



*Significant Challenges Exist in Determining
Whether Taxpayers With Schedule C Losses
Are Engaged in Tax Abuse*

September 7, 2007

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 7, 2007

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report –(Audit # 200630039)

This report presents the results of our review to determine what actions the Internal Revenue Service (IRS) is taking to address noncompliant, high-income¹ Small Business/Self-Employed (SB/SE) Division taxpayers who claim business losses using a U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Business (Schedule C) for activities considered to be not-for-profit. This audit was part of the Treasury Inspector General for Tax Administration's Fiscal Year 2007 audit plan.

Impact on the Taxpayer

In general, if a taxpayer has hobby income and expenses, the expense deduction should be limited to the hobby income amount. About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C showing no profits, only losses, over consecutive Tax Years 2002 – 2005 (4 years); 73 percent of these taxpayers were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially² avoided paying \$2.8 billion in taxes in Tax Year 2005. Changes are needed to prevent taxpayers from continually deducting losses in potentially not-for-profit activities to reduce their tax liabilities.

¹ We categorized taxpayers with total income sources of \$100,000 or greater to be high-income taxpayers.

² The term potentially is used because an examination of books and records is necessary to determine whether there was tax avoidance or abuse.



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Synopsis

According to IRS estimates, incorrect deductions of hobby expenses account for a portion of the overstated adjustments, deductions, exemptions, and credits that result in about \$30 billion per year in unpaid taxes. The IRS faces considerable challenges in administering the tax law for taxpayers who take Schedule C losses year after year for potentially not-for-profit activities. Several recent efforts demonstrate these challenges. In an effort to change noncompliant taxpayer behavior, the IRS sent letters to taxpayers with potentially tax-abusive, home-based businesses as an alternate treatment to save audit resources. However, the taxpayer response rate was low, and IRS researchers concluded that the use of letters would not necessarily be productive as a tool to induce self-correction. The IRS also conducted correspondence examinations.³ However, these examinations did not always deter taxpayers from continuing to claim hobby losses in succeeding tax years.

Internal Revenue Code (I.R.C.) Section (§) 183⁴ (Activities not engaged in for profit), also referred to as the “hobby loss” provision, and related Treasury Regulation § 1.183-1⁵ do not establish specific criteria for the IRS to use to determine whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual’s books and records. The purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in “side-line” diversions to reduce their overall tax liabilities. Our analysis showed 332,615 high-income taxpayers received the greatest benefit by potentially avoiding approximately \$1.9 billion in taxes for Tax Year 2005.

The I.R.C. and Treasury Regulation do not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs just the “objective” of making a profit. I.R.C. § 183 makes it difficult for the IRS to efficiently administer tax law that ensures taxpayers are not deducting not-for-profit losses to reduce their taxes on other incomes year after year.

Recommendations

To reduce potential abuse, the Commissioner, SB/SE Division, should provide a copy of this report to the Department of the Treasury, Office of the Assistant Secretary for Tax Policy, to consider proposal of legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule⁶ for determining whether an activity is a

³ Correspondence examinations are conducted through the mail, with the IRS typically asking taxpayers for more support regarding one or two simple issues on individual income tax returns.

⁴ I.R.C. § 183, Pub. L. No. 100-647, § 1001(h) (3), 102 Stat. 3352.

⁵ T.D. 7198, 37 FR 13683, July 13, 1972.

⁶ A bright-line test is a clear division between what is acceptable and what is not from a legal, accounting, or regulatory perspective.



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business or a not-for-profit activity. Aside from a legislative remedy, due to the large number of tax returns with Schedule C losses being prepared by tax practitioners, the Director, Communications, Liaison, and Disclosure, SB/SE Division, should continue to coordinate with practitioner organizations to encourage compliance with existing provisions.

Response

The Commissioner, SB/SE Division, agreed with the recommendations. The Director, Communications, Liaison and Disclosure, SB/SE Division, will coordinate with the Office of Legislative Affairs to forward a copy of the final report to the Department of the Treasury Office of Tax Policy and will include key messages and talking points about I.R.C. § 183 tax obligations as a Fiscal Year 2008 outreach initiative directed to practitioner organizations. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS officials affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.



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Abbreviations

I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



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Background

The Internal Revenue Code (I.R.C.) generally allows individuals to deduct expenses only when those expenses are incurred either for the purpose of producing income (I.R.C. Section [§] 212)¹ or in a trade or business (I.R.C. § 162).² In contrast, personal expenses are ordinarily not deductible. As Supreme Court Justice John Marshall Harlan, II once wrote, “For income tax purposes Congress has seen fit to regard an individual as having two personalities: one is a seeker of profit who can deduct the expenses incurred in that search; the other is a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures.”³

The first “hobby loss” provision in the I.R.C. was enacted by the Revenue Act of 1943.⁴ It was popularly known as “the Marshall Field Bill.” Some believed (1) Mr. Field was operating his liberal newspapers, *PM* and the *Chicago Sun*, as a sole proprietorship and, (2) because they were both thought to be losing money at that time, the Federal Government was in a sense “financing” these publications out of taxes Mr. Field would otherwise have had to pay. The Act was intended to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in “side-line” diversions to reduce their overall tax liabilities.

***The first “hobby loss”
provision in the I.R.C. was
enacted by the Revenue Act
of 1943.***

The I.R.C. was last modified for this issue in 1988, as I.R.C. § 183⁵ (Activities not engaged in for profit). Current I.R.C. § 183 provides a presumption that an activity is engaged in for profit if the activity is profitable for 3 years of a consecutive 5-year period or 2 years of a consecutive 7-year period for activities that consist of breeding, showing, training, or racing horses. Treasury Regulation § 1.183-1⁶ sets forth the following nonexclusive list of nine factors to guide courts in analyzing a taxpayer’s profit objective:

- (1) The manner in which the taxpayer carries on the activity.
- (2) The expertise of the taxpayer or his (or her) advisers.
- (3) The time and effort expended by the taxpayer in carrying on the activity.
- (4) The expectation that the assets used in the activity may appreciate in value.

¹ I.R.C. § 212, Pub. L. No. 94–12, § 208(b), 68A Stat. 69.

² I.R.C. § 162, Pub. L. No. 108-357, §§ 318(a), (b), §§ 802(b) (2), 118 Stat. 1470, 1568.

³ Justice Harlan, *United States v. Gilmore*, 372 U.S. 39 (1963).

⁴ Title I, § 129(a), 58 Stat. 48.

⁵ I.R.C. § 183, Pub. L. No. 100–647, § 1001(h) (3), 102 Stat. 3352.

⁶ T.D. 7198, 37 FR 13683, July 13, 1972.



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- (5) The success of the taxpayer in carrying on other similar or dissimilar activities.
- (6) The taxpayer's history of income or losses with respect to the activity.
- (7) The amount of occasional profits, if any, that are earned.
- (8) The financial status of the taxpayer.
- (9) The elements of personal pleasure or recreation involved in the activity.

However, the mere fact that the number of factors indicating the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive.

This review was performed at the Internal Revenue Service (IRS) National Headquarters in Washington, D.C., in the Small Business/Self-Employed (SB/SE) Division, the SB/SE Division Campus⁷ Compliance Services function in Florence, Kentucky, and the Office of Appeals, Technical Services, Tax Policy function in Dallas, Texas, during the period October 2006 through June 2007. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁷ The campuses are data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Results of Review

***The Internal Revenue Service Is Aware That Problems Exist With
Taxpayers Claiming Schedule C Losses From Not-for-Profit Activities***

A number of taxpayers who have significant income from other sources reduce their taxable incomes by reporting losses on a U.S. Individual Income Tax Return (Forms 1040) Profit or Loss From Business (Schedule C). According to IRS estimates, incorrect deductions of hobby expenses account for a portion of the overstated adjustments, deductions, exemptions, and credits that result in about \$30 billion per year in unpaid taxes.

The IRS has made several different efforts to administrate the tax law. First, as part of the SB/SE Division Tax Gap⁸ - National Research Project Communication Plan, on April 25, 2007, the IRS issued on its web site (IRS.gov) a Factsheet reminding taxpayers to follow appropriate guidelines when determining whether an activity is a business or a hobby (an activity not engaged in for profit). In general, if a taxpayer has hobby income and expenses, the expense deductions should be limited to the hobby income amount. The Factsheet detailed the nine factors to be considered when making this determination and the limitations for deducting some expenses from not-for-profit activities as itemized deductions on Form 1040 Itemized Deductions (Schedule A). In addition to the general public, the Factsheet's targeted audience included practitioner and industry groups.

Second, in 2005, the SB/SE Division Research function performed a research project on home-based businesses that included a review of Schedule C expenses to identify alternate treatments of potentially noncompliant behavior that would save audit resources. The Research function sent letters to taxpayers with potentially tax-abusive, home-based businesses in an attempt to change their potentially noncompliant tax behavior. Although some taxpayers did file amended returns, the overall response rate was low, and the SB/SE Research function concluded that the use of letters would not necessarily be productive as a tool to induce self-correction by home-based business participants.

In a third effort, in 2003, the IRS performed limited testing to determine if examinations of tax returns with Schedule C losses from potentially not-for-profit activities could be accomplished through correspondence examinations.⁹ In general, a correspondence examination does not

⁸ The tax gap is the difference between the amount of tax that taxpayers should pay for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with the tax laws.

⁹ Correspondence examinations are conducted through the mail, with the IRS typically asking taxpayers for more support regarding one or two simple issues on individual income tax returns.



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include an examination of a taxpayer's books and records. The testing included 148 returns for which 103 taxpayers' Schedule C losses¹⁰ were disallowed because they were considered hobby expenses. These taxpayers were assessed taxes and interest of \$372,089. The IRS has collected \$345,600 from 95 (92 percent) of these taxpayers.¹¹

As a followup to the IRS effort, we reviewed the accounts of the 95 taxpayers who had paid their assessments, to determine whether Schedule C losses were claimed on returns filed subsequent to the correspondence examinations. The results showed 48 (51 percent) of the 95 taxpayers continued to claim these losses in the succeeding tax years. Based on the test results, the IRS Campus Compliance Services function believes working the hobby loss issue through correspondence examination is not productive because the multiple contacts with taxpayers increased the amount of time needed to complete the examinations. While identifying potential hobby losses is part of the tax return examination classification process, the number of taxpayers taking multiple, consecutive year losses presents significant challenges to tax administration.

The Internal Revenue Code and Treasury Regulations Make It Difficult to Determine When a Schedule C Loss Is Related to a Business or Hobby

Two conditions exist to make I.R.C. § 183 a challenge to tax administration. First, I.R.C. § 183, also referred to as the hobby loss provision, and related Treasury Regulation § 1.183-1 do not establish specific criteria for the IRS to use to determine whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual's books and records. The I.R.C. and Treasury Regulation do not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs just the "objective" of making a profit. Therefore, all facts and circumstances need to be considered in each case. In determining whether a profit objective exists, courts have ruled it may be sufficient that there is a small chance of making a profit. For example, an inventor may incur very substantial expenses in a venture for a profit even though the expectation of profit might be considered unreasonable. Additionally, the IRS, not the taxpayer, bears the burden to rebut the presumption that an activity was not a for-profit business.

¹⁰ We and the IRS analyst who oversaw the test reviewed the returns for the remaining 45 taxpayers whose Schedule C losses had not been disallowed. Based on the IRS analyst's recollection of the cases, the Schedule C losses for 36 of the 45 taxpayers should also have been disallowed; however, the original case files were no longer available.

¹¹ This includes [REDACTED]. Five other taxpayers also appealed their assessments. The Office of Appeals conceded the assessment in four cases and [REDACTED]. [REDACTED] The three remaining taxpayers have not paid their assessments and have balance-due accounts.

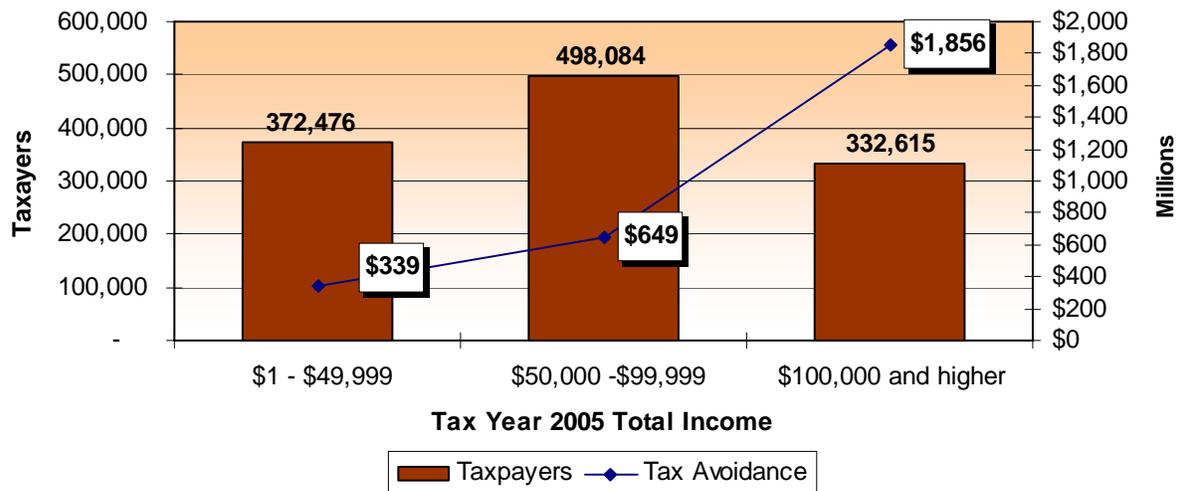


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Second, the law also allows taxpayers to justify a substantial Schedule C loss by claiming a minimal profit. For example, an activity could be considered a for-profit business if a taxpayer shows any profit during a 5-year period, even though much larger losses are claimed in the other taxable years. This allows taxpayers to break the cycle of having continuous years of losses and gives the appearance of being a for-profit business.

To identify the scope of the problem, we performed an analysis of Tax Year 2005 Form 1040 Schedules C showing no profits, only losses, over consecutive Tax Years 2002 – 2005 (4 years). We identified a universe of 1,483,246 taxpayers,¹² many with significant income from other sources, that met this criterion; 1,076,796 (73 percent) of these individuals had their tax returns prepared by tax practitioners. Based on their Tax Year 2005 income levels, 1,203,175 of the universe of taxpayers potentially¹³ avoided paying \$2.8 billion in income taxes (see Appendix IV for additional information).

Figure 1: Tax Year 2005 Taxpayers Who Potentially Avoided Paying Taxes by Claiming Schedule C Losses Over Consecutive Tax Years 2002 – 2005



Source: Our analysis of the Individual Return Transaction File¹⁴ for Tax Years 2002 - 2005.

¹² Because of data limitations, we did not determine whether all consecutive losses were for the same activity.

¹³ The term potentially is used because an examination of books and records is necessary to determine whether there was tax avoidance or abuse.

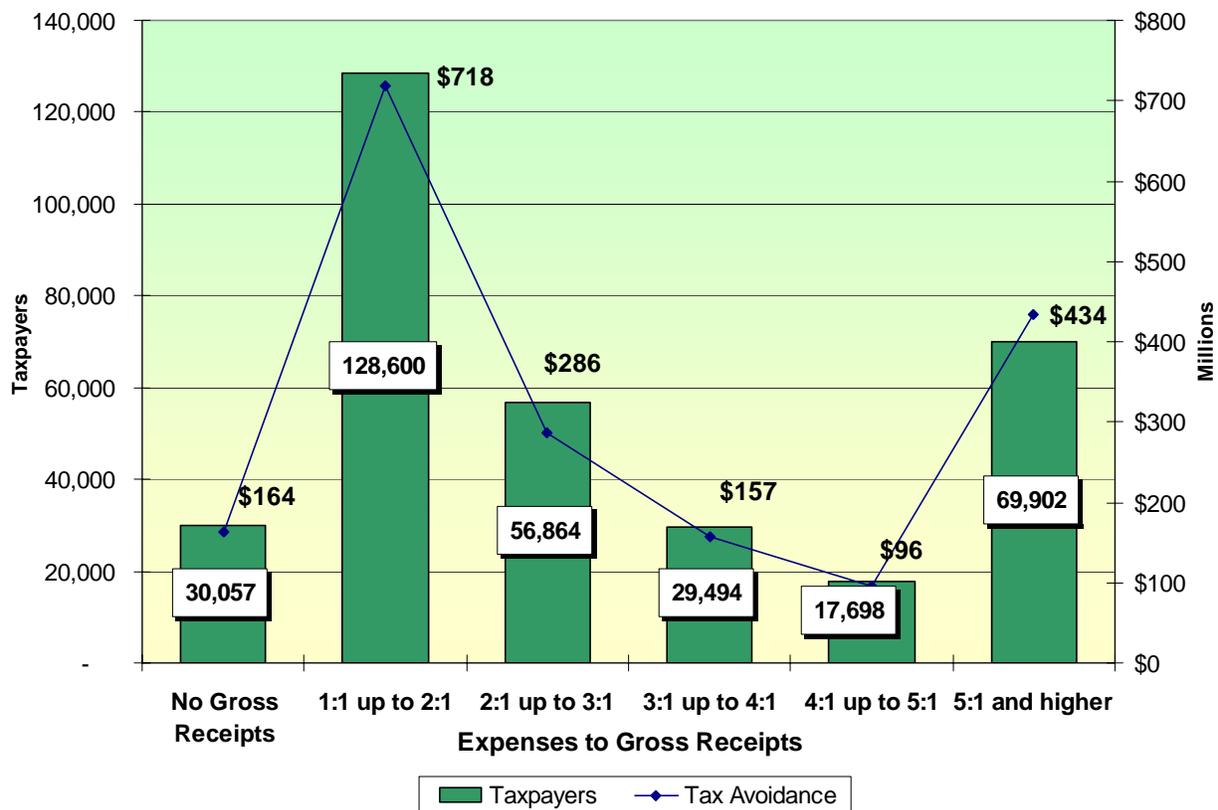
¹⁴ The Individual Return Transaction File contains data transcribed from initial input of the original individual tax returns during return processing. Subsequent or amended return data are not contained in the File.



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As previously noted, the purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in “side-line” diversions to reduce their overall tax liabilities. Figure 1 shows 332,615 high-income¹⁵ taxpayers received the greatest benefit by potentially avoiding approximately \$1.9 billion in taxes for Tax Year 2005. We also computed their expense-to-income ratios. Figure 2 shows almost 70,000 of the high-income taxpayers claimed expenses 5 times greater than their revenues.

Figure 2: Tax Year 2005 High-Income Taxpayers Claiming Schedule C Losses Over Consecutive Tax Years 2002 – 2005



Source: Our analysis of the Individual Return Transaction File for Tax Years 2002 - 2005.

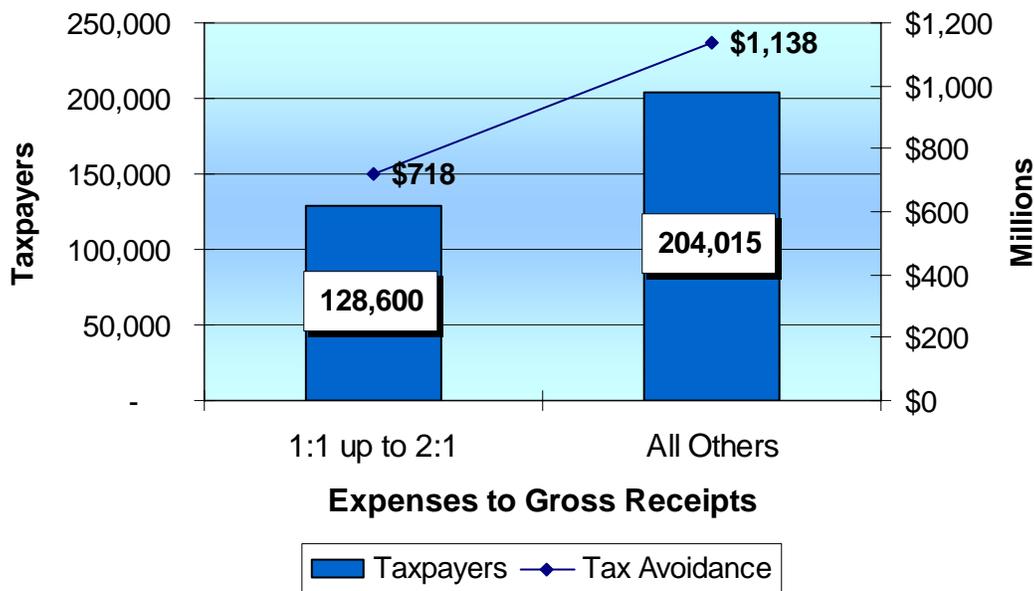
We also analyzed how close the taxpayers were to making a profit by the fourth year. Figure 3 shows 204,015 high-income taxpayers reported either no gross receipts or expenses that were at least 2 times higher than their gross receipts, which allowed them to avoid paying potential taxes of more than \$1.1 billion.

¹⁵ We categorized taxpayers with total income sources of \$100,000 or greater to be high-income taxpayers.



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Figure 3: Comparison of Expenses to Gross Receipts for Tax Year 2005 High-Income Taxpayers



Source: Our analysis of the Individual Return Transaction File for Tax Years 2002 - 2005.

To further determine how well the IRS can actually administrate this provision through examinations, we analyzed IRS Audit Information Management System¹⁶ data and found 73,431 of the 1,483,246 taxpayers have either open or closed examination records for the 4-year period (2002 - 2005). The closed records resulted in assessments of about \$345 million, which is only 12 percent of the \$2.8 billion in potential tax avoidance for Tax Year 2005 alone.¹⁷ However, we were unable to determine the issue for which these taxpayers were examined. Consequently, the taxpayers' Schedule C losses may not be the reason for the tax assessments.

The challenges to tax administration caused by I.R.C. § 183 can be traced back to the legislative process. During the legislative process, the original intent of the hobby loss provision evolved into the existing I.R.C., which does not clearly establish when an activity is a business or a not-for-profit activity.

In February 1969, the House of Representatives Ways and Means Committee proposed a change to the hobby loss provision that would disallow the deduction of losses arising from a "business" that had not been operated with a reasonable expectation of realizing a profit from it. If an individual carried on an activity with a loss in excess of \$25,000 in 3 years out of 5 consecutive

¹⁶ This System traces examination results through final determination of tax liability, including any actions taken by the IRS Office of Appeals and the Tax Court.

¹⁷ Our calculations were based on 1 year's tax, while a disallowed hobby loss could be for 3 or more years.



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years, it would be deemed that (unless shown to the contrary by the taxpayer) the taxpayer was not operating the activity with a reasonable expectation of realizing a profit from it.

However, the Senate Finance Committee substituted a different hobby loss provision and recommended the term “profit” be specifically defined to include not only immediate economic profit but also any reasonably anticipated long-term increase in the value of property. In making the determination of whether an activity is not engaged in for profit, the Senate Finance Committee intended that an objective rather than a subjective approach should be used. A reasonable expectation of profit was not required, and the facts and circumstances would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit. The Senate Finance Committee recommended the IRS bear the burden for rebutting this presumption, not the taxpayer as proposed by the House bill.

In addition, the final Treasury Regulation § 1.183-1 (issued in July 1972) did not clearly establish when an activity is a business or not-for-profit activity. The Treasury Regulation established nine factors that should be taken into account when determining if an activity is engaged in for profit. However, the factors are a guide to assist in making the determination; they do not establish a clear standard.

A study conducted in September 1998 by the Joint Economic Committee¹⁸ defined a “good tax” as:

- Not costly for either the Federal Government or taxpayers to calculate or administer; on the other hand, tax avoidance is difficult and risky.
- Neutral in its impact on resource allocation decisions, minimizing negative effects on economic growth; it does not lead to unproductive economic activity that is tax induced.
- Fair; people believe the tax burden is equitably distributed among the taxpaying population.

When comparing the criteria for a good tax to what is stated in I.R.C. § 183, we conclude that it is difficult for the IRS to efficiently and effectively administer this provision. The tax law cannot be efficiently administered when examination resources would be required to determine compliance. Additionally, taxpayers may be abusing the law by taking multiple, consecutive year losses for expenses that could be for personal use to reduce taxes on other incomes.

¹⁸ *Some Underlying Principles of Tax Policy*, United States Congress Joint Economic Committee Study, Richard K. Vedder and Lowell E. Gallaway, Distinguished Professors of Economics, Ohio University, September 1998.



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Recommendations

Recommendation 1: The Commissioner, SB/SE Division, should provide a copy of this report to the Department of the Treasury, Office of the Assistant Secretary for Tax Policy, to consider proposal of legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule¹⁹ for determining whether an activity is a business or not-for-profit activity.

Management's Response: The Commissioner, SB/SE Division, agreed with the recommendation. Upon receipt of the final report, the Director, Communications, Liaison, and Disclosure, will coordinate with the Office of Legislative Affairs to forward a copy to the Department of the Treasury Office of Tax Policy.

Recommendation 2: Aside from a legislative remedy, due to the large number of tax returns with Schedule C losses being prepared by tax practitioners, the Director, Communications, Liaison, and Disclosure, SB/SE Division, should continue to coordinate with practitioner organizations to encourage compliance with existing provisions.

Management's Response: The Commissioner, SB/SE Division, agreed with the recommendation, stating that the Division's education and outreach activities should include key messages regarding current provisions of I.R.C. § 183 to further supplement the April 2007 Hobby Loss Factsheet. Management will include key messages and talking points about I.R.C. § 183 tax obligations as a Fiscal Year 2008 outreach initiative directed to practitioner organizations.

¹⁹ A bright-line test is a clear division between what is acceptable and what is not from a legal, accounting, or regulatory perspective.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to determine what actions the IRS is taking to address noncompliant, high-income¹ SB/SE Division taxpayers who claim business losses on a U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Business (Schedule C) for activities considered to be not-for-profit. Specifically, we determined the methods the IRS uses to classify tax returns to be selected for examinations and the outreach actions employed to discourage taxpayers who claim these losses to reduce their tax liabilities. To accomplish the objective, we:

- I. Contacted the IRS SB/SE Division Campus² Compliance Services and Examination functions to determine if there were any action plans with target dates for implementation of methods to classify and examine returns with Schedule C hobby losses.
- II. Determined what outreach methods the IRS has in place or planned to advise taxpayers of the rules regarding the use of Schedule C for activities considered to be a hobby.
 - A. Reviewed the public IRS web site (IRS.gov) and the SB/SE Division Intranet web site for information pertaining to the deduction of Schedule C expenses for not-for-profit activities. We also contacted the Stakeholder Liaison Headquarters to determine if there are any additional planned outreach initiatives for either individual taxpayers or tax preparers for this area.
 - B. Obtained the results of the 148 taxpayer cases for the limited testing for Tax Years 1998 through 2002 conducted by the IRS beginning in 2003 to determine if tax returns with hobby loss issues could be examined by correspondence examination.³ We analyzed 95 of the cases in which taxpayers agreed and paid the tax assessments, to determine if IRS contact with these taxpayers deterred them from filing Schedule C losses in the succeeding tax years.

¹ We categorized taxpayers with total income sources of \$100,000 or greater to be high-income taxpayers.

² The campuses are data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

³ Correspondence examinations are conducted through the mail, with the IRS typically asking taxpayers for more support regarding one or two simple issues on individual income tax returns.



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- C. Obtained a computer extract from the Individual Return Transaction File⁴ for Tax Years 2002 – 2005 Form 1040 Schedules C showing no profits, only losses, over the 4 consecutive Tax Years. The universe of taxpayers, many with significant income from other sources, meeting this criterion was 1,483,246.
1. Analyzed data to obtain statistics about the population, including the amount of taxes avoided in Tax Year 2005, by calculating the additional tax that would have been owed if the taxpayers had not taken the Schedule C losses.
 2. Determined the number of taxpayers examined during this period using the IRS Audit Information Management System.⁵ The data were verified by matching a judgmental sample of 33 taxpayers' information to the IRS Integrated Data Retrieval System.⁶
- III. To determine the Congressional intent of I.R.C. Section (§) 183,⁷ we contacted the Treasury Inspector General for Tax Administration Office of Chief Counsel and conducted additional research to obtain the legislative/regulatory history of I.R.C. § 183 and Treasury Regulation § 1.183-1.⁸

⁴ The Individual Return Transaction File contains data transcribed from initial input of the original individual tax returns during return processing. Subsequent or amended return data are not contained in the File.

⁵ The system traces examination results through final determination of tax liability, including any actions taken by the IRS Office of Appeals and the Tax Court.

⁶ This is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁷ I.R.C. § 183, Pub. L. No.100-647, § 1001(h) (3), 102 Stat. 3352.

⁸ T.D. 7198, 37 FR 13683, July 13, 1972.



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Appendix II

Major Contributors to This Report

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Lisa Stoy, Audit Manager

Carole Connolly, Lead Auditor

Timothy Greiner, Senior Auditor

Ted Lierl, Senior Auditor



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Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
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Assistant Deputy Commissioner for Services and Enforcement SE
Chief, Appeals AP
Chief Counsel CC
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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 Chief Counsel CC



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Appendix IV

Methodology for Determining the Number of Taxpayers and Potential Tax Avoided in Tax Year 2005

We used the following methodology to determine the number of taxpayers and potential tax avoided in Tax Year 2005.

First, we obtained from the IRS Individual Return Transaction File¹ a computer extract of Tax Years 2002 – 2005 U.S. Individual Income Tax Returns (Form 1040) with an attached Profit or Loss From Business (Schedule C) showing no profits, only losses, over the 4 consecutive Tax Years. Our results identified 1,483,246 taxpayers that met this criterion.

We then calculated the additional taxes that would have been owed if taxpayers had not taken the Schedule C losses in Tax Year 2005. This was accomplished by using each taxpayer's filing status for Tax Year 2005 and applying the appropriate tax rate.

Next, we added back the amount of the Schedule C loss to each taxpayer's taxable income and computed the tax. We then subtracted the tax computed on the amount including the Schedule C loss from the tax computed by eliminating the Schedule C loss. This calculation provided the amount considered to be the tax avoided in Tax Year 2005 by claiming the Schedule C loss.

The total potential tax avoidance for Tax Year 2005 is \$2,843,919,493 for 1,203,175 taxpayers. We determined 280,071 of the 1,483,246 taxpayers did not avoid any taxes by claiming a Schedule C loss in Tax Year 2005.

¹ The Individual Return Transaction File contains data transcribed from initial input of the original individual tax returns during return processing. Subsequent or amended return data are not contained in the File.



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Appendix V

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
AUG 20 2007

August 20, 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak *Kathy K. Petronchak*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Significant Tax Administration
Challenges Exist in Determining Whether Individual
Returns With Schedule C Losses Are Engaged in Tax
Abuse" (Audit #200630039)

We have reviewed your draft report, "Significant Tax Administration Challenges Exist in Determining Whether Individual Returns With Schedule C Losses Are Engaged in Tax Abuse," and agree with the recommendations.

As you mention in your report, Internal Revenue Code (IRC) Section 183 presents challenges to tax administration. We appreciate your recognition of our efforts to address this difficult provision, especially within our Small Business/Self-Employed Division Tax Gap Communication Plan. An important component of this plan included sharing fact sheets and key messages with our practitioner and industry partners emphasizing proper application of the current tax law.

We plan to continue communicating with practitioners and industry groups to educate them about this and other tax issues where voluntary compliance can be improved. Per your recommendation, we will also share a copy of your final report with Treasury's Office of Tax Policy.

Attached is a detailed response outlining our corrective actions.

If you have any questions, please contact me or call Beth Tucker, Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division, at (972) 308-1676.

Attachment



*Significant Challenges Exist in Determining Whether Taxpayers
With Schedule C Losses Are Engaged in Tax Abuse*

Attachment

RECOMMENDATION 1:

The Commissioner, SB/SE Division should provide a copy of this report to the Department of the Treasury, Office of the Assistant Secretary for Tax Policy, to consider proposal of legislative changes to Internal Revenue Code (IRC) Section 183(d). The proposal should include establishing a clearly defined standard or bright-line rule¹ for determining whether an activity is a business or not-for-profit activity.

CORRECTIVE ACTIONS:

We agree with your recommendation. Upon receipt of the final report, the Director Communications, Liaison and Disclosure will coordinate with Legislative Affairs to forward a copy to Treasury Tax Policy.

IMPLEMENTATION DATE:

October 15, 2007

RESPONSIBLE OFFICIAL:

Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division will notify the Director, Legislative Affairs once the report is shared with Treasury.

RECOMMENDATION 2:

Aside from a legislative remedy, due to the large number of tax returns with Schedule C losses being prepared by tax practitioners, the Director, Communications, Liaison, and Disclosure, SB/SE Division, should continue to coordinate with practitioner organizations to encourage compliance with existing provisions.

CORRECTIVE ACTIONS:

We agree that our education and outreach activities should include key messages regarding the current provisions of IRC Section 183 to further supplement the April 2007 Hobby Loss Fact Sheet. We will include key messages and talking points about IRC Section 183 tax obligations as a FY 2008 outreach initiative directed to practitioner organizations.

IMPLEMENTATION DATE:

July 15, 2008

¹ A bright-line test is a clear division between what is acceptable and what is not from a legal, accounting, or regulatory perspective.



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RESPONSIBLE OFFICIAL:

Director, Communications, Liaison and Disclosure (CLD), Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION(S) MONITORING PLAN:

Director, Communications, Liaison and Disclosure (CLD), Small Business/Self-Employed Division (SB/SE) will advise the Commissioner, SB/SE Division of any delays in implementing this corrective action.