United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

August 1996

TAX ADMINISTRATION

Tax Compliance of Nonwage Earners

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August 28, 1996

The Honorable Nancy L. Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Chairman Johnson:

This report responds in part to the Subcommittee's request that we review the tax administration issues related to tax payments and tax delinquencies of individuals whose primary income is derived from nonwage sources such as pensions, self-employment, interest, dividends, partnerships, and capital gains. This report presents information on the growth of nonwage income, the primary sources of such income, and the impact of nonwage income tax delinquencies on the Internal Revenue Service's (IRS) accounts receivable. We also provide information on several options that we and others identified as having potential for improving the timely payment of taxes on nonwage income. We make no specific recommendations in this report.

A major difference between nonwage income and wage income is how taxes are paid. Although taxes are withheld from wage income, taxpayers with nonwage income are generally required to calculate their projected taxable income and make periodic payments during the tax year.

Results in Brief

Nonwage income has grown significantly since 1970 when it accounted for just 16.7 percent of total income[1] for individuals. For tax year 1992, the most recent available information at the time we did our work, nonwage income accounted for 23.4 percent, or $859 billion, of the $3,665 billion of total income for individuals. The six largest sources of nonwage income—pensions, interest, self-employment, capital gains, dividends, and partnerships/ Subchapter S corporations—accounted for about $787 billion, or 91.6 percent, of all nonwage income reported by taxpayers for tax year 1992. Pension income, at about $186 billion, was by far the largest and fastest growing source of nonwage income.

IRS data show that taxpayers earning most of their income from nonwage sources are more likely to have problems paying their taxes than wage earners and, as a result, owe more delinquent taxes than do wage earners.

[1]For purposes of this report, total income means total gross income for tax purposes. It excludes income not subject to federal tax, such as tax-exempt interest.

IRS' inventory of tax debt[2] for individual taxpayers at the end of fiscal year 1993 totaled $79.2 billion, of which about $58.5 billion, or 74 percent, was owed by taxpayers with primarily nonwage income.

Available IRS information showed that self-employment income was the largest portion of nonwage income included in IRS' inventory of tax debts at the end of fiscal year 1993. Although we were unable to analyze the extent and causes of tax delinquencies by sources of nonwage income, we identified possible options that appear to have potential for improving the timely payment of taxes on nonwage income, some of which we have suggested in the past and others that have support from analysts within IRS or outside tax experts. These options include withholding income taxes on more sources of nonwage income, making taxpayers better aware of their tax payment responsibilities, and modifying the estimated tax payment system.

Background

The Internal Revenue Code requires individuals to pay their income taxes either through withholding by third parties or making estimated tax payments. Both withholding and estimated tax payments are designed to collect income taxes on a "pay-as-you-go" basis during the tax year. IRS collects over 70 percent of individuals' income tax payments through withholding. Taxpayers generally remit the remaining payments directly to IRS as estimated tax payments or final payments with returns.

Wage withholding is mandatory and automatic for wage-earning taxpayers. Under wage withholding, employees pay taxes through regular withholding from their paychecks. Employers are responsible for remitting withholdings to IRS at least monthly (every few days for larger employers). Large employers are required to remit withholdings by electronic fund transfer. Wage withholding is designed to cover employee income, Social Security, and Medicare taxes. The employer determines how much tax to withhold on the basis of employee's wages and employee-supplied data about filing status and withholding allowances. Employees can adjust withholdings to fit their tax situations and can even claim exemption from income tax withholding if they had no income tax liability for the prior year. Furthermore, pension recipients usually have income taxes withheld from their distributions; however, they have the option of not having taxes

[2]The inventory of tax debt includes all outstanding debts owed by taxpayers that are in IRS' detailed accounting records, which is composed of both compliance assessments and financial receivables. According to IRS, its management information system is not designed to specifically identify and separately track those owing taxes reportable as accounts receivable.

withheld. Withholding generally is not available for nonwage income apart from pensions.

Taxpayers without withholdings who expect to owe taxes must make estimated tax payments to pay their income tax liabilities. Furthermore, self-employed people, like independent contractors, must make estimated tax payments to cover their expected self-employment tax, which supports the Social Security and Medicare trust funds. The individual taxpayer is required to make four estimated tax payments each year. Payments generally are due on April 15, June 15, September 15, and January 15. Taxpayers are required to calculate the amount due for each period, on the basis of their estimate of the year's total tax liabilities. Generally, the taxpayer mails the estimated tax payment to an IRS lockbox address, along with a payment voucher, Form 1040-ES.

Taxpayers who make inadequate tax payments during the year are subject to estimated tax penalties. This penalty is equivalent to an interest charge from the due date of the estimated payment to the due date of the annual tax return or the payment date, whichever comes first. Generally, no estimated penalty will be due if the amount due at filing is less than $500, or the amount paid is 90 percent of the total current year tax liability or 100 percent of the taxpayer's prior year tax liability. However, exceptions apply to farmers, fishermen, and high income taxpayers.

Objectives, Scope, and Methodology

The objectives of this assignment were to determine (1) the growth and primary sources of nonwage income, (2) the impact of nonwage income tax delinquencies on IRS' accounts receivable, and (3) options for enhancing the timely payment of taxes on nonwage income.

To determine the growth and primary sources of nonwage income, we analyzed IRS' Statistics of Income (SOI) data for tax year 1992—the most recent information available at the time we did our analyses—and compared the results with similar data for tax years 1970 through 1990. For the second objective—determining the impact of nonwage income tax delinquencies on IRS' accounts receivable—we were limited to using IRS' summary information on its inventory of tax debts because the more detailed information was not readily available. This inventory is a 10-year accumulation of tax delinquencies and includes valid and invalid receivables and duplicate assessments. In addition, this information did not provide the same detailed breakout of income as the SOI data. We noted some potential problems with the summary information on the inventory of tax debts, for example income source data were shown only for the last year that the taxpayer was delinquent. Many taxpayers are several years delinquent in paying taxes, and those years are included in the inventory of tax debts. However, if their primary source of income changed from year to year, the information in the inventory may not reflect the previous years' primary income source. Despite these limitations, we believe the information provides a basis to show the significance of the problem.

For the last objective—determining options for enhancing the timely payment of taxes on nonwage income—we reviewed the Internal Revenue Code and IRS publications, and we interviewed IRS headquarters, regional, and service center staff. Furthermore, we reviewed IRS, GAO, and private studies on nonwage earners' tax compliance and ways to improve tax payment compliance. We also interviewed a wide range of officials from organizations representing taxpayers, tax preparers, and payers of nonwage income. These organizations included the American Institute of Certified Public Accountants, H & R Block, the Securities Industry Association, the U.S. Chamber of Commerce, the National Association for the Self-Employed, and the Small Business Legislative Council.

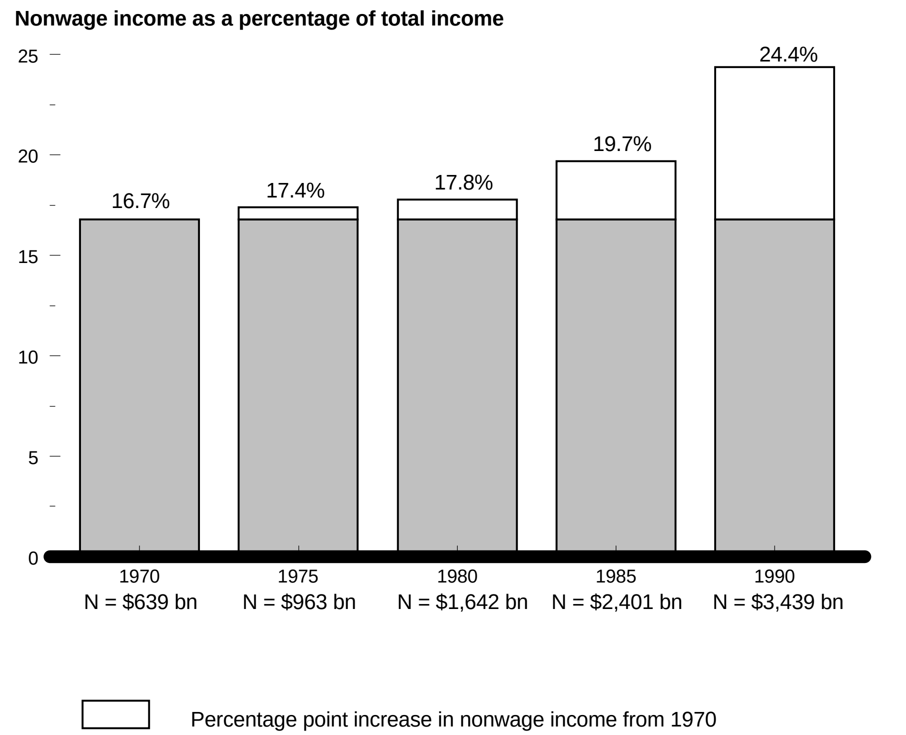
We requested comments on a draft of this report from the Commissioner of Internal Revenue. On July 2, 1996, we received written comments from IRS' Office of Legislative Affairs, which were prepared by the National Director for Compliance Research. These comments are discussed on page 16.

As agreed with your office, we closed our study because data were not readily available to continue our efforts beyond those described above. We did our work from September 1994 to July 1996 in accordance with generally accepted government auditing standards.

Nonwage Income Has Been a Growing Portion of Total Individual Income

Nonwage income has grown significantly since 1970 when it accounted for 16.7 percent of total income. As a portion of total income, nonwage income rose continuously through the 1980s, peaking in 1989 at 25.3 percent of total income. In 1990, nonwage income was 24.4 percent of total income. By 1992, the most recent available information at the time we did our work, nonwage income still accounted for 23.4 percent, or $859 billion, of the $3,665 billion of total income for individuals. This is a 39 percent increase in the proportion of nonwage income to total income from tax year 1970 when nonwage income represented 16.7 percent, or $107 billion, of the $639 billion in taxable income for individuals. Figure 1 shows the growth in nonwage income as a percentage of taxable income in 5-year intervals from tax year 1970 to 1990.

Figure 1: Growth in Nonwage Income, 1970 to 1990

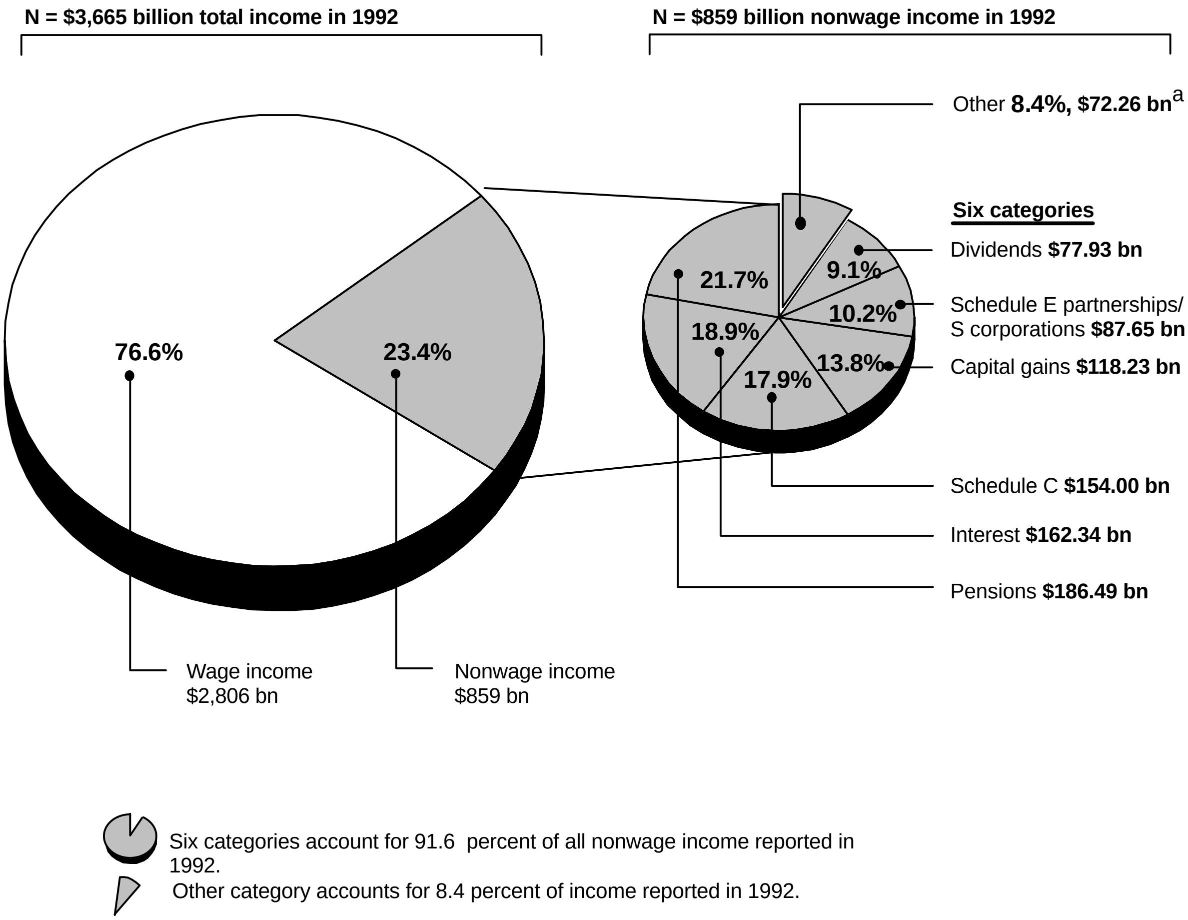


Note: The abbreviation "bn" represents billion.

Source: Percentages are GAO calculations based on data from IRS' Statistics of Income Bulletin, Fall 1994, p. 140.

When reporting nonwage income to IRS, taxpayers use 15 different income categories listed on IRS Form 1040. Of these 15 different categories, we found that 6—pensions, interest, self-employment (Schedule C), capital gains, partnerships/Subchapter S corporations, and dividends—accounted for 91.6 percent of all nonwage income reported by taxpayers for tax year 1992. Figure 2 shows the amount of nonwage income reported by each category for tax year 1992.

Figure 2: 1992 Individual Taxpayer Income by Source



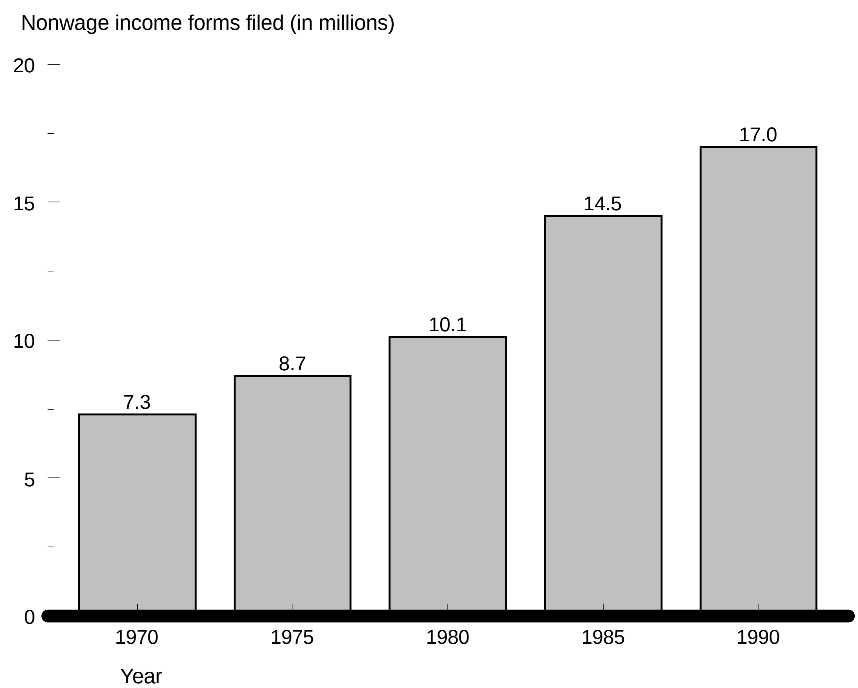
Note: The abbreviation "bn" represents billion.

[a]"Other" includes remaining nonwage categories that comprised nonwage income in 1992, such as unemployment compensation $31.39 bn., taxable IRA distributions $26.27 bn., taxable Social Security $23.14 bn., Schedule E-other $13.63 bn., state/local income tax refunds $10.19 bn., alimony $4.61 bn., farm income/loss –$2.54 bn., supplemental gain/loss –$2.65 bn., and all other –$31.78 bn.

Source: GAO analysis of IRS Statistics of Income data for 1992.

The growth of nonwage income is also reflected by the increase in the number of individual tax returns filed with income from only nonwage sources. In this regard, the number of these returns increased from about 10 percent, or 7.3 million, of the 74 million individual tax returns filed in 1970 to over 15 percent, or 17.3 million, of the 114 million tax returns filed in 1992. Figure 3 shows the growth in tax returns filed showing only nonwage income in 5-year intervals from tax year 1970 to 1990.

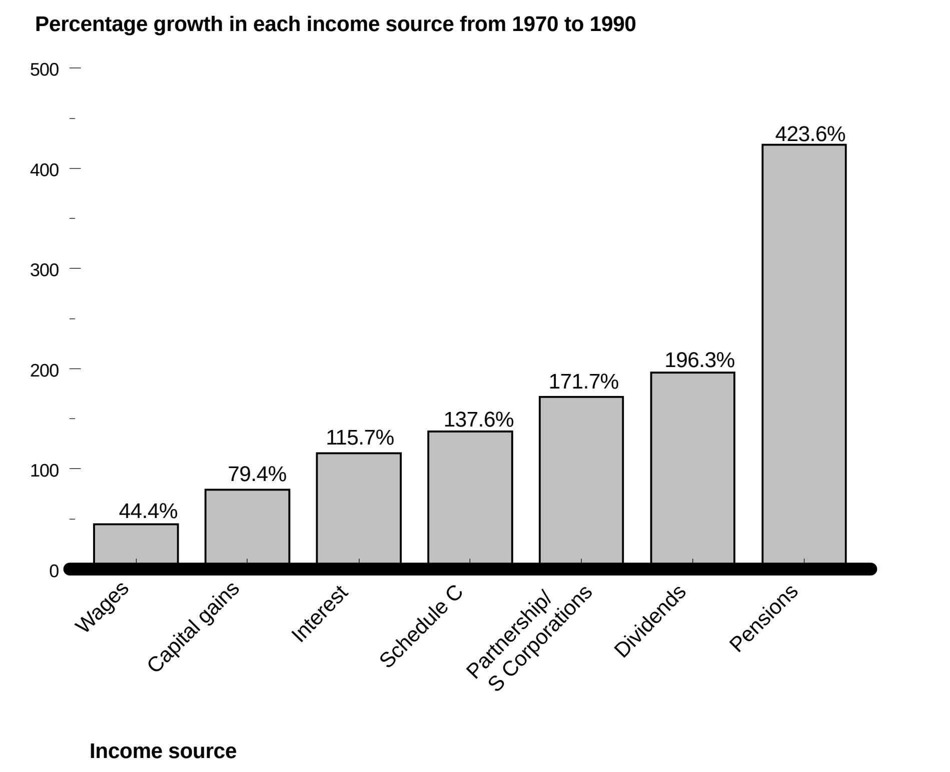
Figure 3: Returns With Only Nonwage Income, 1970 to 1990



Source: GAO analysis of IRS Statistics of Income Bulletin, Fall 1994, p. 140.

Economic and demographic trends suggest that the proportion of taxpayers with nonwage income could continue to grow at a faster pace than those with wage income. For example, as the taxpaying population grows older and people live longer, more and more people will receive pensions and other types of nonwage income. In tax year 1992, over 17 million tax returns included pension income, which was a significant increase from 1970 when only 3.2 million returns included pension income. Other categories of nonwage income have also shown substantial growth in the past 2 decades. For example, the number of tax returns that included self-employment income increased 138 percent from 1970 to 1990. Figure 4 shows the percentage growth in tax returns filed by major income category from 1970 to 1990.

Figure 4: Growth in Forms With Wages and Key Nonwage Income Source



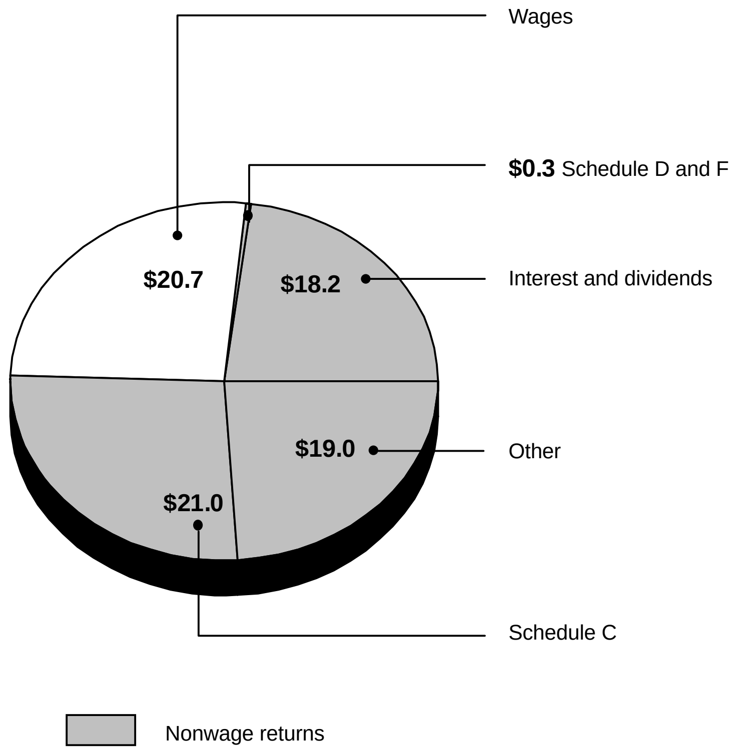
Source: GAO analysis of IRS Statistics of Income Bulletin, Fall 1994, p. 140.

Impact on IRS Inventory of Tax Debts

Because there is generally no withholding of income taxes on nonwage income, taxpayers with such income are required to make periodic payments during the tax year, based on an estimate of their income, deductions, and annual tax liability. When periodic payments are not sufficient, some taxpayers may not file tax returns, or they may file returns without full payment of their tax liability. The result is a large and growing compliance problem, particularly among taxpayers with nonwage income. IRS data show that taxpayers receiving most of their income from nonwage sources owe more delinquent taxes than do wage earners. Specifically, IRS' inventory of tax debt for individual taxpayers at the end of fiscal year 1993 totaled $79.2 billion, of which 74 percent, or about $58.5 billion, was owed by taxpayers with primarily nonwage income. Figure 5 provides a breakdown of the $79.2 billion of individual tax debt by wage and nonwage sources.

Figure 5: Fiscal Year 1993 IRS Receivables Analyzed by Individual Taxpayer Income Type

Amount in billions



Source: IRS Accounts Receivable Management Information System report, September 1993.

Statistical information developed by IRS on the inventory of individual tax debt at the end of fiscal year 1993 showed that about two-thirds, or about $39 billion, of the $59 billion owed by taxpayers with nonwage income was attributable to taxpayers whose primary sources of income were from self-employment, interest, or dividends. IRS data also showed that the average tax delinquency for taxpayers with primarily nonwage income was about 4 times greater than that of wage earners. In that regard, nonwage earners owed an average of about $15,800 while wage earners owed an average of about $3,600.[3]

Options for Enhancing the Timely Payment of Taxes on Nonwage Income

On the basis of our review of relevant IRS and GAO studies, discussions with various tax officials, and related information, we identified several options that appear to have potential for enhancing the timely payment and collection of taxes on nonwage income. These options include expanding tax withholding to cover more nonwage sources of income, making taxpayers with nonwage income better aware of their tax responsibilities, and modifying the estimated tax system.

Expanding Withholding

IRS estimates that tax reporting compliance for wage earners with withholding is about 99 percent, while tax compliance for individuals with income not subject to withholding is significantly less. In the case of self-employed taxpayers, IRS estimates that compliance is about 41 percent. As we mentioned earlier, IRS' breakdown of its tax debts inventory indicates that almost 74 percent of the inventory was associated with nonwage income at the end of fiscal year 1993. However, because taxpayer-related information was not readily available, we were unable to break down annual delinquencies by specific sources of nonwage income.

The Internal Revenue Code provides for three types of withholdings—mandatory, backup, and voluntary. Mandatory withholding has been used to collect income taxes on wages since World War II but has rarely been used for nonwage income in the United States.[4] However, a 1986 IRS study found that mandatory withholding was used for certain nonwage income in other countries. For example, many countries collect taxes on interest and dividends through withholding, and some use mandatory withholding on retirement, commissions, self-employment, and agricultural income. Congress authorized 10-percent mandatory withholding on interest and dividend income in 1982 but repealed the requirement in 1983 before it became effective. Mandatory withholding on interest and dividends was repealed because of perceptions that withholding would impose undue burdens on some taxpayers and financial and administrative burdens on financial institutions. Also, it was believed that the 10-percent withholding

[3]Both figures include tax, interest, and penalties.

[4]An exception would be taxable casino gambling profits paid to Native American tribal members, which became subject to mandatory withholding after December 31, 1994. Also, Congress authorized mandatory withholding on interest and dividends in 1982 but repealed the requirement in 1983 before it became effective. Treasury proposed mandatory withholding on business payments to independent contractors in 1979, but this proposal was never adopted.

would not eliminate all noncompliance. In repealing the mandatory withholding, Congress provided a backup withholding system.

Backup withholding applies to all types of nonwage income that are subject to information reporting when payors find they have an incorrect taxpayer identification number or they lack certification that the payee is not subject to backup withholding. Backup withholding also applies in cases when taxpayers significantly underreport their income from interest and dividends. According to an IRS study, IRS is looking at ways to maximize underreporter backup withholding and possibly expand its use. A 1994 IRS internal study on high-income taxpayers reported that backup withholding on self-employment income of noncompliant taxpayers could bring $7 billion in "new money" into the Treasury over a 5-year period. However, according to IRS' study, broadening the use of backup withholding would require congressional authorization.

Voluntary withholding is another available option that has primarily been used for pension income. Individuals receiving pension payments have the option to have income taxes withheld from their pension payments. In addition, effective January 1, 1997,[5] federal payors[6] and state unemployment commissions will be required to offer payees the option to have income taxes withheld from certain nonwage payments including Social Security.

A number of IRS studies over the last 10 years have noted the high occurrence of noncompliance by taxpayers receiving nonwage income, particularly self-employed taxpayers. We reported in July 1992 that noncompliance among self-employed individuals was serious enough to warrant some form of withholding.[7] As part of a broader effort looking at taxpayer compliance in general, we convened a panel of tax experts in 1995. The purpose was to obtain the views of these experts regarding innovative and practical means of increasing taxpayer compliance. One of several options presented by the panelists was extending the reach of tax system requirements, such as income tax withholding, to promote increased taxpayer compliance. Most panelists favored withholding on

[5]P. L. 103-465, section 702. According to a Social Security Administration (SSA) official, voluntary withholding on Social Security benefits cannot be implemented until Congress amends a Social Security Act provision that bars assignment of benefits.

[6]Federal payors include the SSA, the Railroad Retirement Board, and the Department of Agriculture.

[7]Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

business payments to independent contractors as a means of reducing the relatively high degree of noncompliance among these taxpayers.[8]

Making Taxpayers Better Aware of Tax Responsibilities

Individuals in the private sector and IRS officials whom we met with mentioned that the more taxpayers are aware of their tax obligations, the more likely they are to comply. One area mentioned was the transition period when taxpayers go from wage earning to retirement. According to an IRS study, this can be a time of taxpayer confusion about tax liabilities, and SSA officials said they have not, in the past, educated Social Security recipients on tax issues. As discussed earlier in this report, new legislation effective January 1, 1997, permits withholding from Social Security payments if the recipient so requests. An SSA official informed us that SSA will be ready to implement voluntary withholding in 1997, provided the agency gets a necessary amendment to the Social Security Act.

A tax practitioner told us that tax reminders and payment options provided when income is received could increase taxpayer awareness of tax payment compliance. For instance, periodic statements that report interest and dividend income could include language reminding taxpayers of potential estimated tax requirements. Similar reminders could be given to taxpayers selling assets where capital gains or losses are involved. A practitioner also said this type of information would help remind and educate taxpayers of the potential tax consequences and the potential need to make estimated tax payments. However, broker industry representatives told us that including such information on their statements may not be a cost-effective solution. They said reporting compliance is already very high.

We have previously reported that increasing the awareness of certain self-employed individuals—independent contractors—regarding their tax responsibilities could improve compliance.[9] This is important because of the significant tax liabilities that can arise because, in addition to individual income taxes, these taxpayers are liable for the payment of self-employment Social Security taxes on their income. These self-employment taxes are assessed at a rate of 15.3 percent of taxable income. For self-employed taxpayers with low taxable incomes, these taxes may be greater than their income taxes. One way to increase the awareness of the tax responsibilities of independent contractors is

[8] Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157, June 2, 1995).

[9] Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

through written agreements. In this regard, two bills were introduced in Congress last year dealing with the classification of workers as either independent contractors or employees. Both bills would require written agreements to formalize the arrangement for independent contractors.[10] One aspect of these written agreements would be to specify who is responsible for tax payments and what types of tax obligations are required of the independent contractor.

Modifying the Estimated Tax System

Estimated tax procedures for individual taxpayers generally have not changed for many years. IRS sends individual taxpayers, who were required to make estimated payments the prior year, instructions and estimated tax-payment coupons at the beginning of the tax year. Taxpayers must estimate their annual income, expenses, deductions, and potential tax liabilities, and mail their tax payments to IRS four times a year. We identified four suggestions to improve the estimated tax system: (1) a more flexible payment schedule, (2) modernized payment channels, (3) IRS follow-up for missing payments, and (4) stiffer penalties for noncompliance.

Representatives of private sector groups we spoke with generally favor a more flexible payment schedule, which recognizes that individuals with nonwage income may not easily accumulate the quarterly payments due under the current system. Taxpayers might find smaller monthly payments easier to make and more convenient. This may be especially true of self-employed taxpayers whose estimated payments must include their income tax and self-employment tax.

New technology is also available to simplify the estimated tax payment systems and ease taxpayer burden. Electronic funds transfer and automatic withdrawals from checking or savings accounts, for example, are now commonly used to pay bills. Private sector spokesmen and a tax practitioner suggested that such techniques would help taxpayers meet their estimated tax payment obligations with less burden.

Another area involves IRS reminding taxpayers of their estimated tax payment responsibilities. IRS does not have a system in place to monitor whether an individual's estimated tax payments are made until the tax year has ended. In addition, IRS does not send any type of reminder notice to taxpayers when the periodic estimated tax payments are due. An

[10]"Independent Contractor Tax Fairness Act of 1995" (H.R. 582) and "Independent Contractor Tax Simplification Act of 1995" (H.R. 1972).

internal IRS study on tax delinquencies has recommended that reminder notices be sent each quarter to taxpayers who should be making estimated tax payments but are not. According to an IRS official, IRS has not pursued such a recommendation because implementing such a system would be too complex and could burden too many taxpayers who are not liable for estimated taxes. Some IRS officials believed that developing and operating such a monitoring system and sending reminder notices may not be cost effective, and, as a result, no actions were taken on the recommendations.

Finally, it should be noted that the tax code includes a penalty for taxpayers who fail to meet their estimated tax payment deadlines on time. The penalty for a late payment is essentially an interest charge levied on the amount that was not paid for the period that the payment is overdue. A recent IRS internal study pointed out that this penalty provides little financial reason for taxpayer compliance—noting that the effective annual penalty rate was 4.8 percent. The study recommended increasing the penalty, especially for taxpayers with a history of payment delinquencies.

Conclusions

It appears that income from nonwage sources will continue to be a key portion of total income for individuals. As this type of income grows, tax delinquencies will probably grow because these taxpayers are more likely to be delinquent than wage earners. Dealing with the delinquency problem will not be an easy task for IRS. The tools, primarily the mandatory withholding of income taxes, that increase the compliance of wage earners are not currently available for nonwage income. In addition to withholding of income taxes, we point out several options, including increasing individuals' awareness of their tax responsibilities, simplifying the estimated tax payment, and monitoring of estimated tax payments that have been suggested as ways that have potential to assist taxpayers in making timely payments of income taxes.

IRS Comments and Our Evaluation

We received written comments on a draft of this report from IRS' Office of Legislative Affairs on July 2, 1996. The written comments, prepared by IRS' National Director for Compliance Research, suggested some clarifying language and editorial changes, which have been made, and also addressed two of the options presented in the report. Regarding the option to expand withholding, IRS believes the problem lies mostly with self-employed individuals and that mandatory withholding on nonemployee (independent contractor) compensation should continue to be explored. For interest and dividend income, IRS believes that any expansion of backup withholding should be narrowly focused on taxpayers with egregious compliance situations. Regarding modifications to the estimated tax system, IRS still believes it may not be cost effective to issue notices to all individuals who stop making estimated tax payments because many do so for valid reasons.

As agreed with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies of this report to the Ranking Minority Member of your Subcommittee, the Chairmen and Ranking Minority Members of the Senate Committee on Finance, and the House Committee on Ways and Means, other interested congressional committees, the Secretary of the Treasury, the Commissioner of IRS, and other interested parties. We will make copies available to others upon request.

The major contributors to this report are listed in the appendix. If you have any questions, please contact me on (202) 512-8633.

Sincerely yours,

Lynda D Willis

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