Nonfiler Profiles, Processing Year 1991

by Karla M. Daronco

The Internal Revenue Service (IRS) has initiated a multifaceted strategy designed to "bring taxpayers back into the system," i.e., to have them file their required tax returns. This strategy involves a combination of expanded outreach and education programs, as well as traditional methods of enforcement. It also include an initiative designed to identify groups of taxpayers with common characteristics in order to develop organizational solutions that remove barriers to compliance. Statistics of Income data can be used to identify these common characteristics.

Statistics of Income data show that the number of taxpayers filing delinquent returns (for a prior tax year) has been steadily increasing, e.g., an increase of 153 percent between Processing Years 1986 and 1991 for returns 4 or more years delinquent [1]. It was estimated that there were 2,773,582 prior-year returns processed during 1991, or 2.4 percent of the total filing population.

"Profiles" determine the common characteristics of noncompliant individuals and may enable the IRS to devise optimal strategies for encouraging these taxpayers to comply in the future. An important distinction in terms of IRS strategy relates to taxpayers who file delinquent returns "voluntarily," or who file as the result of direct, "one-on-one," enforcement activities. For instance, the data indicate that delinquent returns submitted voluntarily tend to be small in terms of refund or balance due amounts. These taxpayers also tend to be single wage-earners with no dependents, who claim the standard deduction. By comparison, delinquent returns secured through enforcement tend to have a balance due, have larger tax liabilities, and to be more complex in terms of itemized deductions. Taxpayers filing enforcement-secured returns tend to be wage-earners or are self-employed, and are single or married filing jointly. Through such profiles of taxpayer noncompliance, the IRS can attempt to improve its system of nonfiler detection and filing compliance.

Background

The IRS' Compliance 2000 program is a strategy designed to identify groups of taxpayers with common characteristics (market segment) and to develop organizational solutions that remove barriers to compliance while minimizing the burden on taxpayers. Compliance 2000, however, does acknowledge that not all taxpayers are alike — they may have different tax issues, different compliance behavior, and may differ demographically. Since taxpayers differ, the same approach to tax administration may not be effective or even appropriate for all taxpayers with similar non-compliance.

One measure in the development of a "market segment" is the creation of a taxpayer "profile" that would help in determining optimal strategies aimed at improving compliance. A nonfiler profile can be based on information, such as income level and amounts of deductions contained on taxpayers' delinquently-filed returns. Another aspect of the market segment analysis is to determine if the delinquent return resulted from direct IRS enforcement activities [2]. Since this taxpayer profile of noncompliance is based on statistics, it may illustrate the true characteristics of delinquent filers who come into the tax system. These characteristics may suggest a way to target these taxpayers, e.g., an educational awareness program may not be the answer for a well-educated professional but may be a viable option for a high-school dropout, eligible for the earned income credit.

Statistics of Income Program

Statistics of Income (SOI) samples of individual income tax returns have always included *all processed prior-year returns* (generally, about 2 to 3 percent of the total filing population). One rationale for including prior-year returns is that the SOI sample of individual income tax returns should reflect the filing characteristics of all taxpayers for a given processing year. "Substitute for returns" (SFR's) are not included in the sample [3].

A prior-year return is a return that is filed after the year in which the tax is due, e.g., a 1989 return filed in 1991. Hence, by definition, a prior-year return is a delinquently-filed return. Figure A shows the number of prior-year delinquent individual income tax returns for Processing Years 1986-1991. Returns delinquent 4 years or more increased by 153 percent over the 6-year period, from 92,653 in Processing Year 1986 to 234,806 returns in Processing Year 1991.

An important caveat is that SOI's ability to profile prior-year returns is based entirely on their being filed, processed and subject to sampling. In essence, SOI can only analyze "what comes in;" hence, it is necessary to note that SOI *cannot* measure the universe of "unknown" nonfilers *not in the system*. SOI can capture data on "unknown" nonfilers only *after* they file. More accurate terminology would be to refer to these returns as "delinquent" filers, whether they be "known" or "unknown" to the IRS system of data files that contain tax account information for individual taxpayers, such as the Individual Master File (IMF).

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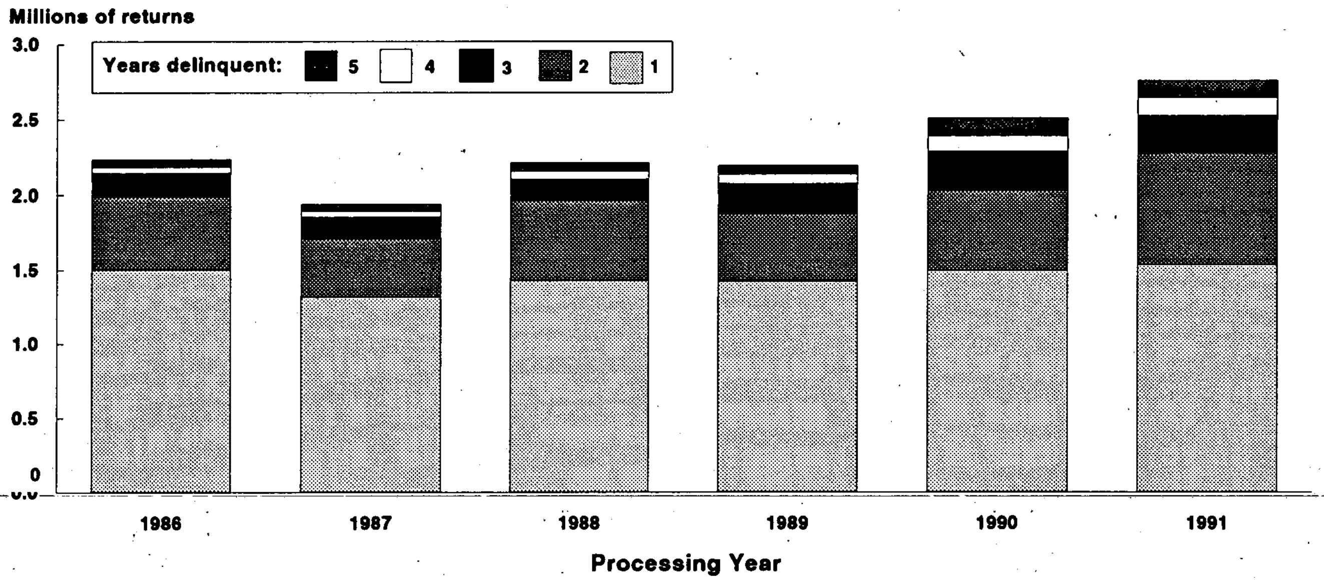
Figure A

Number of Prior-Year Delinquent Individual Income Tax Returns, by Length of Delinquency, Processing Years 1986-1991



Characteristics of Prior-Year Returns

The distinction between returns that are filed as a result of direct IRS enforcement contact (hereafter referred to as submitted through "enforcement") and those that are "voluntarily" filed without any IRS enforcement activity is very important in the analysis of prior-year returns [4]. Figure B classifies current- and prior-year returns for Processing Year 1991 into three groups: returns with refunds, those with a balance due, and "even" returns [5]. A determination as to whether prior-year returns were secured through enforcement or were voluntarily submitted was made by matching the SOI sample of individual income tax returns against the IRS Individual Master File (IMF) which contains taxpayer transaction codes [6].

The characteristics of current- and prior-year returns are often very different. For example, Figure B shows that 74 percent of current-year or timely-filed returns were refund returns. However, slightly over 62 percent of the voluntarily-filed prior-year returns were refund returns, whereas, only 43 percent of enforcement-secured prior-year returns showed refunds. Current-year returns with "even" amounts of tax liabilities and prepayments accounted for 3 percent of the total timely-filed returns, while "even" prior-year returns comprised 9 percent and 8 percent of the total, respectively, for voluntarily-filed and enforcement returns. About 23 percent of the current-year returns had a balance due. By comparison, almost half of the prior-year returns which were secured through enforcement had a balance due.

A comparison can also be made of current- and prior-year returns by the size of the refund and balance due (Figure C). These characteristics are important because delinquent filers who have tax liabilities represent delayed revenues to the Federal Government. Refund returns are also important because people who are due refunds are not receiving their rightful amounts under the law, particularly in the case of citizens entitled to the earned income credit.

The majority of the current-year returns had refunds. For Processing Year 1991, the largest number fell within the under-$500 refund size category, comprising almost one-third (32 percent) of the total number of current-year returns. For nearly one in four timely-filed returns, refunds of $1,000 or more were due. However, current-year returns that had a balance due and fell within the under-$500 size category accounted for only 12 percent of the total number of timely-filed returns.

By comparison, more than one in three of the total number of prior-year returns that were voluntarily filed were refund returns that fell into the under-$500 size category (36 percent). Only 13 percent of the prior-year voluntarily-filed returns had a balance due under $500. For almost 5 percent, between $500 and $1,000 was due, and for only 11 percent was there a balance due of $1,000 or more. Further analysis reveals that 83 percent of voluntarily-filed returns with balances due of $1,000 or

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Figure B

Individual Income Tax Returns: Percentage of Returns with a Refund or Balance Due at Time of Filing, by Type of Return, Processing Year 1991

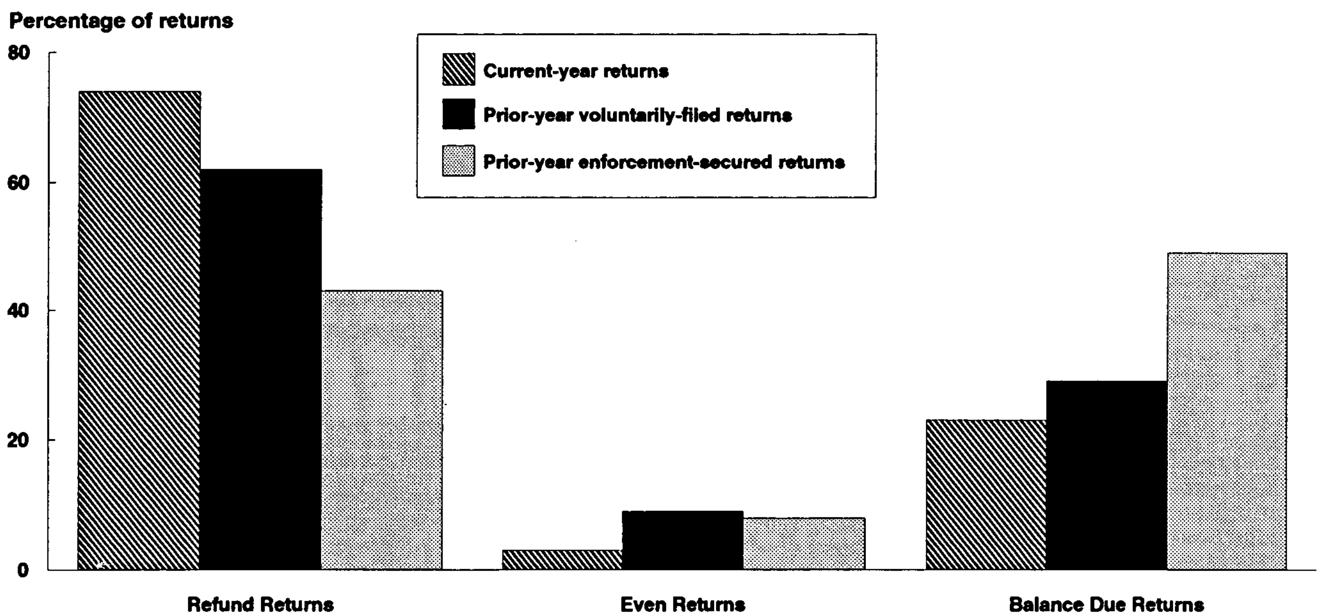
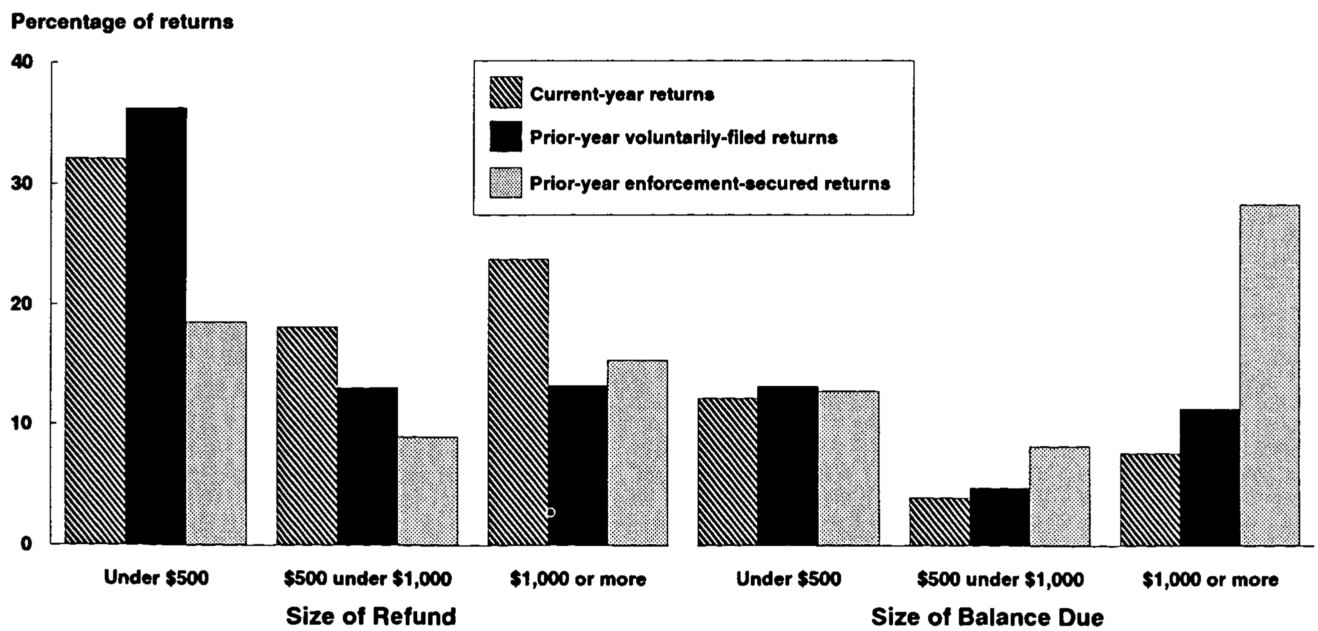


Figure C

Individual Income Tax Returns: Percentage of Returns by Size of Refund and Balance Due at Time of Filing, by Type of Return, Processing Year 1991



more actually fell within the $1,000-$5,000 size category, while 13 percent fell within the $5,000-$10,000 class. For the remainder, each balance due was at least $10,000.

Returns that fell into the balance due of $1,000-or-more category accounted for 28 percent of the total number of prior- year enforcement-secured returns. Of these, 66 percent fell within the $1,000-$5,000 size class, while 23 percent fell within the $5,000-$10,000 category. Of the prior-year enforcement-secured returns, 18 percent were returns with refunds under $500 and 15 percent had refunds of $1,000 or more.

The size of refunds or balance due for delinquent filers reveals that, as expected, the majority of IRS enforcement activity was concentrated on those returns with a larger tax liability (the $1,000-or-more size class) and that many delinquent taxpayers voluntarily filed returns for small refunds (under $500). Based on a survey conducted by the IRS, procrastination (24 percent) and ignorance of the tax laws (11 percent) were cited as the most common reasons for not filing tax returns [7].

Income Characteristics

A chief characteristic of prior-year returns is the difference in the type of income reported, depending on whether the return was voluntarily filed or secured through enforcement. As Figure D shows, over eight in ten (82 percent) voluntarily-filed prior-year returns showed wages. About three in ten (29 percent) reported interest or dividends and one in five reported income from a nonfarm sole proprietorship (Schedule C) [8].

By comparison, based on Processing Year 1991 data, enforcement-secured prior-year returns generally are:

- less likely to have wages (68 percent),
- more likely to have interest or dividend income (about 50 percent),
- and much more likely to have sole proprietorship (Schedule C) income (44 percent); in other words, are more likely to be self-employed.

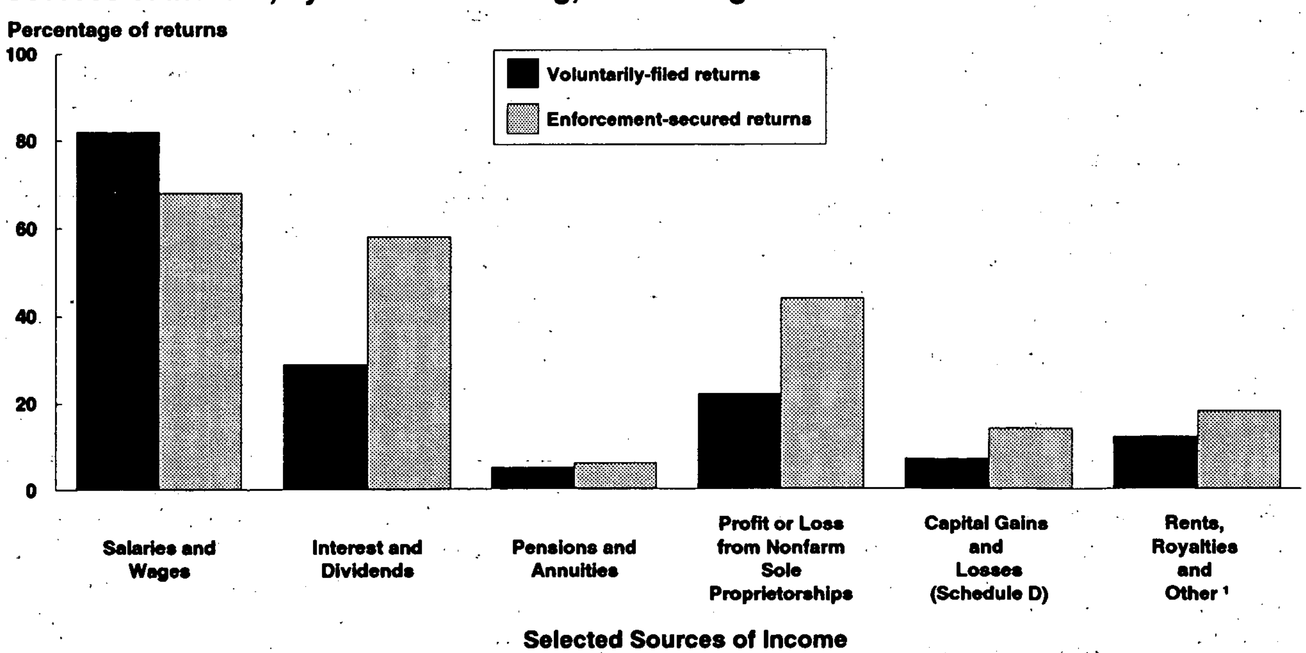
Enforcement-secured returns were more likely to include income that was not cross-checked by the IRS through "information reporting" [9]. For example, they are about twice as likely as voluntarily-filed prior-year returns to show income from capital gains or losses (Schedule D) [10].

Deduction Characteristics

Another characteristic used to profile delinquent filers is the type of deductions they claimed. As Figure E shows,

Figure D

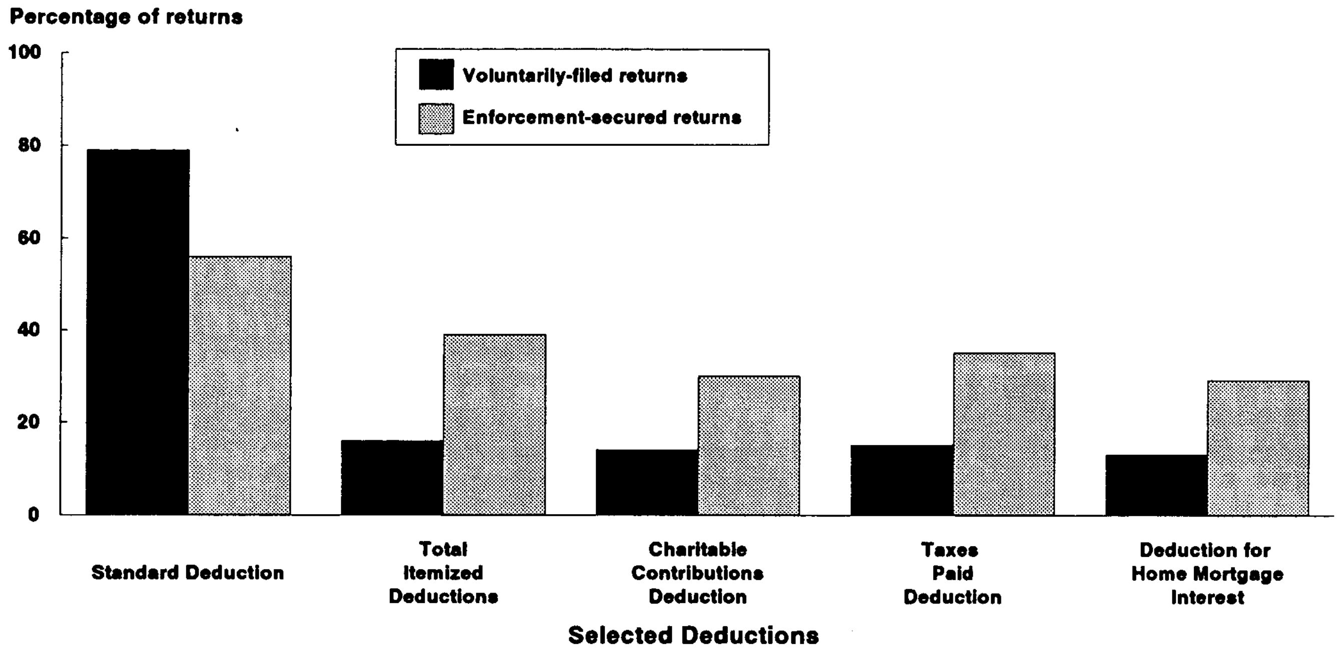
Prior-Year Delinquent Individual Income Tax Returns: Percentage of Returns with Selected Sources of Income, by Reason for Filing, Processing Year 1991



[1] Includes income from partnerships, S Corporations, estates and trusts.

Figure E

Prior-Year Delinquent Individual Income Tax Returns: Percentage of Returns with Selected Deductions, by Reason for Filing, Processing Year 1991



about eight in ten voluntarily-filed prior-year returns showed a standard deduction, whereas approximately 15 percent of voluntarily-filed prior-year returns showed deductions for charitable contributions, taxes paid or home mortgage interest. By contrast, a much higher proportion of enforcement-secured returns showed itemized deductions (39 percent). In particular, a higher percentage of these returns indicated:

- deductions for charitable contributions (30 percent),
- deductions for taxes paid (35 percent), and
- deductions for home mortgage interest (29 percent).

Total Positive Income

Prior-year returns may also be profiled by classifying them by the size of "total positive income" (TPI), for both voluntarily-filed and enforcement-secured returns [11]. The information shown in Figure F indicates that a large proportion of prior-year returns that were filed voluntarily fell within the under-$50,000 TPI-size class (93 percent of the total). As expected, enforcement-secured returns tended to be larger. While only 7 percent of the voluntarily-filed returns had TPI of $50,000 or more, 19 percent of the enforcement-secured returns had TPI of this size. The largest single category of enforcement-secured prior-year returns fell within the $20,000-$50,000 TPI-size class. These returns comprised 40 percent of the total. The second highest category (19 percent) fell in the $10,000-$20,000 range. Overall, 78 percent of the total prior-year enforcement-secured returns had TPI of $10,000 or more.

Additional Characteristics of Delinquent Filers

A comparison of timely-filed returns and prior-year returns by the number of dependents claimed, based on the 1991 data, shows that timely-filed returns are more likely to have no dependents (64 percent) than voluntarily-filed and enforcement-secured prior-year returns, 59 percent and 46 percent, respectively (Figure G) [12]. Taxpayers claiming one or more dependents are less likely to file timely and even less likely to file voluntarily. About 36 percent of taxpayers who filed returns on time had one or more dependents, compared to over 50 percent of the enforcement-secured prior-year returns.

A comparison between timely-filed returns and prior-year returns by filing status shows 44 percent of timely-filed returns were from taxpayers claiming single filing status (Figure H). Only 34 percent of enforcement-secured returns claimed single status. A large proportion (44 percent) of enforcement-secured prior-year returns were joint returns. Only 28 percent of voluntarily-filed prior-year returns were jointly filed. About 6 percent of

Figure F

Prior-Year Delinquent Individual Income Tax Returns: Percentage of Returns by Size of Total Positive Income, Processing Year 1991

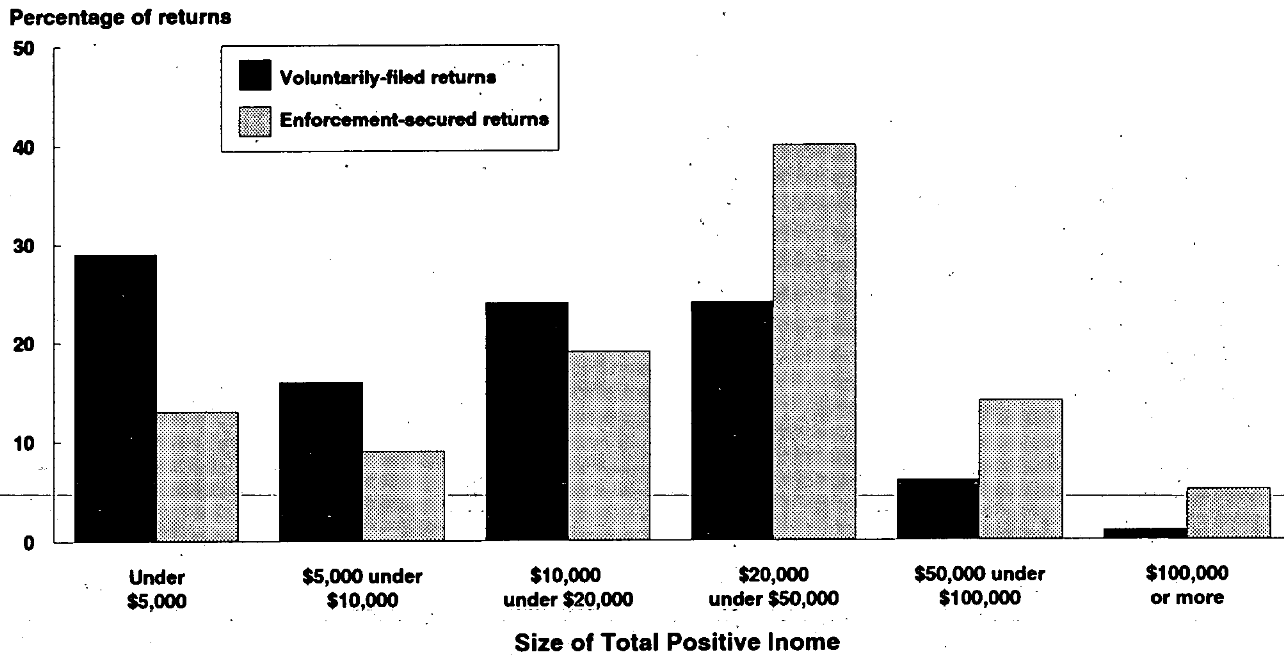


Figure G

Individual Income Tax Returns: Percentage of Returns by Number of Dependents, by Type of Return, Processing Year 1991

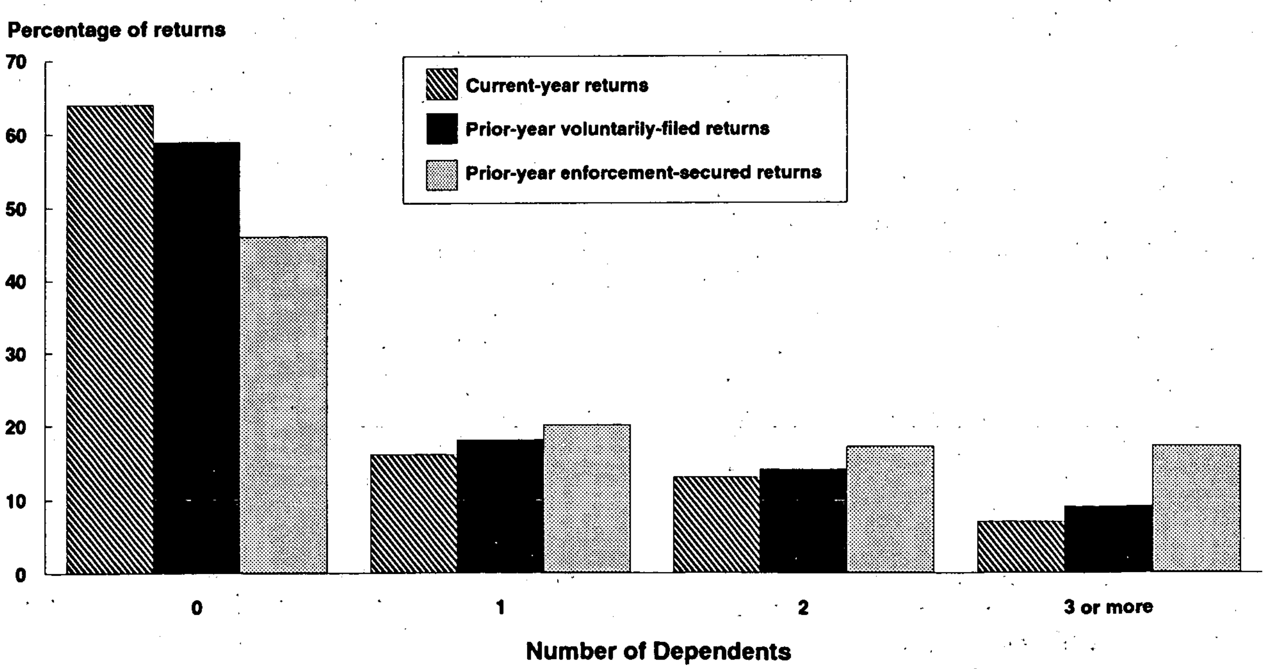
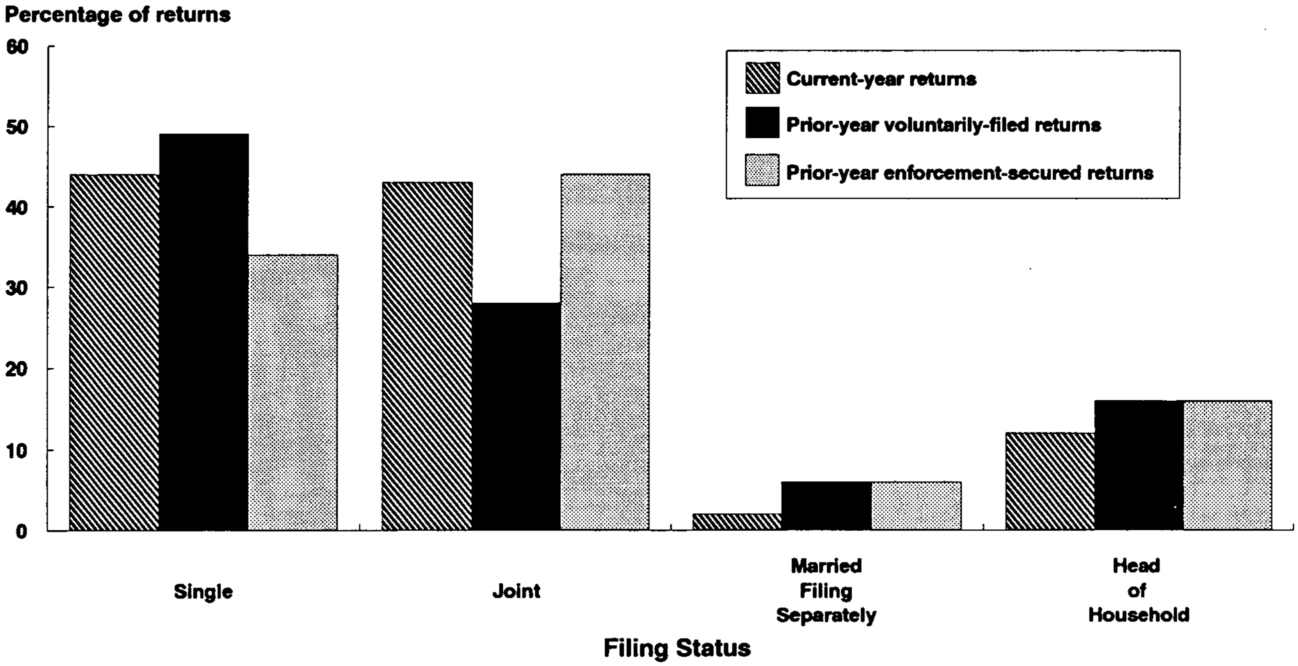


Figure H

Individual Income Tax Returns: Percentage of Returns by Filing Status, by Type of Return, Processing Year 1991



voluntarily-filed and enforcement-secured prior-year returns were for married couples filing separately, as compared to only 2 percent of timely-filed returns. The trauma of separation is often cited by taxpayers to IRS revenue officers as a reason for not filing [13]. Prior-year return filers are also more likely to claim head of household filing status (16 percent compared to 12 percent for timely-filed).

Summary

Taxpayer profiles are necessary to measure patterns and trends of noncompliance, as well as to determine insofar as possible the characteristics of nonfilers at the present time. The goals of Compliance 2000 strive to tailor an approach for these individuals to bring them "back into the system." The decision by an individual not to file on time can cause economic losses to both the nonfiler and to the U.S. Government. Unclaimed refunds, for example, are cases in which people harm themselves. However, a major financial problem is unpaid tax liabilities which represent a drain on the resources of the U.S. Government and, ultimately, are subsidized by society as a whole. Through profiles of taxpayer noncompliance, the IRS can improve its system of nonfiler detection and establish programs to increase filing compliance.

Data Sources and Limitations

The data presented in this article are for Processing Year 1991 and are based on prior-year returns included in the stratified sample of individual income tax returns, Forms 1040, *U.S. Individual Income Tax Return*, used for *Statistics of Income–1990, Individual Income Tax Returns*. The total sample of 104,277 returns was selected from a population of 113,717,138 returns.

About 2.4 percent of the sampled returns were for tax years prior to 1990. Statistics of Income samples include *all processed prior-year returns* (except for SFR's), regardless of the tax year. After weighting the sample, it was estimated that there were 2,773,582 prior-year returns processed during 1991. For further information about the SOI sample and about sampling variability, see *Statistics of Income–1989, Individual Income Tax Returns*. The Description of the Sample section of this publication describes the sample criteria and selection, the method for estimation and the sampling variability of the estimates contained in the report. It also describes some of the limitations of the data.

Notes and References

[1] The term processing year refers to the actual calendar year in which the IRS processes a taxpayer's return,

e.g., a Tax Year 1990 return was normally processed in Calendar Year 1991. In general, the processing year is the year in which the return is filed.

[2] This information can be obtained from the IRS Individual Master File (IMF) which provides tax account information for all taxpayers. It contains information which identifies the taxpayer, such as name, address and social security number. It also contains information regarding transactions relating to adjustments, penalties, tax collections and notices.

[3] When a taxpayer does not file a return, the IRS issues a series of reminder and delinquency notices. If the taxpayer continues to be delinquent, the IRS may choose to file a "substitute for return" (SFR) for the taxpayer. Using the standard deduction and income information available from Form W-2, *Wage and Tax Statement*, and other information returns, the IRS computes the tax liability and penalties for the taxpayer. A bill for the outstanding amount is then issued. Mainly because only the standard deduction is included in the calculation, the tax amount due may be higher than if the taxpayer had filed a return. SFR assessment data are made on a fiscal year basis (counts by tax year are not available). In Fiscal Years 1992 and 1993, the number of SFR assessments averaged 400,000; this does not include the actual number of returns the taxpayer filed after an SFR assessment notification was made.

[4] The IRS has information on many individuals for whom a return for a given year has not been filed. This information may be from third parties who filed "information returns" (such as Form 1099-DIV, *Statement for Recipients of Dividends or Distributions*) or may be based on previous return filings. However, for this article enforcement-secured returns are defined as those for which the IRS sends a "demand notice" or investigates because of information available that indicates a filing requirement should have been met.

[5] A current-year return is filed during the year following the tax year for which it is due, e.g., a 1990 return filed in 1991. A refund return includes those for which the taxpayer elects to credit an overpayment to the estimated tax due for the next year, as well as an overpayment refunded to the taxpayer. Balance due represents the tax due at the time of filing and is therefore calculated before any remittance submitted with the return is credited. An "even" return occurs when there is no tax liability and no prepayment credits or, in rare instances, when the tax liabilities exactly match the prepayments.

[6] The Individual Master File (IMF) contains enforcement transaction codes which indicate that either a notice has been sent to a taxpayer requesting a return, or that there is a "taxpayer delinquency investigation" (TDI) underway. A TDI normally signifies "one-on-one," personal contact by telephone or in person that was initiated by IRS. By obtaining a file containing these codes and matching the records against the sample of tax returns used for *Statistics of Income–Individual Income Tax Returns*, it was determined whether prior-year returns were secured through enforcement (based on the presence of a transaction code) or voluntarily submitted (based on the absence of a transaction code).

[7] Data were obtained from the Taxpayer Compliance Measurement Program, *1988 Individual Nonfiler Survey*, which was developed to profile nonfilers. This survey provides the best depiction of individual tax return filing compliance levels. The survey used a scientifically selected random sample of potential individual nonfiler entities. For further information, see "Self-Employed Nonfilers, 1988," in this issue of the *Statistics of Income Bulletin*.

[8] Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, is an attachment to the Individual Income Tax Return, Form 1040. It is used by the self-employed individual to report income and expenses associated with the operation of a nonfarm business, or practice of a profession, as a sole proprietorship.

[9] The Information Reporting Program (IRP) is part of the Information Returns Master File (IRMF) which is a system designed to collect selected data, such as taxpayer identification numbers (TIN's), payee names and addresses, and payer names and addresses, from documents such as Form 1099-INT, *Statement for Recipients of Interest Income*, and Form W-2, *Wage and Tax Statement* (see also, footnote 4). The IRS uses the program to verify the amount of income claimed on an individual's income tax return and has enforcement programs which are generally based on information derived from the IRP program. Information returns tell the taxpayers how much they have to report. On the other hand, taxpayers having no income or small amounts below the reporting threshold for a given return *may not receive* an information return, but must maintain their own

records contemporaneously as income is earned and expenses incurred.

[10] Schedule D, *Capital Gains and Losses*, is an attachment to the *Individual Income Tax Return*, Form 1040. It is generally used to report the sale or exchange of a "capital asset."

[11] Total positive income (TPI) measures gross income reported on tax returns before losses. Specifically, it sums all the positive amounts of income on the Form 1040 and accompanying schedules, before losses, exclusions, adjustments or deductions, such as payments to an Individual Retirement Account (IRA), used in computing "adjusted gross income." Adjusted gross income (AGI) is what remains after these subtractions.

[12] The number of dependents are for children at home or away from home, parents and others. It does *not* include *exemptions* for the taxpayer or spouse.

[13] As part of the IRS' Nonfiler Strategy program, a pilot survey of nonfiler examinations was conducted in 1992 for use within the IRS, based on information furnished by IRS examination and collection agents. The case studies provided examples of the type of delinquent taxpayers identified and provided some insight regarding the causes of nonfiling.