Opportunities Exist to Identify and Examine Individual Taxpayers Who Deduct Potential Hobby Losses to Offset Other Income

April 12, 2016

Reference Number: 2016-30-031

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:
2 = Risk Circumvention of Agency Regulation or Statute.

Phone Number / 202-622-6500
E-mail Address / TIGTACommunications@tigta.treas.gov
Website / http://www.treasury.gov/tigta

To report fraud, waste, or abuse, call our toll-free hotline at:

1-800-366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration
P.O. Box 589
Ben Franklin Station
Washington, D.C. 20044-0589

Information you provide is confidential and you may remain anonymous.

HIGHLIGHTS

OPPORTUNITIES EXIST TO IDENTIFY AND EXAMINE INDIVIDUAL TAXPAYERS WHO DEDUCT POTENTIAL HOBBY LOSSES TO OFFSET OTHER INCOME

Highlights

Final Report issued on April 12, 2016

Highlights of Reference Number: 2016-30-031 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Internal Revenue Code Section 183(a) generally disallows business tax deductions for activities "not engaged in for profit" and Section 183(d), also referred to as the "hobby loss" provision, provides a presumption that most activities are engaged in for profit if the activity is profitable for three years of a consecutive five-year period (two of seven for breeding, training, showing, or racing of horses). A September 2007 TIGTA report found that approximately 1.2 million taxpayers in Tax Year 2005 may have used hobby losses to reduce their taxable incomes to potentially avoid paying $2.8 billion in taxes. Identifying and auditing additional individual returns that improperly deduct hobby losses could help to reduce noncompliance in this area.

WHY TIGTA DID THE AUDIT

This audit was initiated as a follow-up to the September 2007 TIGTA report to determine whether the IRS was maximizing opportunities to identify the most significant Schedule C, *Profit or Loss From Business*, noncompliance. The overall objective of this review was to determine whether the IRS is taking sufficient action to minimize improper Schedule C losses claimed by taxpayers and the resulting loss of revenue to the Government.

WHAT TIGTA FOUND

TIGTA found that the IRS can improve its methods of addressing taxpayers who offset their income with hobby losses. Specifically, IRS methods for identifying high-income taxpayers who may be offsetting their income with hobby losses do not maximize the use of all relevant taxpayer information available to the IRS, and when returns containing potential hobby losses are selected for audit, the examiners do not always address the hobby loss issues.

TIGTA's evaluation of IRS data from Processing Years 2011 through 2014 identified 9,699 individual returns from Tax Year 2013 that claimed a Schedule C loss of at least $20,000, gross receipts of $20,000 or less, and reported wages of at least $100,000. The taxpayers also reported losses in four consecutive years (Tax Years 2010 to 2013). TIGTA's review of a statistically valid sample of 100 returns determined that 88 returns (88 percent) showed an indication that the Schedule C businesses were not engaged in for profit. TIGTA estimates that 7,511 returns in the total sample population of taxpayers may have inappropriately used hobby loss expenses to reduce taxes by as much as $70.9 million for Tax Year 2013.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) make use of SB/SE Division research capabilities to identify high-income individual returns with multiyear Schedule C losses and other factors that indicate the taxpayer may not have a profit or capital gain motive for the activity and 2) emphasize the importance of required filing checks in the preliminary determination of whether to pursue a hobby loss issue and provide tools to assist examiners in documenting their conclusion.

In response to the report, IRS management agreed with our recommendations and plans to take corrective actions.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 12, 2016

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Opportunities Exist to Identify and Examine Individual Taxpayers Who Deduct Potential Hobby Losses to Offset Other Income (Audit # 201530029)

This report presents the results of our review to determine whether the Internal Revenue Service is taking sufficient action to minimize improper Schedule C, *Profit or Loss From Business*, losses claimed by taxpayers and the resulting loss of revenue to the Government. This audit is included in the Treasury Inspector General for Tax Administration's Fiscal Year 2016 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

If you have any questions, please contact me or Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

Table of Contents

Abbreviations

CIP	Compliance Initiative Project
DIF	Discriminant Function
EQRS	Embedded Quality Review System
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NQRS	National Quality Review System
SB/SE	Small Business/Self-Employed
TY	Tax Year

Background

Internal Revenue Code (I.R.C.) Section (§) 162 allows taxpayers to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business. However, I.R.C. § 183 limits the deductions of expenses for activities not engaged in for profit. I.R.C. § 183, also referred to as the "hobby loss" provision, defines an activity not engaged in for profit as any activity other than those allowable under I.R.C. §§ 162 or 212.[1] I.R.C. § 183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for three years of a consecutive five-year period (or two years of a consecutive seven-year period for activities that consist of breeding, showing, training, or racing horses).

Taxpayers with significant amounts of income from other sources can potentially reduce their tax liability by including losses from an unprofitable small business activity.

While the absence of a profit in three years of a consecutive five-year period does not *per se* create a presumption that the activity is not engaged in for profit,[2] Treasury Regulation § 1.183-2 provides a nonexclusive list of nine factors to analyze a taxpayer's profit objective. These factors include the existence of a profit or loss, as follows:

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.
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.

---

[1] I.R.C. § 212 allows an individual to deduct all ordinary and necessary expenses paid or incurred during a taxable year: 1) for the production or collection of income; 2) for the management, conservation, or maintenance of property held for the production of income; or 3) in connection with the determination, collection, or refund of any tax.

[2] Treas. Reg. § 1.183-1(c)(2)(ii) provides: "If the taxpayer does not meet the requirements of Section 183(d) and this paragraph, no inference that the activity is not engaged in for profit shall arise by reason of Section 183."

The Internal Revenue Service (IRS) should be attempting to identify the cases that present the most significant tax compliance risk. With respect to hobby loss cases, a number of the above factors are readily available for the IRS to query from its taxpayer data, including the regular wages of the taxpayer that might be offset by hobby losses and a history of income or losses with respect to other income- or loss-producing activities.

I.R.C. § 183(e) allows the taxpayer to postpone the determination of whether the activity is engaged in for profit. The taxpayer must file Form 5213, *Election To Postpone Determination As To Whether the Presumption Applies That an Activity Is Engaged in for Profit*, to make this election. Form 5213 allows the taxpayer to postpone the determination of whether the activity has a profit motive until at least the close of the activity's fourth tax year.[3] The form must be filed within three years after the due date, determined without extension, for the activity's first tax return or within 60 days of receiving a notice of IRS examination disallowance on issues pertaining to hobby loss.

Taxpayers with significant amounts of income from other sources may attempt to use the tax code to reduce their tax liability by including losses from activities not engaged in for profit. A significant number of high-income taxpayers with high wage and investment incomes also file Schedule C, *Profit or Loss From Business*, as sole proprietors to report losses that offset their wages and other income.[4] Although many of these losses could be from legitimate business activity, a September 2007 Treasury Inspector General for Tax Administration report found that approximately 1.2 million taxpayers in Tax Year (TY) 2005 may have used hobby losses to reduce their taxable incomes to potentially avoid paying $2.8 billion in taxes.[5]

Since our September 2007 report, the IRS has taken several actions to address the hobby loss noncompliance issue:

- The IRS provided guidance in the form of an Audit Technique Guide, *I.R.C. § 183: Activities Not Engaged in For Profit*, in June 2009. The Audit Technique Guide provides the reader with an overview of the hobby loss provision and discusses the limitation of deductions under the hobby loss provision. In addition, the IRS provided guidance for its employees conducting examinations to gauge whether a business activity is engaged in for profit. The techniques included, but were not limited to, analyzing whether: a) the activity with large expenses had little or no income, b) the losses offset other income on the return, c) the activity loss resulted in a large tax benefit to the taxpayer, and d) the history of the business in showing profits in any year.

[3] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[4] According to the IRS, high-income individual taxpayers are those reporting income of $200,000 or more.
[5] Treasury Inspector General for Tax Administration, Ref. No. 2007-30-173, *Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses Are Engaged in Tax Abuse* (Sept. 2007).

- As part of its media outreach program, the IRS developed a video discussing the rules for determining whether a business is engaged in for profit as it pertains to direct seller businesses. The video included an in-depth discussion about what are considered gross receipts and how to report them on Schedule C. It also discussed how to determine when the business activity may not be treated as being engaged in for profit. This video is available on the IRS.gov website for anyone with internet access to view at any time.
- The IRS stated that, during the last three calendar years, its technical advisors specializing in the hobby loss provision have conducted approximately 210 one-on-one consultations with examiners encountering hobby loss issues in their examinations. The IRS also stated that its technical advisors reviewed the facts and circumstances of each case and discussed with the examiners how to further develop sustainable cases. The advisors also conducted group training as requested. Since a hobby loss assessment could be appealed by the taxpayer, the training taught examiners how to develop hobby loss cases that could be sustained by the IRS Appeals function.
- The IRS has authorized and launched a number of local compliance initiative projects (CIP)[6] to identify the level of noncompliance with the hobby loss provision. The Small Business/Self-Employed (SB/SE) Division Examination function audits tax returns to promote the highest degree of voluntary compliance by taxpayers. CIPs are one method used by the IRS to identify and examine tax returns from a group of taxpayers who may have a specific area of tax noncompliance.

While the IRS has taken actions to address hobby loss issues, there are indications that a significant portion still needs to be addressed. For example, in TY 2013, 687,382 taxpayers reported over $7.1 billion in losses from Schedule C businesses that also reported losses in the previous three tax years (TYs 2010 through 2012). Sixty-eight percent of these taxpayers (470,741 of 687,382) reported less than $5,000 in gross receipts in TY 2013, while 23 percent (157,914 of 687,382) reported no gross receipts at all. Figure 1 below provides more detail on those taxpayers whose reported Schedule C expenses consistently exceed their receipts by a substantial amount and who used the net losses to offset other taxable income. The first row in Figure 1 shows that over 150,000 taxpayers had four consecutive years of losses and yet in year four of their trade or business activity had zero gross income (and on average almost $8,000 of losses). Those same taxpayers who reported no gross receipts in their Schedule C businesses had an average total positive income of $198,960 from other sources.

[6] CIPs are any activity involving contact with specific taxpayers within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting noncompliance. CIPs refer to activities formerly categorized as Return Compliance Programs, Information Gathering Projects, and Compliance 2000 Projects.

Figure 1: Tax Year 2013 Gross Receipts, Average Loss, and Total Positive Income for Selected Taxpayers

Gross Receipts	Taxpayers	Average Loss	Average Total Positive Income
$0	157,913	$7,993	$198,960
$1 to $4,999	312,828	$6,825	$107,136
$5,000 to $9,999	76,258	$13,794	$106,697
$10,000 to $14,999	35,547	$19,004	$110,070
$15,000 to $19,999	20,374	$24,236	$119,289
$20,000 or more	84,462	$108,454	$251,883

Source: IRS Individual Return Transaction File for Processing Year 2014.[7]

We initiated this audit to follow up on our September 2007 report and determine whether the IRS is maximizing opportunities to identify the most significant Schedule C noncompliance. The hobby loss provision applies to individuals, partnerships, S corporations, and trusts and estates, but not to C corporations. The focus of this review is the application of the hobby loss provision to individual taxpayers.

This review was performed at the SB/SE Division Headquarters in Lanham, Maryland, and in the SB/SE Division area offices in Los Angeles, California, and Atlanta, Georgia, during the period February through September 2015. We conducted this performance audit 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. 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] A processing year is the calendar year in which the tax return or document is processed by the IRS.

Results of Review

The IRS can improve its methods of addressing taxpayers who offset their income with hobby losses. Specifically:

- IRS methods for identifying high-income taxpayers who may be offsetting their income with hobby losses do not maximize the use of all relevant taxpayer information available to the IRS.
- When returns containing potential hobby losses are selected for audit, the examiners do not always address the hobby losses.

The IRS Does Not Maximize the Use of Relevant Taxpayer Data to Select the Highest Risk Hobby Loss Cases

When a return is filed at an IRS processing campus,[8] it goes through a series of checks to ensure that all applicable schedules and forms are attached and that it is free of mathematical errors, among other things. After returns are processed, the IRS uses multiple sources for selecting returns for examination. One source is through the use of Discriminant Function (DIF) formulas. The DIF system uses mathematical formulas to score a return for the probability of significant tax change to that return. Generally, the higher the DIF score for a given return, the higher the audit potential. In a typical year, approximately 40 to 60 percent of an SB/SE Division revenue agent's workload may come from returns selected using DIF scores. The IRS also selects returns using non-DIF methods, such as CIPs, to identify and examine tax returns from a group of taxpayers, *e.g.*, a particular type of occupation, tax issue, or tax return, who may have a specific area of tax noncompliance.

To determine the compliance rate with the tax law regarding hobby losses, we used data from the IRS's Individual Return Transaction File[9] and Individual Master File[10] to identify 9,699 individual returns for TY 2013 with wages of $100,000 or more that also contained a Schedule C with gross receipts of $20,000 or less and a loss of $20,000 or more.[11] These

[8] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[9] The IRS database that contains data transcribed from initial input of the original individual tax returns during tax return processing.
[10] The IRS database that maintains transactions or records of individual tax accounts.
[11] We used the Return Transaction Files for Processing Years 2010 through 2014 in our analysis. The data files were current as of December 31, 2014. Additionally, we eliminated horse racing, breeding, and training activities in our analysis since those activities have a longer period to establish profitability pursuant to I.R.C. § 183. A processing year is the calendar year in which the tax return or document is processed by the IRS.

taxpayers also reported losses in four consecutive years through TY 2013 for the same businesses. We used these criteria because the materiality of the taxable income offset would likely make these returns a high priority for IRS Examination resources. *******2***** ******************************2************************************* *******2*****.

For the 9,699 returns, the average reported wage income was $238,634, with 4,321 returns (45 percent) having total positive income of $200,000 or more and 372 having total positive income of $1 million or more.[12] More than 64 percent (6,231 of 9,699) of these returns also had gross receipts of less than $5,000, and almost 35 percent (3,373 of 9,699) had no gross receipts. The average reported Schedule C loss was more than $40,000, with a median loss of $28,889. Therefore, an individual in our sample population with an average wage income of $238,634 who reported a median Schedule C loss of $28,889 could inappropriately avoid as much as $8,000 in income taxes if the Schedule C loss was due to a hobby loss.[13] As of May 2015, 409 of the 9,699 returns (4.2 percent) had been selected for audit.[14] We researched the project code descriptions for the 409 returns, and none appear to have been selected exclusively for potential hobby losses, although the examiner could decide to include the issue in the audit.

From the population of 9,699 returns identified by our analysis, we randomly selected a statistically valid sample of 100 returns for review. Based on our review of the tax returns, we determined that 88 returns (88 percent) showed an indication that the Schedule C businesses were not being engaged in for profit. We estimate that 7,511 returns from the total sample population of 9,699 taxpayers may have inappropriately used hobby losses to reduce income taxes by as much as $70.9 million for TY 2013.[15]

IRS examiners are instructed to use the nine factors contained in Treasury Regulation § 1.183-2(b) to determine if an activity is engaged in for profit. We performed our raw data analysis primarily using the factor that considers the taxpayer's history of income or losses with respect to the activity. According to the I.R.C. § 183 Audit Technique Guide, this factor is one of the most important factors of the nine. This factor supports the framework stated in the following subsection of Treasury Regulation § 1.183-2(b)(6):

---

[12] Total positive income is the sum of the total positive values from the following income fields (losses are treated as a zero): wages, interest, dividends, other income, distributions, Schedule C Net Profits, and Schedule F (*Profit or Loss From Farming*) Net Profits.

[13] The example uses the TY 2013 marginal tax rate of 28 percent applicable to a taxpayer with a married filing jointly filing status, assuming the average wage income of $238,634 in our sample, reduced by the average itemized deduction of $56,664 in our sample and the TY 2013 married filing jointly exemption amount of $9,640. Hypothetical examples in this report are not drawn from any actual taxpayer's case.

[14] More returns will likely be selected for audit before the statute of limitations expires for TY 2013 returns.

[15] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 6,967 and 8,054. We are 95 percent confident that the amount by which hobby losses were used to reduce income taxes is between $57,622,873 and $84,108,329. For simplicity, we applied the tax rates for all returns using the married filing jointly filing status.

A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses, if not explainable as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.

We coordinated with the IRS to review our results, and the IRS reviewed 32 of our cases. The IRS concluded that all cases had potential hobby loss noncompliance. IRS officials informed us that they do not have an automated systemic capability to identify returns with losses for multiple tax years. In contrast, our sample population came from an analysis of returns from multiple tax years. In addition, IRS officials told us that other examination priorities limited the resources available to audit the additional hobby loss returns.

We compared the sample of 100 returns selected for our analysis to other returns selected by the IRS for a recent CIP on the hobby loss issue and found that the DIF scores for our returns were generally the same as the returns selected by the IRS for its CIP.[16] Furthermore, early results from the CIP are showing significantly better productivity statistics than DIF-selected returns, as shown in Figure 2.[17]

Figure 2: Comparison of DIF and CIP Audit Results

Type	Dollars Per Hour	No-Change Rate	Hours Per Return	Total Days To Close
DIF Examinations	$204	22%	43	262 Days
CIP Examinations	$498	12%	33	264 Days

Source: IRS closed Examination files for Fiscal Years 2014 and 2015.

Recommendation

Recommendation 1: The Director, Examination, SB/SE Division, should make use of its research capabilities to identify high-income individual returns with multiyear Schedule C losses and other factors that indicate the taxpayer may not have a profit or capital gain motive for the activity.

[16] We compared DIF scores for return types most frequently selected for the CIP.
[17] Our analysis compared the same type of returns, examination start dates, and tax periods for the same fiscal years. A fiscal year is any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

present. This lead sheet provides guidance for the examiners to evaluate the nine factors specified in Treasury Regulation § 1.183-2 to determine if a business is engaged in for profit.

Using IRS data for Processing Years 2010 through 2013, we identified 1,188 audits of TY 2012[18] individual returns that appeared to have hobby loss issues present because the returns reported Schedule C losses in four consecutive years from TYs 2009 through 2012. From the 1,188 returns, we reviewed 77 EQRS and 64 NQRS case files from the quality review systems. Because the returns showed Schedule C losses in four consecutive years, we also reviewed the activity records in the case files to determine if examiners took steps to identify whether the businesses might not be engaged in for profit.

From our review of the examination case files for the 141 returns from the population that had been reviewed in either the EQRS or NQRS, we determined that examiners should have addressed an I.R.C. § 183 issue in 10 cases, but the case file did not contain any documentation that the examiner had done so. The I.R.C. § 183 issue was also noted by IRS quality reviewers in three of the 10 cases. In reviewing the 10 cases, the IRS agreed that the I.R.C. § 183 issue should have been addressed in four cases and agreed in three cases that there was no documentation to show that the examiner took steps to address the I.R.C. § 183 issue. However, the IRS indicated that the pursuit of an I.R.C. § 183 issue in cases where the business is not a typical hobby loss business is normally time-consuming, since the examiner must develop the nine factors of Treasury Regulation § 1.183-2. Even when the examiner does approach the case using I.R.C. § 183, they also consider an alternative position of eliminating the expenses under other I.R.C. sections. However, as previously shown in Figure 2, the examiner hours per return were lower for returns selected under the I.R.C. § 183 CIP than for DIF-selected returns, and the total cycle days were similar.

Our review found that the Schedule C businesses were generally home-based and had poor recordkeeping. All the businesses had incurred large losses for several years that would have led a prudent businessperson to discontinue the business. Specifically, our review noted the following indications of potential I.R.C. § 183 issues that the examiners should have addressed in their audits:

- Minimal Schedule C income and large expenses for several years.
- A history of unprofitability and elements of personal pleasure and recreation were present.
- The Schedule C trade/retail businesses reporting losses for several years with no customers.

We also noted that the IRS examiners documented in all 10 cases that they had performed filing checks on prior and subsequent year returns for filing compliance and had performed a

[18] Taxpayers who filed TY 2012 returns with a Schedule C loss of $20,000 or more and also filed returns with Schedule C losses for TYs 2009 through 2011.

three-year Schedule C comparative analysis in six of 10 cases. However, the examiners did not note the multiyear losses as an unusual or questionable item or indicate a potential hobby loss issue in any of the case files.

Recommendation

Recommendation 2: The Director, Examination, SB/SE Division, should emphasize the importance of required filing checks in the preliminary determination of whether to pursue an I.R.C. § 183 issue and provide tools to assist examiners in documenting their conclusion.

> ***Management's Response:*** IRS management agreed with this recommendation. The Director, Exam/AUR Policy, will update Internal Revenue Manual 4.10.5.3, *Prior and Subsequent Year Returns*, to include I.R.C. § 183 issues and will include a hobby loss example in the Fiscal Year 2016 briefing for Lead Sheet 130, *Multi-Year and Related Returns*, revisions. IRS management also stated that the Director, Exam Quality and Technical Support, will review the I.R.C. § 183 lead sheet, make any needed revisions, and provide the revised lead sheet for inclusion in the next available update.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS is taking sufficient action to minimize improper Schedule C, *Profit or Loss From Business*, losses claimed by taxpayers and the resulting loss of revenue to the Government. To accomplish this objective, we:

I. Determined the procedures for identifying individual tax returns claiming Schedule C losses during return processing at IRS campuses.[1] These included return processing instructions, Examination referral procedures, automated systems for identifying potential hobby losses, and examination classification criteria.

II. Determined examination productivity and reviewed quality data for individual returns to identify any trends in the identification of returns with Schedule C losses.

   A. Obtained IRS closed Audit Information Management System[2] data files for SB/SE Division examinations of individual returns from Fiscal Years[3] 2014 through 2015 (as of the third quarter).

      1. Calculated productivity indicators such as the overall no-change rate, assessed dollars per hour, and assessed dollars per return for DIF returns.

      2. Extracted data on examinations of returns for CIP[4] 0555 and calculated the productivity indicators listed in Step II.A.1. We compared these indicators to the overall productivity indicators calculated in Step II.A.1.

   B. Obtained access to the EQRS and obtained NQRS data for Fiscal Years 2011 through 2013. We reviewed judgmental samples[5] of closed Schedule C examinations on the EQRS and NQRS to determine if any quality problems with Schedule C hobby loss examinations were identified. Additionally, we reviewed the case files for the

[1] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[2] A computer system used by the IRS Examination functions to control returns, input assessments and adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[3] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[4] CIPs are a method used by the IRS to identify and examine tax returns from a group of taxpayers who may have a specific area of tax noncompliance.
[5] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population. Judgmental samples were used because we did not intend to project the results to the entire population.

reviews for which the EQRS and NQRS reviewer sheets did not mention that the hobby loss issue was addressed.

III. Identified returns reporting questionable Schedule C losses to assess the effectiveness of the Examination return selection process and the examination potential of returns with improper Schedule C losses in multiple years.

A. Selected TY[6] 2013 returns reporting a Schedule C loss. We matched the returns back three prior tax years that to ensure that the returns also reported losses in the prior tax years.

B. Analyzed and stratified gross receipts, total deductions, and total positive income.

C. Selected TY 2013 returns with Schedule C losses of more than $20,000 that also reported losses in the immediate three prior tax years (2012, 2011, and 2010).

D. Matched the returns identified in Step III.A to IRS Individual Return Transaction File[7] data to obtain the wages, other income, and adjusted gross income.[8]

E. Matched the data file in Step III.B to the Individual Master File to eliminate the returns with examination indicators (as identified using specific codes for transactions posted to the Master File, *i.e.*, Transaction Codes 300, 301, 420, or 421).

F. Reviewed a statistically valid random sample of 100 returns identified in Step III.C.[9] Our sampling criteria included a confidence level of 95 percent, a precision rate of 9.51 percent, and an expected error rate of 50 percent. We collaborated with our contracted statistician in developing the sampling plans and forecasts.

G. Coordinated with appropriate IRS personnel to review our analysis of questionable returns for groups of returns identified in Step III.C.

H. Selected random samples of 10 records from the Individual Return Transaction File for each of the tax years (TYs 2010 through 2013) and validated a total of 390 data fields against the IRS's Integrated Data Retrieval System. We also randomly selected 10 records from the Individual Master File for similar validation for a total of 110 data fields. We concluded that the data were adequate for our analysis because we did not identify any discrepancies in the validation.

[6] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[7] The IRS database that contains data transcribed from initial input of the original individual tax returns during tax return processing.
[8] As defined by Section 62 of the I.R.C., in the case of individual, adjusted gross income means gross income minus certain deductions.
[9] Selected TY 2013 returns that reported wages of $100,000 or more, gross receipts less than or equal to $20,000, and Schedule C loss of $20,000 or more. We used simple random sampling to ensure that each taxpayer had an equal chance of being selected from the population.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices (*i.e.*, systemic filters, file matching, *etc.*) for the processing and examination of individual returns containing a Schedule C with consecutive multiple years of losses. We evaluated these controls by reviewing source materials, interviewing management, and reviewing samples of closed examination cases.

Appendix II

Major Contributors to This Report

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Glen J. Rhoades, Director
Robert M. Jenness, Audit Manager
William Tran, Lead Auditor
Kenneth E. Henderson, Senior Auditor
John S. Park, Auditor

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Small Business/Self-Employed Division
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Exam Policy, Small Business/Self-Employed Division
Director, Exam Planning and Delivery, Small Business/Self-Employed Division
Director, Office of Research, Analysis, and Statistics
Director, Office of Audit Coordination

Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $70,865,612 from examining an additional 8,535 returns and making assessments to 7,511 returns[1] reporting hobby losses; $354,328,060 forecasted over five years[2] (see page 5).

Methodology Used to Measure the Reported Benefit:

We used Individual Return Transaction File[3] data for Processing Year[4] 2014 to identify TY[5] 2013 individual returns reporting a Schedule C, *Profit or Loss From Business*, loss of $20,000 or more. We reviewed the filing history of these returns for the three previous TYs (2010 through 2012) to identify the returns that had also reported losses in those years. We then identified 9,699 individual returns with wages of $100,000 or more and gross receipts of $20,000 or less.

We randomly selected a statistically valid sample of 100 returns from the population of 9,699 returns. Our review of this sample determined that 88 returns (88 percent) had a reasonable indication that the Schedule C losses met the definition of a hobby loss and therefore the taxpayers' deductions of the losses could be disallowed. We reduced this percentage by the no-change rate of 12 percent from the IRS's recent CIP on the hobby loss issue, leaving 77.4 percent of the sample population that would result in an examination assessment. Based on this exception rate, we estimate that 7,511 of the 9,699 returns in our population would have had hobby losses that were used to improperly reduce taxable income.[6]

[1] We estimated a no-change rate of 12 percent for the 8,535 returns examined.
[2] The five-year forecast for the potential for increased revenue is based on multiplying the base year result by five and assumes, among other considerations, that economic conditions and tax laws do not change.
[3] The IRS database that contains data transcribed from initial input of the original individual tax returns during tax return processing.
[4] A processing year is the calendar year in which the tax return or document is processed by the IRS.
[5] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[6] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 6,967 and 8,054.

To compute the estimated tax impact of $70,865,612,[7] we multiplied the original estimate of $80,529,106 by 88 percent (assuming the same 12 percent no-change rate as the IRS's recent CIP on the hobby loss issue). The original estimate of the tax impact was computed by adding back the Schedule C loss to the amount of taxable income for each sample return. Next, we computed the new tax due based on the revised taxable income and subtracted the taxes paid before tax credits. For simplicity, we used the married filing jointly tax rate in our computation regardless of the original filing status used on the returns.

[7] The point estimate projection is based on a two-sided confidence level. We are 95 percent confident that the point estimate is between $57,622,873 and $84,108,329.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

MAR 23 2016

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Opportunities Exist to Identify and Examine Individual Taxpayers Who Deduct Potential Hobby Losses to Offset Other Income (Audit # 201530029)

Thank you for the opportunity to review and comment on the subject draft audit report. We appreciate your acknowledgement of the numerous actions IRS has taken to address hobby loss non-compliance issues. These efforts include:

- Publishing an audit technique guide to assist examiners in determining and supporting their conclusion whether an activity is engaged in for profit.
- Producing an IRS video to educate taxpayers with direct seller businesses on reporting requirements for Schedule C and calculating gross receipts.
- Providing Small Business/Self-Employed Division (SB/SE) technical advisors to support examiners with identifying and developing hobby loss issues.
- Authorizing several Compliance Initiative Projects (CIPs) to examine tax returns with characteristics of noncompliance with the hobby loss provision.

Internal Revenue Code (IRC) § 183 limits the deductions of expenses for activities not engaged in for profit, also referred to as the "hobby loss" provision. While § 183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for three years of a consecutive five-year period (or two years of a consecutive seven-year period for activities that consist of breeding, showing, training, or racing horses), the absence of a profit in those years does not *per se* create a presumption that the activity is not engaged in for profit. Instead, Treasury Regulations provide a nonexclusive list of nine factors to analyze a taxpayer's profit objective. Given neither the Internal Revenue Code nor Treasury Regulations establish specific criteria to determine whether an activity is legitimately engaged in for profit, we agree with your 2007 report on this topic that IRC §183 poses significant challenges to tax administration.

It should be noted that the IRS, not the taxpayer, bears the burden of proving the taxpayer does not have a profit motive. Therefore, identifying returns with limited gross receipts, repetitive losses, and income from other sources, as used for your audit sample, is not sufficient to conclude that an activity was not engaged in for profit. A full

2

examination of the individual's books and records, addressing all nine factors outlined in the Treasury Regulations in light of the taxpayer's specific facts and circumstances, must be conducted to draw an accurate conclusion.

While we agree your use of certain filters may uncover a potential compliance risk, we do not agree with your presentation of the outcome measure of "additional revenue" in the amount of $70.9 million, $354.3 million over five years. The mere existence of two of the nine factors indicating the lack of a profit objective on the surface of the return is not conclusive. An examination which fully develops all nine factors outlined in the Treasury Regulations must be conducted. Further, we do not agree with your computation. While it does factor in the possibility that some audits may result in no adjustments, it incorrectly assumes that the Schedule C losses on the remaining 7,511 returns are hobby losses that would be disallowed in their entirety. Some losses may arise from the deduction of personal expenses or employee business expenses or may simply come from unsubstantiated deduction amounts while others may prove to be allowable within the laws and regulations.

We continually look for ways to improve our return selection processes to increase voluntary compliance and improve productivity. *******************************2************* ******************************2********************. We are in agreement with your recommendation and will continue to undertake efforts to identify high-income individual returns with multiple year Schedule C losses. We will also take steps to emphasize the importance of required filing checks in the preliminary determination of whether to pursue an IRC §183 issue, and provide tools to assist examiners in documenting their conclusions.

Attached is a detailed response outlining our corrective actions to address your recommendations.

If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director Examination, Small Business/Self-Employed Division at (513)263-3239.

Attachment

Attachment

RECOMMENDATION 1:
The Director, Examination, SB/SE Division, should make use of its research capabilities to identify high-income individual returns with multiple year Schedule C losses and other factors that indicate the taxpayer may not have a profit or capital gain motive for the activity.

CORRECTIVE ACTION:
SB/SE Exam will conduct an analysis of past and current Hobby Loss CIPs and look at the thresholds used by TIGTA to determine if a National CIP is warranted. We will also review our Discriminant Function (DIF) classification guidelines to determine if improved guidance to our classifiers on the hobby loss issue is warranted.

IMPLEMENTATION DATE:
March 15, 2017

RESPONSIBLE OFFICIAL(S):
Director, Examination Case Selection, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
The Director, Examination, SB/SE Division, should emphasize the importance of required filing checks in the preliminary determination of whether to pursue an IRC §183 issue and provide tools to assist examiners in documenting their conclusion.

CORRECTIVE ACTIONS:

1. The Director, Exam/AUR Policy will update Internal Revenue Manual section 4.10.5.3, Required Filing Checks – Prior and Subsequent Year Returns, to include reference to IRC §183 (Activities not engaged in for profit) and the five and seven year presumption periods.
2. The Director, Exam AUR/Policy will include a hobby loss example in the FY 2016 briefing for Lead Sheet 130, Multi-Year and Related Returns, revisions.
3. The Director, Exam Quality and Technical Support will review the IRC §183 lead sheet, will make any needed revisions, and will provide the revised lead sheet to Report Generation Software for inclusion in their next available update.

IMPLEMENTATION DATES:

1. September 15, 2017
2. November 15, 2016
3. November 15, 2016

2

RESPONSIBLE OFFICIALS:

1. Director, Exam/AUR Policy, Small Business/Self-Employed Division
2. Director, Exam/AUR Policy, Small Business/Self-Employed Division
3. Director, Exam Quality & Technical Support, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.