service (IRS) data. | GAO-24-105281

Note: The data for the number of sole proprietors are estimates, and thus are subject to sampling error. For each year, the estimated number of sole proprietors has a margin of error of no more than +/- 100 (or 0.0001 million) at the 95 percent confidence level.

[32]Because of the time it takes to finalize audit results, we reviewed data through 2017.

IRS officials cited budget limitations as the reason for the decline in total audits performed. In August 2022, Congress enacted the Inflation Reduction Act of 2022 (IRA), which included a number of provisions related to taxes, energy, and health care. The IRA gave IRS $45.6 billion through fiscal year 2031 for tax enforcement activities such as hiring more enforcement agents.[33] The Secretary of the Treasury directed that these funds should not be used to increase the audit rate of taxpayers earning less than $400,000 relative to historic levels. While a precise estimate is not available and we do not have data on sole proprietors earning more than $400,000, in 2019, about 490,000 sole proprietors earned more than $500,000, based on IRS data.[34] As such, the IRA presents an opportunity to increase compliance among high-earning sole proprietors. See appendix IV for more information about sole proprietor income levels.

IRS Methods to Assess Risk Are Not Specific to Sole Proprietors

IRS's Small Business/Self-Employed (SB/SE) Division has not conducted a comprehensive risk assessment of sole proprietor noncompliance, according to agency officials we interviewed. SB/SE has some processes to assist it in determining the rates of potential noncompliance among sole proprietors. However, these efforts do not constitute a comprehensive risk assessment. They also are not used to inform a broader strategy to improve sole proprietor compliance to reduce the tax gap.

Standards for Internal Control in the Federal Government states that managers should assess the internal and external risks facing the entity and develop appropriate responses.[35] A risk assessment should encompass the following four elements: (1) define objectives and risk tolerances; (2) assess and respond to risks related to the defined objectives; (3) consider the potential for fraud when assessing risks; and (4) assess changes that could significantly affect the internal control system. Of these four elements, IRS has demonstrated some efforts to respond to risks and consider fraud but has not defined objectives and

[33] Pub. L. No. 117-169, § 10301(1)(A)(ii), 136 Stat. 1818, 1831 (2022). This $45.6 billion is part of a total of $79.4 billion in appropriations for IRS. The Fiscal Responsibility Act of 2023 rescinded over $1.389 billion of amounts appropriated for the IRS by Public Law 117-169. Pub. L. No. 118-5, § 251, 137 Stat. 10, 30 (2023).

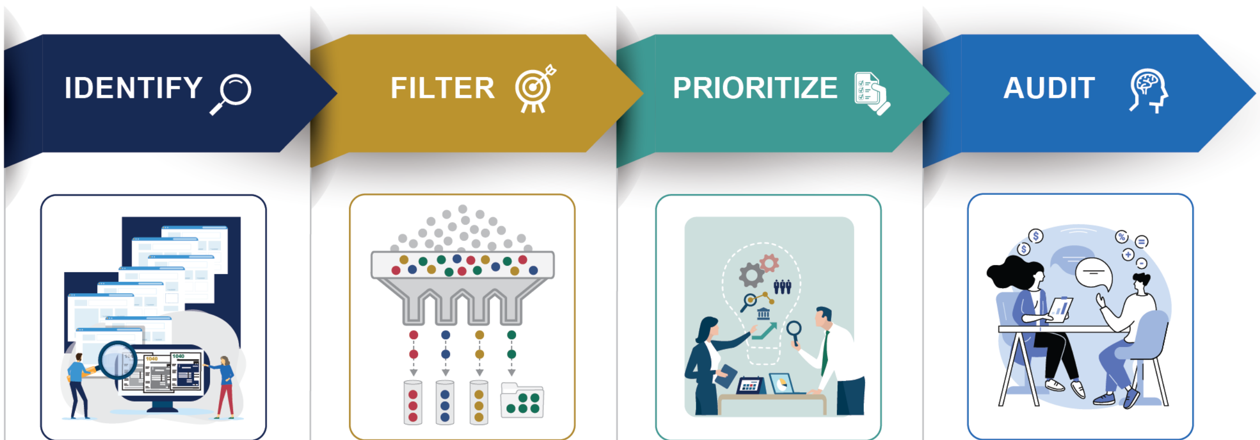
[34] The relative margin of error is less than 3 percent.

[35] GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014), 34.

risk tolerances or assessed changes that could significantly affect sole proprietor compliance.

SB/SE officials told us that their processes adequately assess and cover the risk of sole proprietor noncompliance. Officials said that the risk of sole proprietor noncompliance is assessed throughout the audit planning and selection process, which is described in figure 10 below, as well as during the IRS tax gap analyses.

Figure 10: IRS's General Process for Audits



IDENTIFY: IRS uses more than 30 methods to identify a pool of tax returns that have audit potential. For example, computer programs detect information mismatches in tax returns or other agencies refer potentially noncompliant taxpayers.

FILTER: IRS filters the initial pool of returns to reduce the number of possible audits. IRS determines which returns have the highest potential for tax change and which parts of the return should be audited. No further action is taken if a return has limited potential for tax change.

PRIORITIZE: Field offices, where audits are conducted, receive an inventory of returns for audit. Managers have the discretion to prioritize returns due to resource constraints or workload priorities.

AUDIT: Auditors audit the assigned return by interviewing taxpayers and/or their representatives. Auditors review taxpayers' records and determine whether any additional taxes are owed or refunds are warranted.

Sources: GAO analysis of Internal Revenue Service (IRS) information and Viacheslavikus/apinan/artemstepanov/bizvector/stock.adobe.com (illustrations). | GAO-24-105281

Officials also stated the SB/SE exam plan provides a balanced approach to addressing the tax gap by taking into account factors such as income levels, geographic locations, and return types. However, a risk assessment should consider factors beyond audit selection because, as we have noted previously, the tax gap cannot be closed by IRS enforcement alone.

We have reported on the need for multiple approaches to reduce the tax gap, including improved taxpayer services, more information reporting, better use of compliance data, and improved use of technology.

As part of a broader IRS effort, SB/SE contributed an enterprise risk list that identified the effect of tax law changes as a key risk facing IRS. The list noted that failure to effectively implement legislative requirements in a timely manner may erode trust and confidence in the IRS. In turn, this could contribute to decreased voluntary compliance, ultimately increasing the risk of not collecting taxes owed. However, although IRS identified this risk at the agency level, SB/SE did not assess the effect of the statutory change to the Form 1099-K reporting requirements enacted in 2021.

While SB/SE has taken some steps to address the four elements of a risk assessment, including assessing risks of noncompliance through the methods described above, it has an incomplete understanding of the risks specific to sole proprietors. Further, by not defining objectives and the risk tolerance SB/SE is willing to accept, SB/SE is limited in its ability to make strategic decisions related to enforcement and outreach priorities to help it reduce sole proprietor's $80 billion share of the annual income tax gap. SB/SE may otherwise overlook new compliance risks prompted by the Form 1099-K reporting change—such as confusion related to personal transactions and business transactions reported on the form.

IRS Could Better Utilize Form 1099-K Data

As a result of the Form 1099-K reporting threshold change, IRS is expected to receive millions more Forms 1099-K for tax year 2023 than for prior years. However, IRS neither has plans to analyze the higher volume of Form 1099-K data to strategically assess sole proprietor noncompliance nor has plans to use this information to make informed decisions about enforcement and outreach priorities for sole proprietors. Further, SB/SE officials told us the lowered Form 1099-K reporting threshold will provide more data to check for underreporting and fraud through its existing enforcement programs. However, IRS does not fully leverage all existing data it receives from information returns nor do IRS officials recognize that sole proprietors' compliance issues may differ from other business types.

IRS's Inflation Reduction Act Strategic Operating Plan includes an initiative to strategically use data to improve tax administration. Specifically, it calls for IRS to expand its use of data and analytics to allocate resources effectively to meet the needs of enforcement and customer service activities throughout the organization. It also calls for

IRS to use new data and enhanced analytics to improve its understanding of voluntary compliance by enhancing the timeliness, granularity, and comprehensiveness of the tax gap measurement.

While IRS policy requires audit coverage of sole proprietors, SB/SE does not have a formal strategy or goal specific to sole proprietors to ensure sufficient coverage in audits.[36] SB/SE officials stated that they have adequate audit coverage of sole proprietors through their various processes. They also stated the SB/SE audit plans, which are approved by executive leadership, ensure each fiscal year's audit coverage includes individual returns with a Schedule C. However, IRS has no data supporting its assertion that the compliance of sole proprietors is not distinct from other taxpayer types. Without such quality information, IRS is limited in its ability to identify its enforcement priorities for the largest part of the individual income tax underreporting gap—sole proprietor noncompliance.

Further, since the American Rescue Plan Act of 2021 lowered the 1099-K reporting threshold, there continues to be discussion of the effect of the threshold on taxpayer burden and voluntary compliance. Without assessing the additional data from the lower 1099-K reporting threshold strategically for sole proprietor noncompliance, IRS and policy makers will not have potentially key insights into the effect of the change on taxpayer burden and tax compliance.[37]

[36]Internal Revenue Manual section 4.1.1.2.3(c).

[37]In May 2020, we recommended that IRS work with Treasury to determine the most appropriate thresholds for payment information reporting and, if warranted, recommend Congress make adjustments. IRS did not agree with our recommendation, stating that it could not commit to an implementation date because of higher priority guidance projects, especially in light of the many new tax provisions. See GAO-20-366.

IRS's Lack of Strategy Limited Its Outreach Efforts to Sole Proprietors

IRS Does Not Have a Communications Plan to Improve Sole Proprietor Compliance

IRS does not have a coordinated communications plan focused on informing the wide variety of sole proprietors about their tax and reporting responsibilities. In May 2020, we reported that IRS has a communications plan for platform workers; however, these workers are only one type of sole proprietor.[38]

IRS also collects some feedback from sole proprietors and stakeholders on issues that sole proprietors face in understanding their tax obligations. While agency officials stated that an IRS priority is to increase engagement with small businesses and self-employed taxpayers, they did not cite specific objectives or goals for improving their engagement with sole proprietors.

IRS's Inflation Reduction Act Strategic Operating Plan includes an initiative to help taxpayers understand and claim appropriate credits and deductions. Specifically, it calls for IRS to expand the scale and scope of outreach and education forums. It also calls for IRS to enhance and cultivate community-based relationships and improve direct outreach to taxpayers, including small businesses. The lack of a communications plan focused on improving sole proprietor compliance is at odds with this effort. Moreover, Standards for Internal Control in the Federal Government states that management should communicate and use quality information to achieve the entity's objectives, including establishing two-way reporting of quality information to achieve its objectives.[39] Management should monitor activities and periodically evaluate the quality of information received to achieve its objective.

To be consistent with Standards for Internal Control in the Federal Government, an effective communications plan should include the following elements:

---

[38]GAO-20-366.

[39]GAO-14-704G.

- **Timeliness.** Sole proprietors need timely information to voluntarily comply with tax law and IRS guidance changes. For example, when tax law changes, such as the threshold for reporting requirements or eligibility for credits or deductions, IRS should ensure that sole proprietors have the information they need to maintain appropriate records and receipts as early as feasible in the tax year.
- **Targeted audience.** Sole proprietors vary widely and may face different tax requirements from other small business taxpayers. A communications plan should ensure that affected taxpayers such as sole proprietors receive relevant information. This is distinct from efforts to communicate with other types of small businesses.
- **Stakeholder engagement.** As part of establishing effective two-way communication, a plan should include a strategy to engage relevant stakeholders and establish a mechanism to monitor and address feedback.

IRS officials pointed to outreach efforts targeted to platform economy workers. While many platform economy workers are sole proprietors, not all sole proprietors are platform economy workers. Without a communications plan focused on improving outreach to sole proprietors, they may have difficulty meeting their tax and reporting obligations, particularly when tax law or IRS guidance changes. Without IRS tailoring communications to sole proprietors, including taxpayers who do not consider themselves to be operating a business, sole proprietors may not know to seek out information for small businesses on the IRS website to understand their tax filing obligations.

IRS Delayed Implementation of the Lower Reporting Threshold for Form 1099-K Due to Taxpayer Confusion

On December 23, 2022, IRS announced that it would delay implementation of the lower Form 1099-K reporting requirement for one year.[40] According to IRS officials, this decision was directed by the then-Acting Commissioner because of confusion among taxpayers and stakeholders about how IRS was implementing the statutory change.[41] During our review, we shared our preliminary findings with IRS on the threshold change, which are outlined below. IRS took some steps to improve its communications about tax questions related to the lower threshold. However, stakeholders told us they did not think there had

[40]IRS Notice 2023-10, 2023-3 I.R.B. 403.

[41]While IRS officials cited the IRS Commissioner's general authority that allowed it to take this action, we did not assess IRS's authority for delaying the reporting requirement through the adoption of a transition year for enforcement.

been enough guidance and that existing guidance was overly technical and difficult to understand.

While IRS does not have a coordinated communications plan to improve sole proprietor compliance, it does have one for the Form 1099-K reporting requirement change. IRS officials provided a version of the Form 1099-K communications plan in January 2023—after the decision to delay implementation. However, the plan contained limited information on the steps IRS had taken to communicate the change to stakeholders. In April 2023, IRS provided us with a revised Form 1099-K communications plan that had more details and initiatives. Specifically, it included events with stakeholder groups and more detailed status updates. IRS officials stated that the communications plan is a living document that is continually updated.

The threshold change highlighted some of the existing confusion that sole proprietors have about their tax obligations. At the same time, it also introduced new areas of confusion about how to appropriately meet tax obligations.

Unaware of tax obligations. While the threshold change did not change taxpayers' obligation to report and pay taxes on their respective incomes, this change was a point of confusion for taxpayers. According to stakeholders we met with, some sole proprietors are unaware of their tax obligations on income earned through online platforms. As a result, some sole proprietors may not have taken steps during the calendar year to keep records of expenses and calculate, save, and remit quarterly tax payments on income they earned from those sources, and could be penalized for underpayment of taxes. These sole proprietors may now receive a Form 1099-K. This may help taxpayers comply, but it also exposes and could exacerbate confusion.

Moreover, some sole proprietors are confused about why TPSOs are requesting their social security numbers and why TPSOs may withhold tax from their payments if they fail to provide them. When it applies, backup withholding requires a payer—such as a TPSO—to withhold tax from payments not otherwise subject to withholding. As a result, some sole proprietors may be subject to backup withholding if they, for example, do not provide a TPSO their social security numbers when required. IRS has not directly addressed this topic in the frequently asked questions (FAQ) for the Form 1099-K, to which TPSOs could direct sole proprietors if they include this information. In the FAQs for Form 1099-K, the question addressing duplicative backup withholding states that the regulations do not eliminate the backup withholding requirements where the potential for duplicative withholding exists.

Confusion on how to meet tax obligations. Additionally, some taxpayers who use online platforms may not be operating a business or earning a profit. Figure 11 describes two examples where taxpayers might receive a Form 1099-K. Taxpayers receiving the form in these instances may not understand the information reported on the form, which puts them at risk of inaccurately reporting their income to IRS or not meeting their tax obligations. While these scenarios could have created confusion for some taxpayers in prior years, the lower threshold means they will affect far more taxpayers.

Figure 11: Certain Scenarios in Which Taxpayers May Receive Form 1099-K

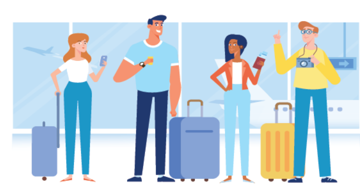
Digital payment platform issues Form 1099-K to IRS and the individual when the...

Individual sold used goods and received a total of over $600 in payments that were designated as a business transaction during the calendar year.

Potential tax challenge

IRS will expect to see those payments reported as income or losses on the individual's tax return. However, the individual may not know how to calculate the profit or loss earned from each sale (e.g., via receipts, comparable sales, appraisal), or how to report the profit or loss on their tax return.

Individual received over $600 in total from friends for a trip and the payments were mistakenly designated as a business transaction during the calendar year.



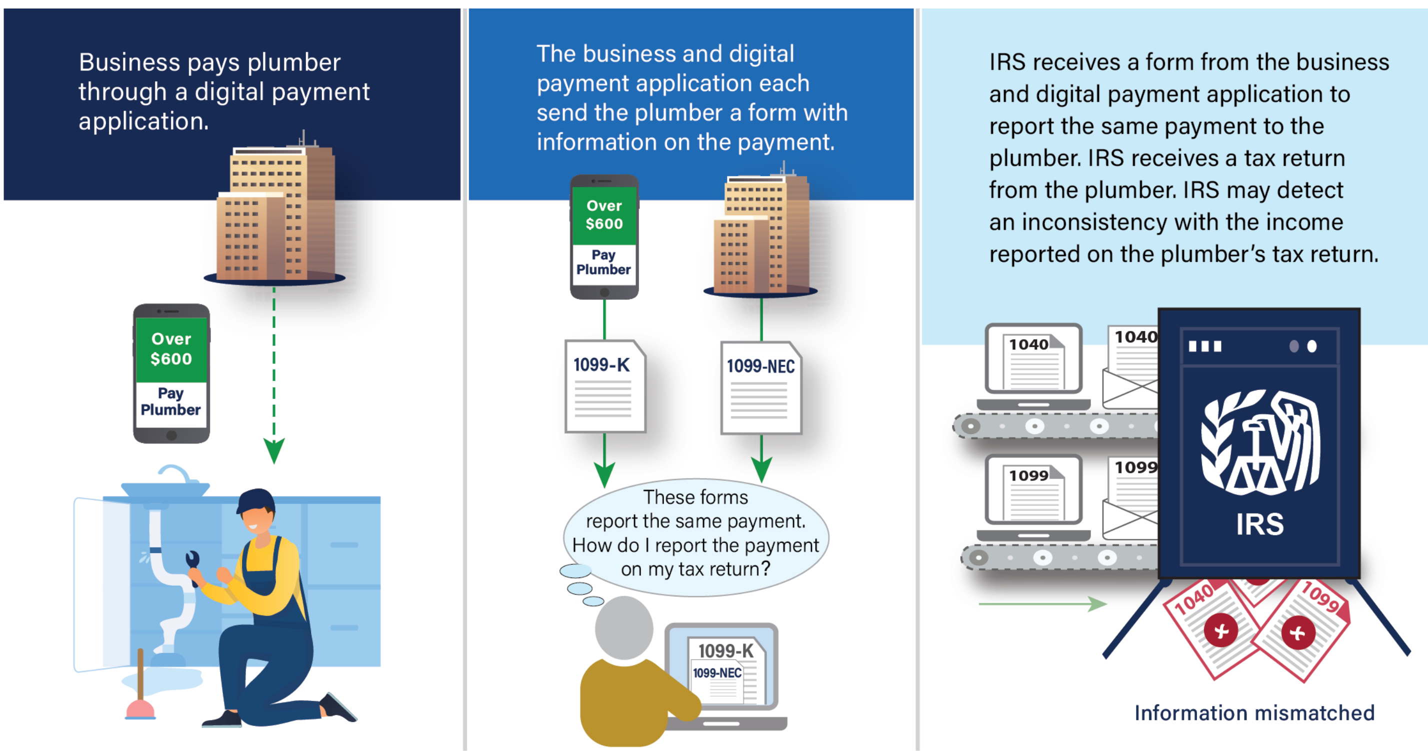
Potential tax challenge

If the payments were mistakenly marked as a business transaction, IRS will expect to see the income reported on the individual's tax return. However, the individual may not have kept records to demonstrate the payments were for a personal transaction.

Sources: GAO analysis of Internal Revenue Service (IRS) information and Tartila/Oksana/stock.adobe.com (illustrations). | GAO-24-105281

We also heard from stakeholders that some sole proprietors receiving payments through TPSOs for services they provided caused confusion. IRS issued guidance in December 2022 and March 2023 about how taxpayers should report the income in these scenarios. However, these issues continue to be discussed among tax professionals as being confusing for taxpayers. Additionally, we found that sole proprietors could face difficulty calculating their taxable income if they were issued multiple 1099s on the same transaction (see fig. 12). IRS tracks the frequency and type of filed information returns, but officials said they do not track the extent to which duplicative information is reported on the same transaction.

Figure 12: Same Payment May Be Reported on Multiple Information Returns



Sources: GAO analysis of Internal Revenue Service (IRS) information and Rudzhan/stock.adobe.com (illustrations). | GAO-24-105281

According to companies we spoke to, taxpayers may receive duplicate information returns for the same payment when companies are uncertain about who is responsible for reporting it. These companies said that they err on the side of sending information returns to avoid penalties for failing to report transactions. This can cause confusion among sole proprietors. The lower threshold for reporting requirements means this issue will affect more taxpayers.

IRS officials stated that if a taxpayer receives Forms 1099-K and 1099-NEC, or 1099-MISC, for the same payment, it is due to a reporting error. According to IRS guidance, when a business uses a TPSO to pay a sole proprietor for their services, it is not required to report the payment using Form 1099-NEC, or 1099-MISC.

IRS pointed to guidance for these forms as well as changes they made in response to feedback. However, IRS attributed its decision to delay implementation of the Form 1099-K threshold change to confusion among taxpayers and tax professionals. This is consistent with what we heard from representatives from Low Income Taxpayer Clinics who anticipate confusion from their clients.

Conclusions

Each year, approximately $80 billion in tax revenue is lost because sole proprietors underreport their net income. As we have previously reported, the tax gap cannot be closed by IRS enforcement alone. This report outlines options that have been put forward by experts and stakeholders for improving sole proprietor compliance. All of these options have pros and cons and would be most effective 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.

We have previously recommended that taxpayer burden for some sole proprietors could be eased through a voluntary withholding program. IRS and Treasury have the statutory authority to take such an action if the Secretary of the Treasury finds that withholding would be appropriate; however, IRS has indicated that it does not intend to pursue it. Voluntary withholding could help some sole proprietors save and remit their taxes to IRS and could eliminate the need for some sole proprietors to file quarterly estimated payments.

IRS's Inflation Reduction Act Strategic Operating Plan outlines IRS priorities for the coming years. However, neither the plan nor other IRS documents present an approach that includes key elements for improving sole proprietor compliance. Specifically, IRS does not have (1) a comprehensive risk assessment for sole proprietor noncompliance, (2) a plan to strategically analyze the millions of additional Forms 1099-K it will receive for tax year 2023 to gain insights into sole proprietor noncompliance and taxpayer burden, or (3) a coordinated communications plan to improve outreach to sole proprietors. A proactive approach to identifying relevant risks, analyzing data, and conducting outreach and education for sole proprietors could help IRS more effectively enhance sole proprietor compliance.

Matters for Congressional Consideration

We are recommending the following two matters for congressional consideration:

Congress should consider legislation requiring the Secretary of the Treasury to ensure the tax gap strategy includes (1) a segment on improving sole proprietor compliance that is coordinated with broader tax gap reduction efforts, and (2) a specific, integrated plan that could include options we identified, as we recommended in July 2007. (Matter for Consideration 1)

Congress should consider requiring the Commissioner of Internal Revenue to work with the Secretary of the Treasury to implement tax withholding that is voluntary for companies facilitating payments for services provided by sole proprietors for those taxpayers who choose to participate, as we recommended in May 2020. (Matter for Consideration 2)

Recommendations for Executive Action

We are making the following three recommendations to IRS:

The Commissioner of Internal Revenue should ensure that the Small Business/Self-Employed (SB/SE) Division assesses the risks of sole proprietor noncompliance, including defining objectives and the risk tolerance SB/SE is willing to accept, as part of its broader efforts to enforce compliance among small businesses. (Recommendation 1)

The Commissioner of Internal Revenue should analyze existing data and forthcoming Form 1099-K data to better understand and gain insights into sole proprietor noncompliance and taxpayer burden that may be unique to sole proprietors, and use that information to make decisions on enforcement and outreach priorities for sole proprietors. (Recommendation 2)

The Commissioner of Internal Revenue should develop and implement a communications plan focused on outreach and education to improve sole proprietor compliance, particularly when tax laws or IRS guidance change. This should include mechanisms to ensure IRS communicates relevant information to sole proprietors in a timely manner and engages stakeholders, as appropriate. (Recommendation 3)

Agency Comments and Our Evaluation

We provided a draft of this report to IRS and Treasury for review and comment. In its comments, reproduced in appendix V, IRS disagreed with our findings that the challenges associated with sole proprietor compliance merit additional efforts beyond those for other small businesses. Specifically, IRS disagreed with the recommendations to assess the risks of sole proprietor noncompliance (Recommendation 1) and to develop and implement a communications plan focused on education and outreach to improve sole proprietor compliance (Recommendation 3). IRS agreed with the recommendation to analyze existing data and forthcoming Form 1099-K data (Recommendation 2). IRS and Treasury also provided technical comments, which we incorporated as appropriate.

In its letter, IRS says that there is no consistent set of attributes that apply to all sole proprietors which would make it useful to address these taxpayers separately from other small business taxpayers. However, as we discuss in the report, sole proprietors have important attributes that distinguish them from other small businesses.

- First, sole proprietors have a higher noncompliance rate than other small businesses. As noted previously, IRS's 2014 to 2016 tax gap estimates indicate that sole proprietor income is misreported 57 percent of the time, compared to partnership, S-corp, estate, and trusts income, which is misreported at a combined rate of 12 percent. IRS attributes $80 billion of the annual tax gap to sole proprietor misreporting.

- Additionally, because no legal action is required to establish a sole proprietorship, some taxpayers may not realize they are sole proprietors and may be unaware of their tax obligations. This contrasts with other forms of small businesses which are actively created. These sole proprietors will have different compliance risks and would benefit from different education efforts than taxpayers who have established small businesses.

- Moreover, taxpayers can easily start and stop their businesses as sole proprietors from year to year, particularly when working part-time or as platform workers. This can make it more difficult for taxpayers to voluntarily comply with their respective tax obligations.

- Finally, as we reported, IRS provided no data supporting its assertion that compliance behavior of sole proprietors is the same as other taxpayer types.

Therefore, we do not believe it is reasonable to conclude that it is most effective and efficient to assess sole proprietor compliance risks and educational needs together with broad strategies focused on all small businesses.

In reference to our recommendation to assess the risk of sole proprietor noncompliance, IRS points to steps in its audit process where risk is assessed, including the National Research Program, Discriminant Function System, and other risk modeling. While these are important ways to assess risk during the audit process, as we discussed in the report, a risk assessment should consider factors beyond audit selection because the tax gap cannot be closed through audits alone. A comprehensive risk assessment may include, for example, identifying the extent to which taxpayer confusion is causing noncompliance. As of November 2022, IRS had not identified taxpayer confusion about the Form 1099-K change as a compliance risk. However, it announced a one-year delay in Form 1099-K reporting requirements in December 2022, citing taxpayer confusion. Without a comprehensive risk assessment, SB/SE is limited in its ability to make strategic decisions related to enforcement and outreach priorities.

Regarding our recommendation to develop and implement a communications plan focused on education and outreach to improve sole proprietor compliance, IRS said it addresses sole proprietor audiences as part of its broader communications and outreach plans. Its letter discusses resources for platform economy workers as well as its efforts related to the Form 1099-K change, which are discussed in this report. However, while many platform economy workers are sole proprietors, not all sole proprietors are platform economy workers. IRS's letter also describes its stakeholder partner events, quarterly Small Business Forums, and IRS seminars at Small Business Expos that include information relevant to sole proprietors. These are important and valuable efforts. However, without IRS tailoring communications to sole proprietors, some—including those who do not realize that they are sole proprietors—may not know to seek out information for small businesses on the IRS website to understand their tax filing obligations.

In addition to their comments on the recommendations, IRS stated that we did not consider all that the agency has accomplished to address and improve sole proprietor compliance through its multiple enforcement and educational activities aimed at small businesses. In the report, we cite various examples of these programs and initiatives and considered all such documented efforts in our review, including those described in IRS's Strategic Operating Plan and internal documents provided to us by IRS. While we recognize that these are important efforts, we maintain that IRS would benefit from completing a comprehensive risk assessment for sole proprietor noncompliance and a coordinated communications strategy to improve outreach and education for sole proprietors.

Finally, IRS incorrectly stated that our report shows that SB/SE audits a greater percentage of sole proprietor taxpayers than other business types. While our report includes data on the declining number of sole proprietor audits, it does not include data on audit rates for other business types, nor does it make comparative statements about audit rates of sole proprietors versus other taxpayers.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Commissioner of Internal Revenue, the Secretary of the Treasury, and other interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-6806 or mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VI.

James R. McTigue, Jr.
Director, Tax Policy and Administration
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

This report (1) reviews options for the Internal Revenue Service (IRS) to close the tax gap by increasing sole proprietor compliance; (2) evaluates IRS efforts to assess the risk of sole proprietor noncompliance; and (3) assesses IRS efforts to conduct outreach to improve voluntary compliance among sole proprietors.

Options for IRS to Close the Tax Gap by Increasing Sole Proprietor Compliance

We reviewed relevant literature and surveyed subject matter experts to obtain their views on the policy options.

Literature Review of Relevant Studies

In 2007, we identified a list of potential policy options to improve sole proprietor compliance.[1] To update this list for this report, we first reviewed relevant studies published between 2017 and 2021. To identify literature for this review, in November and December 2021, we conducted multiple keyword searches of 16 publication databases focused on scholarly articles and another literature search focused on working papers, conference presentations, and trade and government publications. Our initial searches yielded more than 130 articles. We also identified three relevant articles outside our database searches.

We then conducted an initial abstract review to determine which studies identified by our database searches seemed relevant to our research objective. We considered an article relevant if the abstract indicated that the article was related to improving sole proprietor compliance. We determined that nearly 60 of the articles were relevant to our review and assessed the full text of these articles. We reviewed these studies to determine if they (1) included one or more options to improve sole proprietor compliance, (2) contained well-developed policy proposals that outlined details for legislative or executive action, and (3) did not explicitly state that IRS needs more funding to improve sole proprietor compliance.

We reviewed relevant articles to identify additional options. We excluded options that did not align with the current U.S. tax system or with our criteria for a good tax system, which state that a good tax system should be equitable, economically efficient, simple, transparent, and administrable.[2] For example, we did not include options that would

[1]GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

[2]GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

fundamentally change the U.S. tax system, such as changing to a value added tax system. We identified seven new options from our review. We also refined five options from our initial list based on our review, such as by including modern technology elements.

Selection of Experts and Stakeholders

To obtain feedback on our updated list of potential options, we surveyed experts and stakeholders. To identify potential experts with a depth and breadth of knowledge on sole proprietor compliance, we reviewed literature returned from our database searches described above. We began building an initial list of potential experts by identifying those individuals who had authored multiple publications relevant to our topic of interest or proposed or wrote extensively on at least one new option we had identified in the literature. We then gathered information about each of the potential experts to help us assess their expertise, such as their titles, affiliations, education and training, type of work experience, and publication history, among other information. Using this information, we selected 20 experts with a range of knowledge and experience across various sectors including academics, researchers, economists, former government officials, think tank analysts, and attorneys with expertise in sole proprietor tax policy.

We defined stakeholders as those who represented groups of people affected by policy changes. Based on the 2007 options list, we identified categories of stakeholders who could be affected by each policy option. These categories included: employee organizations for self-employed workers, federal and state government officials, financial institutions, for-profit tax preparers and other tax professionals, nonprofit tax preparers, advocacy organizations, platform companies, and tax software developers. We solicited feedback from 18 stakeholders across these categories. While fielding the survey, we received multiple responses from two of the organizations we selected that are comprised of subsidiary member organizations. We reviewed information from the subsidiary member organizations and determined it was appropriate to treat them as distinct entities and include them in the survey population and exclude the umbrella organizations.

Survey on Options to Improve Sole Proprietor Compliance

Based on the literature review, our analysis of the 21 options included in the 2007 report, IRS feedback, and our pretest of the survey, we developed 22 potential options to improve sole proprietor compliance for inclusion on the survey. We also revised the options from the 2007 report, as appropriate. We then developed a draft survey instrument that included the updated list of 22 potential options. We surveyed 20 experts and 18 stakeholders in October 2022 to collect perspectives on the potential options.

The practical difficulties of conducting any survey may introduce errors. For example, difficulties in interpreting a particular question, sources of information available to respondents, or analyzing data can introduce unwanted variability into the survey results. We took steps in developing the questionnaire, collecting the data, and analyzing them to minimize such error. For example, we pretested and refined the draft questionnaire with three experts to ensure that the questions were relevant, clearly stated, and easy to understand.

We emailed the questionnaire with an attached PDF-fillable form that respondents could return electronically after marking checkboxes or entering responses into open answer boxes. Prior to sending the questionnaire to respondents, we contacted them in advance with information about the survey and its purpose. We also followed up with email reminders before and after the requested response date.

The survey instrument included a series of closed-ended questions that asked respondents to rate each of the potential policy options according to specific factors: improving compliance, feasibility, and burden on sole proprietors, third parties, and IRS. The survey also included open-ended questions that asked respondents to provide any comments on their ratings and on the options. If respondents were unfamiliar or had no opinion on a given policy option, they could skip the option and select “no basis to judge this option” as their rating. We provided respondents the following definitions of each factor.

- **Improving compliance.** Potential effect of the policy option on increasing tax compliance among the affected sole proprietor population, if the option is implemented.
- **Feasibility.** Potential for the option to take effect—either by agency actions or legislative change.
- **Burden on sole proprietors.** Potential burdens on the sole proprietors (i.e., taxpayers who file a Schedule C) if the option is implemented. These include any financial costs and administrative burdens to sole proprietors and tax preparers or accountants assisting sole proprietors.
- **Burden on third parties.** Potential burdens on third parties affected by the option, if implemented. These include any financial costs and

administrative burdens to third parties. Examples of third parties may include financial institutions and employers, among others.

- **Burden on IRS.** Potential burdens on IRS, including financial costs and administrative burdens related to staffing and other agency resources, if the option is implemented.

The survey results are based on opinions of 25 subject matter experts and stakeholders who responded to our questionnaire. The results are not generalizable. We include these data to present varying opinions from knowledgeable individuals and organizations that may be affected by these options, if they are to be implemented. Table 2 shows the response rates for the survey.

Table 2: Response Rates by Experts and Stakeholders for Survey on Options to Improve Sole Proprietor Compliance

	Number surveyed	Number of survey respondents	Response rate
Experts (individuals)	20	14	70.0%
Stakeholders (organizations)	18	11	61.1%
Total	**38**	**25**	**65.8%**[a]

Source: GAO survey. | GAO-24-105281

[a]We conducted a nonresponse bias analysis and found no concerns for bias. All of our selected sectors of experts and selected categories of stakeholders were sufficiently represented by participating respondents.

Table 3 shows the number of respondents for each option by factor. We categorized the options by issue areas as follows A = Conduct Education and Outreach, B = Implement Administrative Actions, C = Leverage Data, and D = Improve Technology.

Table 3: Number of Responses by Question for Survey on Options to Improve Sole Proprietor Compliance

Option		Compliance	Feasibility	Burden on sole proprietors	Burden on third parties	Burden on IRS	No basis to judge
A1	Education	20	22	21	22	23	2
A2	New filers	20	21	19	21	21	3
A3	Worker classification	18	19	18	15	19	6
A4	Informational notices	21	21	21	21	20	4
B1	Separate accounts	24	21	23	23	23	1
B2	Form 1099-K	23	22	24	23	24	1
B3	Cash transactions	19	19	18	18	19	5

Option		Compliance	Feasibility	Burden on sole proprietors	Burden on third parties	Burden on IRS	No basis to judge
B4	Voluntary withholding	23	23	23	24	22	1
B5	Standard deduction	18	19	18	18	18	6
C1	High-income earners	22	22	21	21	22	3
C2	Gross receipts	19	18	18	15	19	6
C3	Third-party data	19	20	18	19	19	4
C4	Expense reporting	18	19	19	18	19	5
C5	State data	16	17	18	17	17	7
D1	Deduction matching	18	17	17	15	18	7
D2	Return Review Program	16	15	16	18	16	7
D3	Service	21	20	21	20	20	3

Source: GAO survey. | GAO-24-105281

Notes: A total of 25 respondents completed this survey. The survey included a series of the same five closed-ended questions that asked respondents to rate each of the potential options according to specific factors: 1) improving compliance, 2) feasibility, 3) burden on sole proprietors, 4) burden on third parties, and 5) burden on IRS. If respondents were unfamiliar or had no opinion on a given policy option, they could skip rating the option and select “no basis to judge this option” as their rating.

We analyzed the data using statistical software. When analyzing the closed-ended questions, we coded them based on a scale of 0 to 4 and calculated the average ratings for each option, where the higher number indicates a higher likelihood or potential. We consider likelihood to improve compliance and potential feasibility as favorable outcomes and potential burdens on sole proprietors, third parties, and IRS as less favorable outcomes. As a result, we made the three scores for burden negative to reflect the negative impact of burden on compliance.

We analyzed broad themes and patterns in the open-ended comments and incorporated those results into each option’s “key considerations.”

Finalizing the List of Options

The final list of options incorporates results from completed surveys we received from 25 experts and stakeholders, as well as input from federal agencies that would be affected by the options.

To finalize the list of options, we considered three primary criteria: (1) likelihood for increasing compliance, (2) feasibility, and (3) burden on sole proprietors, third parties, and IRS. To apply these criteria, we used the following information sources:

- Survey data that indicated an option was highly or moderately likely to improve compliance

- Survey data analysis of options that fell in the bottom quarter of the average ratings for each question
- Survey data analysis of open-ended responses
- Feedback from federal agencies that would be affected by the policy option. IRS provided input on all draft options while the Social Security Administration provided input on one option.

We considered additional assessments as applicable, such as if our prior work or recommendations related to an option. We also reviewed the final list to exclude any option that did not meet our criteria of a good tax system.

Based on feedback from experts and stakeholders in the survey as well as input from IRS and the Social Security Administration, we removed five of the 22 options included in our survey.[3] This gave us a final list of 17 options that we present in this report.

IRS Efforts to Assess the Risk of Sole Proprietor Noncompliance

We reviewed IRS documents and interviewed agency officials about the objectives, procedures, and processes for IRS compliance programs relevant to sole proprietors. We then evaluated IRS's written procedures for implementing the selected compliance programs against the relevant federal standards for internal control, particularly the risk assessment component.[4]

To understand what IRS knows about sole proprietors and sole proprietor noncompliance, we interviewed IRS officials and reviewed IRS reports to identify relevant data that IRS collects. After we identified relevant data sources, we analyzed them to understand the characteristics of sole proprietors and sole proprietor noncompliance. Specifically, we analyzed IRS's tax gap estimates and IRS's Statistics of Income (SOI) data. The SOI estimates in this report are presented along with their margins of error or relative margins of error at the 95 percent confidence level. We interviewed officials from IRS's Research, Applied Analytics, and Statistics Division and SOI Division to discuss existing data on the sole proprietor population and its limitations, including the Nonfarm Sole Proprietorship Returns Report for tax year 2018, the SOI Tax Stats -

[3]The Social Security Administration would have been affected by one of the options included in the survey which is not included in the 17 options in this report.

[4]GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: Sept. 10, 2014), and Internal Revenue Service, *Inflation Reduction Act Strategic Operating Plan*, Publication 3744 (Rev. 4-2023) (Washington, D.C.: April 2023).

Nonfarm Sole Proprietor Statistics for tax year 2019, and the Individual Returns Report for tax year 2019, including the reliability of the data.[5] IRS reports these data annually and these were the most current data at the time we conducted the analysis. Additionally, we analyzed IRS's National Research Program (NRP) tax gap data on misreporting from tax years 2014 to 2016 (the most current data available). Further, we met with officials from the Small Business/Self-Employed Division to discuss audit data and verify our correct usage of data provided by IRS. We determined that these data were sufficiently reliable for our purposes.

To describe the tax gap, we reviewed IRS's tax year 2014 to 2016 tax gap estimate. IRS uses several approaches to estimate the different components of the tax gap, but these approaches have limitations. Estimates can have measurement and sampling error and can vary in the quality of information available. Sampling errors arise due to the selection of a probability sample rather than examining the entire population of tax returns. Non-sampling errors arise from other sources such as those due to data collection and processing procedures. Further, the estimates do not fully reflect all areas of the tax system. For example, foreign or illegal activities, digital assets, and some corporate income tax are not fully included because data are either not reliable or not available.

In estimating the individual income tax gap, IRS applies an econometric technique called detection controlled estimation which is a regression-based model that controls for variables that could affect the amount of underreporting detected. The statistical technique first produces a hypothetical ‘‘best practices’’ examiner—an ideal which is unattainable—based on who conducted the examinations and the observed examination results. It then statistically estimates the noncompliance detected by the hypothetical examiner to adjust the findings from research examinations conducted by actual examiners upward. The technique estimates total undetected underreporting by imputing the average underreporting undetected by IRS's NRP examination to the detected underreporting, controlling for certain return line item characteristics. We determined that the tax gap data were sufficiently reliable for our purposes.

To describe the estimated percentage of net misreporting amounts (NMA), we reviewed IRS's NMA data from tax years 2013 to 2015. Typically, we use a measure of uncertainty in sample data to determine

[5]IRS, *Statistics of Income—2019 Individual Income Tax Returns*, Publication 1304 (Rev. 12-21), (Washington, D.C.: December 2021); and *Statistics of Income Bulletin—Sole Proprietorship Returns, Tax Year 2018,* (Washington, D.C.: Spring 2021).

whether differences between estimates are statistically different. These same measures of uncertainty are also used to construct lower and upper bounds on the potential range of each estimate to account for the uncertainty due to sampling procedures. However, IRS does not publish such uncertainty estimates for the NMA estimates for tax years 2013 to 2015, which are used in this report. We found the data sufficiently reliable for describing estimated NMA over time for broad level line items. However, inferences about differences between NMA estimates, or the range of an NMA estimate, may be unreliable due to the standard errors being on the same order of magnitude as the estimates themselves.

IRS Efforts to Conduct Outreach to Improve Voluntary Compliance among Sole Proprietors

We gathered feedback on IRS's outreach and education efforts by evaluating IRS's 1099-K communications plan, and interviewing officials from IRS, the Center for Taxpayer Rights, the Coalition for 1099-K Fairness, and Low-Income Taxpayer Clinics. We then evaluated IRS's outreach against IRS's Fiscal Year 2023-2031 Inflation Reduction Act Strategic Operating Plan, as well as the relevant federal standards for internal control for information, communication, and monitoring.

For each of our objectives, we reviewed our relevant prior reports.

We conducted this performance audit from June 2021 through October 2023 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Small Business Traits and Tax Reporting Requirements

Table 4: Examples of Business Traits and Tax Reporting Requirements of Selected Types of Small Businesses

	Sole Proprietorship	Partnership	S Corporation
Ownership	One individual	Two or more individuals or entities (e.g., corporations, other partnerships)	Between one and 100 shareholders (e.g., individuals, certain trusts, estates, certain tax-exempt entities)
May link entities together to form a network of pass-through entities[a]	No (a separate business entity does not exist)	Yes	Yes
Business passes profit or loss to owners (individual, partners, or shareholders) who must include the income or loss on their income tax return	Yes	Yes	Yes
Business must file an annual tax return for the business entity	No (a separate business entity does not exist)	Yes (IRS Form 1065)	Yes (IRS Form 1120-S)
Business reports to IRS and each partner/shareholder the amount of income or loss allocated to each partner/shareholder	No (one owner)	Yes	Yes

Source: GAO analysis of IRS documentation. | GAO-24-105281

[a]While there are legitimate reasons for businesses to set up multitiered networks such as isolating one part of a business from liability for the losses of another part, networks can also be used to evade taxes and make misreporting difficult for IRS to trace and identify the responsible entity or individual. For more information about tax evasion by networks, see GAO, *Tax Gap: IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities*, GAO-10-968 (Washington, D.C.: Sept. 24, 2010).

Appendix III: Options to Improve Sole Proprietor Compliance

In 2007, we reported on options for reducing the tax gap for sole proprietors by (1) reviewing our past reports and other related literature, and (2) consulting experts and knowledgeable persons. In this report, we updated the prior list of options by (1) conducting a literature review of studies from 2017 to 2021 to identify relevant new options, (2) removing options that have been implemented or did not meet our criteria for inclusion, and (3) obtaining input from knowledgeable stakeholders and experts through a survey. Additional details on the approach were discussed in appendix I.

These options are not intended to be exhaustive, nor are we ranking their desirability. Rather, we have aligned these options within four general categories for improving sole proprietor tax compliance:

1. Conduct education and outreach,
2. Implement administrative actions,
3. Leverage data, and
4. Improve technology.

Some of the options overlap, covering more than one problem area, while other options only deal with specific aspects of a problem.

The final list of 17 options below represents a collection of potential strategies from recent wide-ranging literature including what we reported in July 2007 (see table 5). We briefly summarize each option, the goal and specific “issue” or problem it could address, and key considerations that either the Internal Revenue Service (IRS), Congress, or both could further develop into a more comprehensive plan. For key considerations, we incorporated feedback from 25 subject matter experts and stakeholders. In a survey, we asked respondents to rate and comment on each option with respect to the following key factors:

- the likelihood of the option to improve tax compliance,
- the feasibility of implementing the option, and
- the potential burden of the option on sole proprietors, third parties, or IRS.

Responses from the survey represent the opinions of the experts and stakeholders that responded to our questionnaire. They are not representative of other experts or stakeholders in this area that we did not survey. However, we incorporated their feedback to more fully present the range of views from knowledgeable individuals and organizations that may be affected by these options, if they are to be implemented.

Table 5: Details on Options to Improve Sole Proprietor Compliance

A. Conduct Education and Outreach	
A1. Education	**Improve education and guidance for sole proprietors**
Issue	Tax law related to sole proprietors is complex. As technology advances to provide new ways to earn money, many taxpayers may not be aware of their related tax obligations.
Goal	Improve voluntary compliance through better education and guidance
Option Summary	The Internal Revenue Service (IRS) could work with sole proprietors and their representatives to more effectively focus their outreach efforts across different communication channels on topics that would have the greatest effect in facilitating voluntary compliance. IRS could provide information about tax obligations and respond to questions on discussion forums, platform apps, and social media pages used by sole proprietors. For example, IRS could communicate guidance on the lowered reporting threshold ($600) for the 1099-K form for tax year 2023.
Key Considerations	IRS research found that a majority of taxpayers agreed that more information and guidance from the agency is likely to help more taxpayers file their taxes correctly.[a] IRS does provide guidance and resources for sole proprietors on multiple web pages, such as those dedicated to self-employed individuals, the sharing economy, and the 1099-K.[b] However, IRS could improve these efforts by more effectively using technology and modern marketing tools that can test and measure the effect of outreach to sole proprietors.[c]
May Require Legislation	No
A2. New Filers	**Identify sole proprietors filing a tax return for the first time and provide them with assistance**
Issue	Sole proprietors filing a tax return for the first time face challenges complying with complex tax law.
Goal	Increase compliance by proactively offering education and assistance to first-time filers
Option Summary	IRS could take steps to assist first-time filers in at least three ways: • identify sole proprietors filing a tax return for the first time and inform them of available services; • automatically send computer-generated notices to sole proprietors filing a return for the first time who did not use a paid tax preparer and who also had returns that were more complex or included items that put the return at higher risk of noncompliance (e.g., accounting method, depreciation, travel, or home office); and • develop videos or other multimedia directed to sole proprietors filing a return for the first time.
Key Considerations	It may be challenging for IRS to identify new Schedule C filers, but more engagement with key stakeholders could help IRS's efforts to provide timely assistance to new sole proprietors. These stakeholders could include the tax practitioner community, platform companies, and the payment processing industry. IRS could also leverage the 1099 information reporting to prompt an educational notice for new 1099 recipients that might be required to file a Schedule C. If IRS sends information resources to first-time filers, it would need to consider the timing and the tone of the letters to avoid raising taxpayer concerns such as fear of being audited, or increasing calls to IRS.
May Require Legislation	No

A3. Worker Classification	**Repeal legal limitations restricting IRS from setting rules for classifying workers**
Issue	IRS is limited by law in its ability to issue guidance on classifying workers (Section 530 of the Budget Act of 1978).[d] The classification of workers as employees or independent contractors—who are subject to different tax requirements—is a challenge for businesses.[e]
Goal	Provide taxpayers clear criteria on worker classification to reduce misclassification and improve compliance
Option Summary	Congress could authorize IRS to issue guidance on criteria to determine whether a worker is an employee or an independent contractor for tax purposes as well as possible safe harbors for employers that misclassified workers as independent contractors.
Key Considerations	IRS currently has information on the classification of workers including several online resources to assist taxpayers in determining whether a worker is an employee or independent contractor.[f] However, the factors that determine the classification of workers are confusing and difficult to interpret consistently. The evolving platform economy has created a new class of workers that makes it difficult to clearly apply these factors. Allowing IRS to issue guidance on specific classification criteria could help reduce confusion in the area. This could improve the accuracy of worker classification, which would facilitate voluntary compliance.
May Require Legislation	Yes
A4. Informational Notices	**Use more informational notices to encourage compliance**
Issue	Informational notices inform and educate taxpayers about a potential problem with a tax reporting obligation and suggest that they either recheck and possibly amend their filed tax returns or change their reporting on future returns.
Goal	Improve compliance by alerting and allowing sole proprietors to correct potential problems before a potential audit
Option Summary	IRS could expand its capacity to send informational notices to Schedule C filers when it sees potential compliance issues to help both the taxpayer and IRS avoid potential audits.
Key Considerations	Notices can reduce taxpayer burden and improve compliance moving forward. With instructions to the taxpayer about the specific issue identified, taxpayers may be less likely to reach out to IRS with questions. IRS would need to dedicate resources to send notices and respond to questions or process amended returns. Taxpayers may seek help from their tax return preparers or third parties that issued information returns to interpret the notices and determine next steps.
May Require Legislation	No
B. Implement Administrative Actions	
B1. Separate Accounts	**Require sole proprietors to use a business account for all business transactions**
Issue	Sole proprietors are not required to maintain separate business and personal records and bank accounts.
Goal	Help sole proprietors improve compliance by distinguishing their business transactions from personal ones
Option Summary	Congress could require, to the extent it is within its constitutional authority, or authorize IRS to require sole proprietors to use a business account to conduct all business—and not personal—transactions. To ease reporting requirements, financial institutions could provide sole proprietors with an annual summary of inflows and outflows from the business account(s). Some taxpayers could be exempted from this requirement based on gross receipts or other criteria.

Key Considerations	This option could help improve recordkeeping for some taxpayers by preventing comingling of personal and business funds, which could result in more accurate returns. It may also make it easier for IRS to track and distinguish business transactions from personal ones during an audit. However, it could be costly for some taxpayers in terms of time spent in keeping separate records and fees paid to banks, and the costs may outweigh the benefits for some. In particular, Schedule C filers who are engaged in "micro" businesses may find the need to use a separate account for business transactions burdensome and costly.
May Require Legislation	Yes
B2. Form 1099-K	**Distinguish between gross and net income on Form 1099-K**
Issue	Some sole proprietors in the platform economy do not know that the gross amount reported on the 1099-K Form could include fees and commissions retained by the platform and may not be all taxable income. As a result, some taxpayers may inadvertently over-report their taxable income.
Goal	Clarify the information reported on Form 1099-K to increase accuracy of reporting income and expenses
Option Summary	IRS could redesign Form 1099-K to distinguish between gross and net payment amounts. The instructions could explain how to accurately report income on the Schedule C when a platform company's fees or commissions are captured in the gross payment line.
Key Considerations	Platform companies may know how much in certain fees, commissions, or other costs are deducted from payments made to workers, and they could report both gross and net payment to IRS and the worker on the Form 1099-K. IRS could work collaboratively with stakeholder companies to develop and issue guidance on the definition of net payment and continue to provide that guidance as methods of payments evolve.[g] However, the net payment may not all be taxable income. The taxpayers will be responsible for determining their net income. For example, platform companies do not know all of the taxpayer's potential expenses such as mileage or cost of goods. This option could simplify matters for both taxpayers and IRS and lead to more accurate reporting of income and expenses.
May Require Legislation	No
B3. Cash Transactions	**Include direct questions about income from cash or cash equivalents on the Schedule C**
Issue	Payments made to sole proprietors in cash or cash equivalents (e.g., checks made out to cash; peer-to-peer payment apps such as Venmo, PayPal, and Cash App; or cryptocurrency payments) can be taxable but may not always be reported as business-related income. Additionally, sole proprietors may not know the consequences of failing to report these payments.
Goal	Increase compliance by clarifying cash reporting requirements on Schedule C
Option Summary	IRS could include more direct questions on the Schedule C that specifically ask for (1) the total amount of business-related cash or cash equivalents received, and (2) the amounts that were deposited in financial institutions, retained in peer-to-peer payment apps, or converted to cryptocurrency. IRS could also explain the consequences of failing to report all income, including cash and cash equivalents, on the Schedule C instructions.
Key Considerations	Research has shown that directly asking about specific types of cash income may improve compliance by reminding taxpayers to report all income. Answering these questions would require taxpayers to keep accurate records of cash and cash equivalent payments, which may be challenging for those who do not already track payments by these types of income.
May Require Legislation	No
B4. Voluntary Withholding	**Withhold tax to encourage compliance**
Issue	Sole proprietor income is not subject to tax withholding, a proven tax compliance technique for many individual taxpayers.

Goal	Reduce the tax gap by implementing proven tax compliance technique on a voluntary basis
Option Summary	IRS could work with the Department of the Treasury to implement withholding that is voluntary for companies making payments for services to eligible sole proprietors who choose to participate. Congress could authorize IRS to expand withholding, as appropriate.
Key Considerations	IRS research supports that withholding facilitates voluntary tax compliance. Benefits of this option include reducing the burden on sole proprietors in estimating, saving, and remitting quarterly payments for income, Social Security, and Medicare taxes. Further, allowing this option to be voluntary for both the taxpayer and employer reduces burden. Some sole proprietors may not choose to have taxes withheld if doing so is more burdensome. For example, they may have inconsistent income throughout the year or operate on thin profit margins—which makes estimating accurate withholding difficult—or have limited working capital from which to support business growth and pay expenses.
May Require Legislation	Yes
B5. Standard Deduction	**Offer a standard business deduction**
Issue	Sole proprietors are currently required to itemize their qualified deductions. This requires them to maintain receipts and records of all business expenses over the course of the taxable year.
Goal	Improve compliance by simplifying tax reporting for sole proprietors
Option Summary	Congress could allow businesses, including sole proprietors, to receive a standard business deduction within their respective business classifications. It could be available as an alternative or replacement to the current system. Also, the allowable amount for the deduction could be set as a fixed amount or a fixed percentage of the taxpayer's gross business receipts.
Key Considerations	Offering a standard business deduction could simplify tax reporting for taxpayers. It would especially benefit newer sole proprietors who may have limited knowledge about business expense deductions and ease administrative burden for those who lack good recordkeeping. However, further research would be necessary to develop and design a standard business deduction that is equitable and considers inherent differences among businesses. Also, depending on the design, it could simplify tax filing for many and also may change the tax liability for some taxpayers.
May Require Legislation	Yes
C. Leverage Data	
C1. High-income Earners	**Require information reporting on financial accounts of high-income sole proprietors**
Issue	Taxpayers are more likely to report the correct amount of income if they know that IRS can verify that income through third-party information reporting. However, sole proprietor income is subject to limited information reporting requirements.
Goal	Increase compliance through information reporting of business transactions
Option Summary	IRS could require financial service providers to submit a new information return for sole proprietors whose income is (1) above a certain threshold, and (2) from sources that have little to no information reporting requirements. IRS and eligible sole proprietors would receive an annual summary of deposits and withdrawals from accounts covered by this proposed reporting requirement.
Key Considerations	This option could increase transparency and significantly increase compliance. IRS would need to invest resources up front to create new forms and processes for how third parties would file the information and how IRS would use it. The option may be more effective if implemented in conjunction with a requirement to separate business and personal bank accounts (option B1). However, increased reporting of banking transactions could lead some taxpayers to move financial transactions to other intermediaries to remain undetected.
May Require Legislation	Yes

C2. Gross Receipts	Expand gross receipts reporting on the Schedule C
Issue	Misreporting on Schedule Cs is higher than for other types of income and expenses because IRS has limited information reporting and fewer means to confirm the accuracy of the reported data.
Goal	Increase compliance by expanding reporting requirements on Schedule C
Option Summary	IRS could expand reporting requirements to include: (1) a breakdown of gross receipts by various income categories, and (2) the number of information returns they received and details on large payments, which would need to be defined.
Key Considerations	IRS would need to change the Schedule C to separate income into multiple categories or report the number of information returns and associated income the sole proprietor received. Revising the Schedule C to include this information could help sole proprietors identify sources of income. It could also facilitate information return matching, which could result in more accurate examination selection and increase compliance.
May Require Legislation	Yes, depending on the nature of the new requirements
C3. Third-Party Data	**Collect additional information from third parties tracking platform workers' transactions**
Issue	Platform companies (e.g., digital platform, marketplace, or businesses in the gig economy) often have information on sole proprietors' earnings and expenses that could assist sole proprietors in the completion of their tax returns. However, these companies do not report this information to IRS.
Goal	Improve information reporting by leveraging third-party transaction data
Option Summary	Some platform workers voluntarily use transaction-tracking apps. These apps may have features such as expense tracking and receipt imaging, which could help facilitate compliance. Some apps help track deductions that a company may not report, such as miles a worker may drive in between pickup locations that are unaccounted for on a ride-sharing platform. IRS could request that companies providing these tracking services simultaneously report this same information to the agency. IRS would have to work with such companies to enable information sharing, establish guidelines to protect taxpayer data, and ensure compatibility with its information systems.
Key Considerations	This option could improve compliance by making income and expense information available to sole proprietors and IRS. It would be especially useful for sole proprietors who use multiple platforms as it could simplify their recordkeeping. However, it may also raise privacy concerns and could reduce use of the tracking apps, which could then undercut potential compliance gains. Ensuring system compatibility and protecting taxpayer data would also be costly for the IRS to administer.
May Require Legislation	Yes, depending on the nature of the new requirements
C4. Expense Reporting	**Expand expense reporting on the Schedule C**
Issue	Taxpayers who misreport information contribute to noncompliance. Misreporting on Schedule C is higher than for other types of income and expenses because IRS has limited information reporting and fewer means to confirm the accuracy of the reported data.
Goal	Improve compliance by requiring expanded expense reporting
Option Summary	IRS could require sole proprietors to break out the amount of payments made for services on the relevant expense lines of the Schedule C or require additional information, such as for payments above a specified threshold.

Key Considerations	This option could be combined with a requirement that platform businesses share relevant information with IRS and taxpayers about expenses (option C3). Requiring greater clarity on expenses could encourage sole proprietors to accurately claim expense deductions on the Schedule C. However, it may be challenging for some sole proprietors to track their expenses in this way. If properly designed and implemented, this option could reduce burden on IRS by improving the selection of returns for audit and the quality of audits.
May Require Legislation	Yes, depending on the nature of the new requirements
C5. State Data	**Enhance access to state data**
Issue	IRS does not have access to some state data that could help it identify taxpayers who have not filed a return or have not reported all income.
Goal	Use additional data to identify unfiled returns or underreported income
Option Summary	IRS could seek to improve arrangements with the states to access data on business licensing, ownership of real estate or other large assets, sales receipts, and state tax compliance.
Key Considerations	IRS has agreements with some states to obtain tax return and audit information and to share information about tax fraud schemes. However, IRS does not have access to key state-level data points to confirm a sole proprietor's business assets, such as business licensing and real estate ownership. Such information could help identify noncompliance. Also, it could motivate taxpayers to become more compliant if they know this information is shared with IRS. Sharing data could pose burdens to both IRS and states if the data are not in a compatible format.
May Require Legislation	Yes, depending on the nature of the new requirements
D. Improve Technology	
D1. Deduction Matching	**Identify overstated deductions for expenses**
Issue	IRS does not fully identify noncompliant sole proprietors who overstate business deductions, in part because business expense payments made by sole proprietors are not matched with available third-party information returns. For example, IRS does not use its computer systems to compare sole proprietors' expenses that they claim on Schedule C against information returns that they file, such as for employee wages or payments to contractors.
Goal	Improve compliance by expanding IRS's information matching capabilities
Option Summary	IRS could take steps to identify overstated deductions in at least two ways: • IRS could match the existing information returns filed by sole proprietors to report their payments made for expenses to the related lines of the Schedule C to ensure the expenses claimed are consistent with the amounts reported on information returns. • IRS could verify additional business expenses in those cases where sole proprietors claim the additional expenses after IRS informs them that it has discovered unreported business income. This verification could be done through some form of review or audit of documentation.
Key Considerations	This option could increase sole proprietor compliance by expanding IRS's current matching program. IRS would incur initial costs to update and develop computer systems that could implement an expanded matching system. This would include coordination with tax preparation software companies and tax professionals to ensure that data are entered consistently to perform such matching. This option complements other options that call for increased reporting from taxpayers and third parties. An efficient matching system could improve detection of noncompliance and encourage taxpayers to make accurate deductions.
May Require Legislation	No

D2. Return Review Program	Use the Return Review Program to detect underreported income early
Issue	Before issuing a refund, IRS's Return Review Program (RRP) checks returns for potential fraud using various means, such as third-party information returns.[h] However, IRS does not fully use all the data it receives.
Goal	Use existing technology to improve compliance before a potential audit
Option Summary	With increased electronic filing of information returns, along with some earlier due dates, IRS has more information returns available to match against a tax return at the time it is filed. With these data, IRS could expand RRP's capabilities to detect underreported income on individual returns.
Key Considerations	RRP can be used in conjunction with the option above (option D1) to identify underreported income and notify taxpayers about potential discrepancies on their tax returns. This could help improve customer service by using technology to help taxpayers. Further, while some taxpayers may owe additional tax after amending, some taxpayers could receive refunds if they qualify for certain tax credits. Currently, IRS is unable to fully use information returns data because not all forms are available early. Legislation may be required to change the deadlines for when information returns are due to IRS.
May Require Legislation	Yes, depending on the nature of the new requirements
D3. Service	**Use technology to improve customer service**
Issue	Improving taxpayer service can improve taxpayer compliance.
Goal	Close the tax gap by improving service
Option Summary	IRS could improve the taxpayer service experience by leveraging the use of technology. Three examples include: • provide taxpayers direct online access to their own data, including all tax returns, taxpayer correspondence, IRS actions, and taxpayer interactions with IRS; • provide flexible options to interact with IRS, such as secure messaging and video conferencing; and • improve IRS communications with taxpayers by better utilizing taxpayer data, using methods such as deploying more machine learning to analyze tax returns and 2D barcoding on paper returns and Schedule K-1 forms.[i]
Key Considerations	Improving taxpayer service can help improve compliance. Taxpayers are more likely to comply if they can more easily receive the assistance they need, including access to their records and timely processing of their tax returns.
May Require Legislation	No

Source: GAO analysis of literature and survey data. | GAO-24-105281

Notes: The questionnaire that experts and stakeholders responded to included the Issue and Option Summary included in this table. Minor edits were made for readability and clarity. For Key Considerations, we incorporated respondents' comments on the pros and cons of each option along with literature and other sources.

[a]Internal Revenue Service, *Comprehensive Taxpayer Attitude Survey (CTAS) 2021 Executive Report, Publication 5296* (Rev. 4-2022) (Washington, D.C.: April 2022).

[b]Internal Revenue Service, Self-employed Individuals Tax Center, accessed July 19, 2023, https://www.irs.gov/businesses/small-businesses-self-employed/self-employed-individuals-tax-center; Gig Economy Tax Center, accessed July 19, 2023, https://www.irs.gov/businesses/gig-economy-tax-center; and Understanding Your Form 1099-K, accessed July 19, 2023, https://www.irs.gov/businesses/understanding-your-form-1099-k.

[c]We recently made a similar recommendation that IRS should collect sufficient, relevant, and comparable data on the usefulness and accessibility of its communications and outreach efforts for refundable tax credits, and use these data to develop performance metrics to assess the effectiveness of ongoing efforts. See *GAO, COVID-19: Current and Future Federal Preparedness*

Requires Fixes to Improve Health Data and Address Improper Payments, GAO-22-105397 (Washington, D.C.: Apr. 27, 2022).

[d]Revenue Act of 1978, Pub L. No. 95-600, § 530(b), 92 Stat. 2763, 2886 (1978).

[e]For example, if a worker is classified as an employee, then the employer is required to withhold and deposit income tax from wages paid to the employee and prepare a Form W-2, Wage and Tax Statement, reflecting the amounts paid and withheld. 26 U.S.C. § 3401; 26 C.F.R. § 1.6041-2(a)(1).

[f]Internal Revenue Service, Worker Classification 101: Employee or Independent Contractor, accessed July 19, 2023, https://www.irs.gov/newsroom/worker-classification-101-employee-or-independent-contractor.

[g]In October 2022, IRS updated its online frequently asked questions on Form 1099-K to include questions that clarify that the law requires payment settlement entities to report gross unadjusted total amounts and merchant acquiring entities to report the gross amount of transactions instead of net amounts. 26 U.S.C. § 6050W(a)(2). See Internal Revenue Service, Form 1099-K Frequently Asked Questions: Reporting, accessed August 10, 2023, https://www.irs.gov/newsroom/form-1099-k-frequently-asked-questions-reporting.

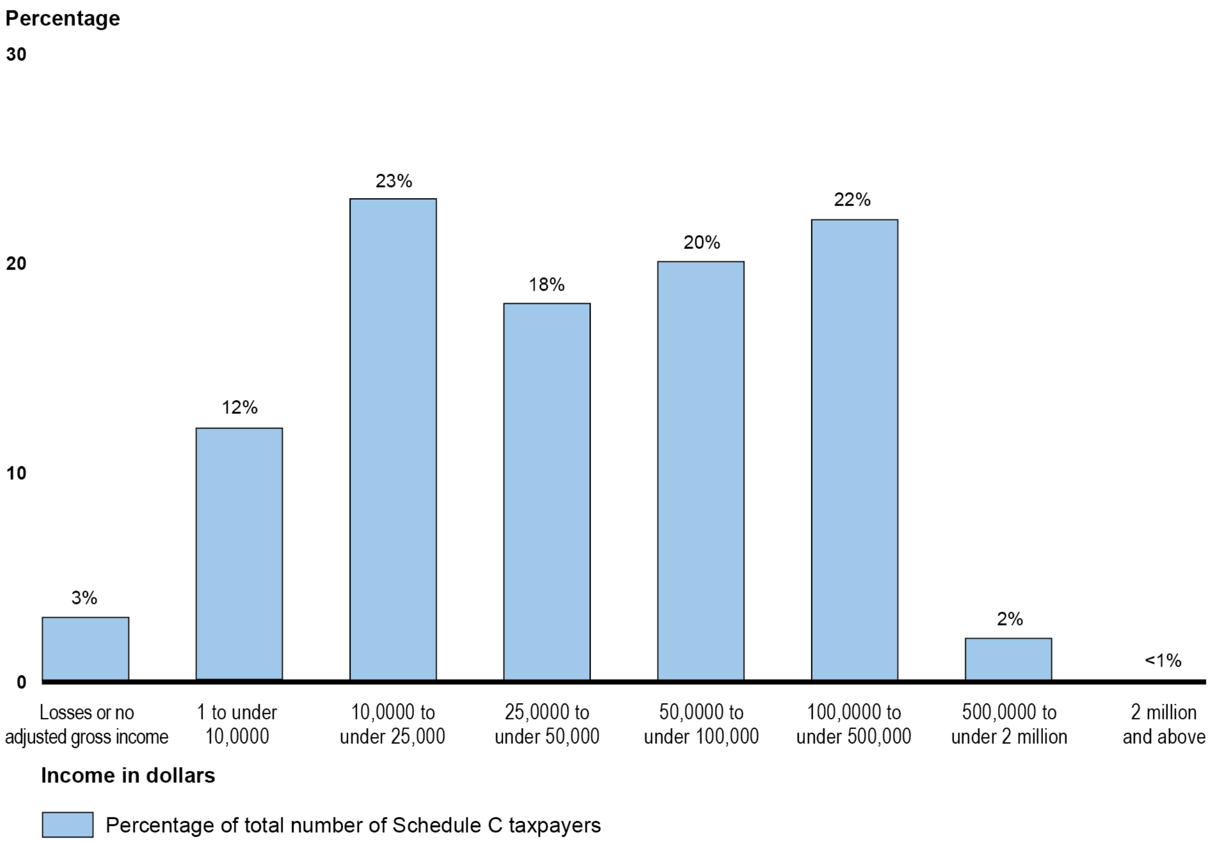
[h]Information returns are forms filed by third parties, such as employers, businesses, and financial institutions, to provide information about payment transactions to IRS and taxpayers.

[i]IRS partnered with the tax software companies on a two-dimensional bar code project in 2003. Certain tax software packages were modified to generate 2-D bar codes on Schedules K-1 (Form 1065 to report a partner’s share of income, deductions, and credits) to improve efficiency and increase data accuracy. Rather than manually transcribe information from the Schedule K-1, IRS scans the bar code and electronically uploads the information from the K-1.

Appendix IV: Sole Proprietors Vary Widely in Income Levels and Business Activities

Sole proprietors vary in their income levels. For purposes of this report, we consider individuals who filed or should have filed a Schedule C a sole proprietor. Sole proprietors' income or losses are reported on Schedule C (Form 1040), Profit or Loss from Business (Sole Proprietorship). We estimate that in tax year 2019, 38 percent (or about 10.6 million) of Schedule C filers reported making less than $25,000 or had no reported adjusted gross income (AGI).[1] Additionally, we estimate about 24 percent (or about 6.7 million) of Schedule C filers reported making more than $100,000 in 2019 (see fig. 13).[2]

Figure 13: Distribution of Schedule C Filers and Their Total Adjusted Gross Income, Tax Year 2019



Source: GAO analysis of Internal Revenue Service (IRS) data. | GAO-24-105281

[1]The relative margin of error is less than 1 percent with 95 percent confidence.

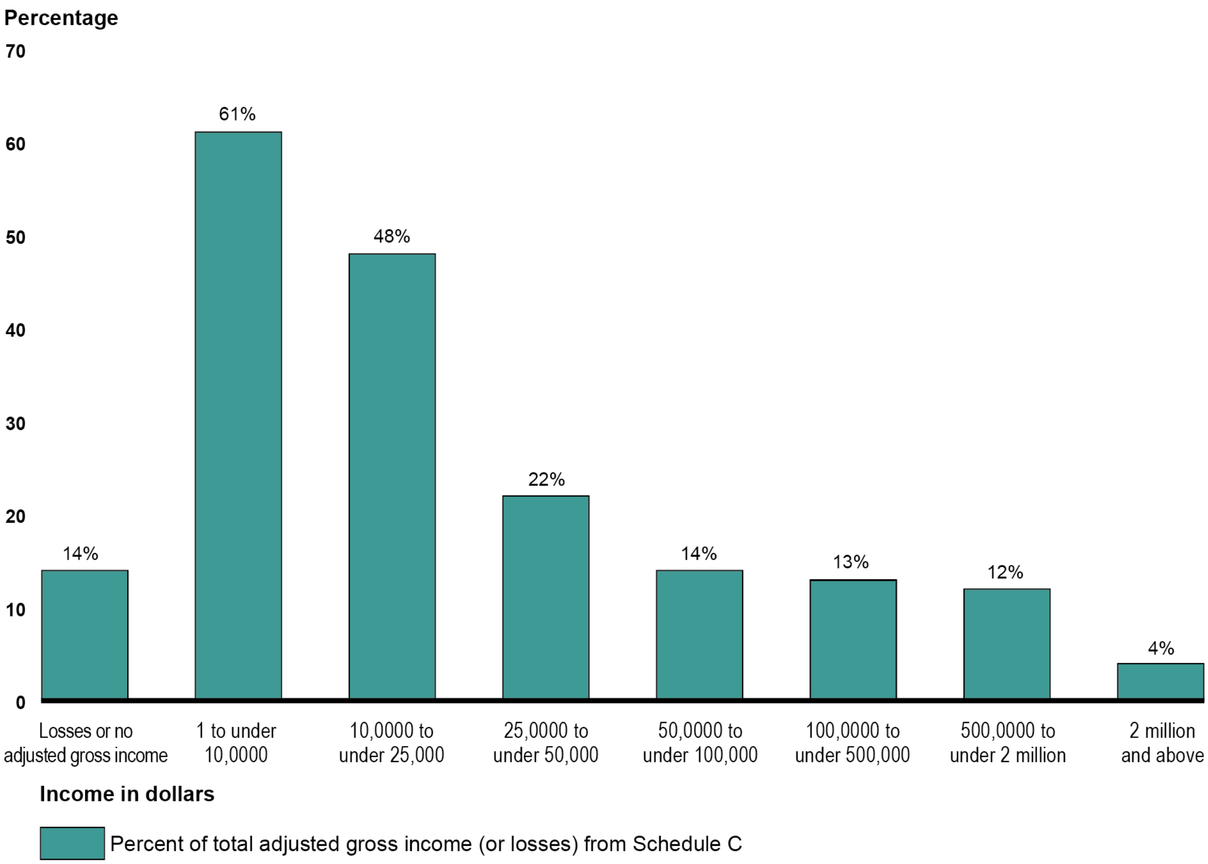
[2]The relative margin of error is less than 2 percent with 95 percent confidence.

Note: The 95 percent confidence intervals for estimates in this graph are within +/- 1 percentage points of the estimates themselves.

In tax year 2019, Schedule C filers who reported making between $1 and $25,000 reporting earning a larger share of their income from their sole proprietorship than those who reported earning more than $25,000 (see fig. 14). Specifically, we estimate that for Schedule C filers who reported earning between $1 to under $25,000, between 47 percent to 52 percent of their total AGI less deficit was from Schedule C businesses.[3] In contrast, we estimate that for Schedule C filers who reported earning more than $25,000, between 12 to 13 percent of their total AGI less deficit was from Schedule C businesses.

[3]AGI is defined as gross income minus adjustments to income. Gross income includes wages, dividends, capital gains, business income, and retirement distributions, as well as other income. Adjustments to Income include such items as educator expenses, student loan interest, alimony payments, or contributions to a retirement account. AGI will never be more than gross total income on a tax return and in some cases may be lower. For this analysis, we excluded returns when losses resulted in no AGI.

Figure 14: Percent of Schedule C Income Out of Adjusted Gross Income (or Losses), Tax Year 2019



Source: GAO analysis of Internal Revenue Service (IRS) data. | GAO-24-105281

Notes: The 95 percent confidence intervals for income from 1 to under 10,000 in this graph are within +/- 6 percentage points of the estimates themselves. The 95 percent confidence intervals for income from 10,000 to under 25,000 in this graph are within +/- 3 percentage points of the estimates themselves. The 95 percent confidence intervals for the other estimates in this graph are within +/- 2 percentage points of the estimates themselves.

As we reported in May 2020, IRS has limited data on the number of platform economy workers which means the data on sole proprietors are also limited.[4] We recommended that IRS change Schedule C or Form 1099-NEC so that taxpayers can indicate to IRS if they received payment for platform work. IRS disagreed with the recommendation, stating that it has no evidence that platform workers pose a greater compliance risk. As of July 2023, IRS has not implemented this recommendation. However,

[4]GAO-20-366.

we continue to believe that such data could be used to identify relevant taxpayers and inform IRS's taxpayer outreach and education efforts. For example, if IRS had more data on the types of deductions that certain types of workers were reporting, IRS would be better able to craft guidance on such deductions or reach out to help those types of workers comply.

Appendix V: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

DEPUTY COMMISSIONER

September 21, 2023

James R. McTigue, Jr.
Director, Tax Policy and Administration, Strategic Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review your draft report entitled, *Sole Proprietor Compliance: Treasury and IRS Have Opportunities to Reduce the Tax Gap* (GAO-24-105281).

The mission of the IRS Small Business/Self-Employed (SB/SE) operating division is to help small business and self-employed taxpayers understand and meet their tax obligations, while applying the tax law with integrity and fairness to all. Small businesses and self-employed taxpayers include, but are not limited to, sole proprietors.

We disagree with the view that the compliance challenges associated with sole proprietors are separate and distinct from those facing other small business taxpayers. As GAO's report acknowledges, the term "sole proprietor" encompasses all types of taxpayers: retail sellers and professional service providers; taxpayers who have physical locations and others who work through virtual platforms; taxpayers with employees and those without. In other words, there is no consistent set of attributes that apply to all sole proprietors and that would make it useful to address these taxpayers separately from other small business taxpayers. At the same time, these more specific attributes or activities apply equally to non-sole proprietor small businesses. Therefore, it is not only appropriate but most effective and efficient to address sole proprietor compliance risks and educational needs in the context of specific strategies focused on all similar small businesses.

GAO did not consider all that the IRS has accomplished to address and improve sole proprietor compliance through our multiple enforcement and educational strategies aimed at small businesses, which we describe in detail below.

Tailoring Enforcement to Returns Posing the Greatest Risk for Noncompliance
With the National Research Program (NRP), Discriminant Function System (DIF) and other risk modeling, we have the most well-developed and rigorous compliance risk assessment for sole proprietors relative to any other business entity type. The NRP data that is the foundation of the tax gap estimates provides extensive information on

2

the nature and extent of sole proprietor noncompliance. The DIF is a risk-based model that scores returns based on noncompliance risk and the likelihood that further review would result in an additional tax. DIF modeling is conducted by activity codes. Of the thirteen individual income tax return activity codes typically worked by SB/SE examiners in Field Examination, seven focus specifically on sole proprietors (Schedule C or F filers). SB/SE audit plans are developed around these DIF activity codes, making sole proprietor cases a major component. As GAO's report shows, SB/SE audits a greater percentage of sole proprietor taxpayers than other business types. We also apply significant efforts and resources aimed at increasing sole proprietors' compliance with employment tax filing, payment, and reporting compliance.

The IRS Inflation Reduction Act (IRA) Strategic Operating Plan, released in April 2023, discusses several initiatives for expanding enforcement in key areas and addressing the tax gap, with a particular focus on high income and high wealth taxpayers. GAO's report notes that in 2019, 490,000 (or two percent) of sole proprietors earned more than $500,000, and suggests the IRA presents an opportunity to increase compliance among high-earning sole proprietors. We agree. We believe our new IRA resources will be used most effectively to reduce the tax gap when focused on high-income individuals, including those who may be sole proprietors; large corporations; and complex partnerships that are not paying the taxes they legally owe. In addition, the Strategic Operating Plan contains multiple initiatives that will assist all taxpayers, including sole proprietors, to meet their payment obligations by providing improved access to account information, payment reminders, easy payment options, and assistance with past-due obligations.

Educational and Outreach Efforts to Benefit Sole Proprietors
SB/SE partners with the IRS Communications and Liaison (C&L) function to create and plan outreach aimed at informing sole proprietors of the information and resources they need to understand their tax obligations. Our ongoing communications and engagement with small businesses, including sole proprietors, is integral to the IRS' larger focus in the Strategic Operating Plan on improving our taxpayer service and communications to help taxpayers meet their tax obligations and receive the tax incentives they deserve.

We offer significant resources for sole proprietors and gig workers on IRS.gov, including detailed instructions for filing Schedule C, the Gig Economy Tax Center, Tax Tip 2023-05, *Tax tips for gig economy entrepreneurs and workers*, and Tax Tip 2023-85, *Info to help gig economy workers stay on top of their tax responsibilities* – to name just a few.

The IRS incorporates messaging for the many types of sole proprietors in its communications and outreach plans, engaging with regional and local small business organizations across the country on a nearly daily basis. The IRS hosted or attended more than 1,300 stakeholder partner events since July 2020. The agency also hosts a quarterly Small Business Forum with national small business organizations providing them important updates and information for their millions of members. In addition, C&L's outreach team engages with small business audiences in nontax-related sole proprietor

3

events at IRS seminars at Small Business Expos across the country, presenting plain-language tax information to these sole proprietor audiences. This outreach is expected to continue and grow through Fiscal Year 2024.

We also have a specific communications and outreach plan to support sole proprietors and other audiences in understanding the change in the Form 1099-K reporting threshold, a living document that is updated as stakeholder feedback and SB/SE input is received. Since March 2023, C&L has issued about 60 communication products targeting sole proprietors for external audiences through media channels, social media, employee communications and newsletter distributions that reach millions of subscribers. This built on the more than 50 communication products from the previous Form 1099-K communication plans. Additionally, C&L hosted 19 Form 1099-K roundtables and about 180 other outreach engagements to help educate the wide variety of sole proprietors and others who may receive a Form 1099-K.

With all of our work, the IRS strives to serve taxpayers and uphold the nation's tax laws. We face tough choices each year regarding where to deploy resources given the breadth of our responsibilities and our choices are guided by fairness, impartiality, and effective stewardship of public funds. We appreciate GAO's suggestions to strengthen our outreach and engagement with small businesses, including sole proprietors, and will look for opportunities to develop more robust outreach plans and deepen relationships and feedback loops with this taxpayer community.

Responses to your specific recommendations are enclosed. If you have any questions, please contact me or Rich Tierney, Director, Examination, Small Business/Self-Employed Division.

Sincerely,

Douglas W. Odonnell Digitally signed by Douglas W. Odonnell Date: 2023.09.21 09:49:32 -04'00'

Douglas W. O'Donnell
Deputy Commissioner for Services and Enforcement

Enclosure

Enclosure

GAO Recommendations and IRS Responses to GAO Draft Report
SOLE PROPRIETOR COMPLIANCE: Treasury and IRS Have Opportunities to Reduce the Tax Gap Compliance (GAO-24-105281)

Recommendation 1:
The Commissioner of Internal Revenue should ensure that the Small Business/Self-Employed (SB/SE) Division assesses the risks of sole proprietor noncompliance, including defining objectives and the risk tolerance SB/SE is willing to accept, as part of its broader efforts to enforce compliance among small businesses.

Comment:
SB/SE assesses noncompliance risk at every step – when identifying the returns likeliest to result in adjustments to liability, selecting the most promising cases for further review, and resolving cases. We use the National Research Program (NRP) to identify, quantify, and regulate risk tolerance through our workplan according to our available resources. SB/SE audits sole proprietors, by percentage of our workplan, more than other business types. Our compliance efforts are not limited to audits; we address sole proprietor compliance in most of our workstreams, including our information return matching programs. These efforts, together with our education and outreach to encourage voluntary compliance, demonstrate our holistic approach to addressing noncompliance by all small businesses, including sole proprietors. We disagree that further risk assessment that is specific to sole proprietors, whose circumstances and attributes are as varied as among small businesses generally, is needed.

Recommendation 2:
The Commissioner of Internal Revenue should analyze existing data and forthcoming 1099-K data to better understand and gain insights into sole proprietor noncompliance and taxpayer burden that may be unique to sole proprietors and use that information to make decisions on enforcement and outreach priorities for sole proprietors.

Comment:
We agree. Consistent with the Strategic Operating Plan, the IRS is focused on using resources from the Inflation Reduction Act to dramatically improve compliance by deploying enhanced data and analytics to select compliance cases based on highest risk of noncompliance, and to choose enforcement actions predicted to be most effective. In addition, the Plan encompasses continuing communications and engagement work with small businesses, including sole proprietors, as part of the IRS's larger focus on helping taxpayers meet their obligations and receive the tax incentives for which they are eligible. SB/SE already uses Form 1099-K data to inform our enforcement efforts, and we will continue to use past results to modify future compliance efforts. Additionally, we analyzed tax year 2020 and 2021 Form 1099-K

2

filings by state and zip code to identify areas for localized educational and outreach efforts and will do the same for tax year 2022 1099-K filings when they are available for analysis.

Recommendation 3:
The Commissioner of Internal Revenue should develop and implement a communications plan focused on outreach and education to improve sole proprietor compliance, particularly when tax laws or IRS guidance change. This should include mechanisms to ensure IRS communicates relevant information to sole proprietors in a timely manner and engages stakeholders, as appropriate.

Comment:
We disagree. IRS C&L already incorporates sole proprietor audiences as a focus in its robust compliance communications and outreach plans and conducts programs and events of interest to sole proprietors across the country on almost a daily basis. We will continue to identify additional opportunities to expand and deepen our communication with and outreach to this taxpayer segment to help them understand their tax obligations through the 2024 filing season.

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact

James R. McTigue, Jr., 202-512-6806 or McTigueJ@gao.gov

Staff Acknowledgments

In addition to the contact named above, the following individuals made contributions to this report: Erin Saunders Rath (Assistant Director), Melissa King (Analyst in Charge), Marybeth Acac, Jacqueline Chapin, Caitlin Cusati, Ann Czapiewski, Yasmine Evans, Taylor Gauthier, Krista Loose, Edward Nannenhorn, Afsana Oreen, Robert Robinson, Andrew J. Stephens, and Frances Tirado.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through our website. Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. You can also subscribe to GAO's email updates to receive notification of newly posted products.

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's website, https://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

Connect with GAO

Connect with GAO on Facebook, Flickr, Twitter, and YouTube.
Subscribe to our RSS Feeds or Email Updates. Listen to our Podcasts.
Visit GAO on the web at https://www.gao.gov.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact FraudNet:

Website: https://www.gao.gov/about/what-gao-does/fraudnet

Automated answering system: (800) 424-5454 or (202) 512-7700

Congressional Relations

A. Nicole Clowers, Managing Director, ClowersA@gao.gov, (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

Strategic Planning and External Liaison

Stephen J. Sanford, Managing Director, spel@gao.gov, (202) 512-4707
U.S. Government Accountability Office, 441 G Street NW, Room 7814,
Washington, DC 20548