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Does credit-card information reporting improve small-business tax compliance?

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ABSTRACT

We investigate the response of small businesses operating as sole proprietorships to Form 1099-K, an information report introduced in 2011 which provides the Internal Revenue Service with information about electronic sales (e.g., credit card sales). The overall impact of the policy appears to be relatively small. However, theory and distributional analysis isolates a subset of taxpayers expected to be especially sensitive to reporting, who report receipts equal to or slightly exceeding the receipts reported on 1099-K. Among this set of taxpayers, information reporting induced more complete tax reporting–30% of sensitive taxpayers filed a return declaring business income for the first time, and among those that were already filing, we estimate an increase in reported receipts by up to 24%. These taxpayers largely offset increased reported receipts with increased reported expenses, which do not face information reporting, diminishing the impact on reported net taxable income.

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1. Introduction

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Data from randomized audits and other administrative data suggest that, in 2006, $385 billion in taxes legally owed to the United States government were not remitted, amounting to about 14.5% of total tax payments required by the law (Internal Revenue Service, 2012). To combat tax evasion, Congress has historically subjected various types of income to third-party information reporting, which dramatically increases compliance for those income types. In 2006, for example, 99% of wage and salary income subject to information reporting and withholding was, according to the IRS, properly reported and taxed, compared to an estimated 44% compliance rate for taxable income subject to little or no information reporting (Internal Revenue Service, 2012). While subjecting individual wage and salary income to information reporting by employers has proved successful at sustaining very high rates of compliance, tax

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enforcement for small businesses is more challenging. Small businesses often collect receipts in cash, keep poor or no records, have no external financial reporting requirements, and are closely held—all factors that can facilitate under-reporting of tax liability.[1]

In this paper, we study a recent attempt to curb small-business tax evasion in the United States. Beginning in 2011, electronic payments received by businesses (for example, credit card payments) were reported to the IRS and businesses by the firms processing these payments, via the new Form 1099-K—"Payment Card and Third Party Network Transactions".

There is good reason to suspect the effect of the Form 1099-K might differ from that of existing information reporting. Taxpayers can still be noncompliant by under-reporting their cash receipts, and they can substitute expense over-reporting for receipt under-reporting.[2] Economic theory predicts that businesses affected by Form 1099-K should report their receipts close to the amount reported on Form 1099-K. These firms should have (1) a high propensity to under-report receipts prior to the introduction of information reporting, and/or (2) a high share of true receipts subjected to information reporting. When a firm reports very little to the IRS before the Form 1099-K appears (the first trait), and the 1099-K then informs the IRS about a large amount of their receipts (the second trait), that firm is likely to increase its reported receipts in response to the policy change. These two firm-level traits are likely to be closely linked in our setting, due to the paper trail created by electronic payments: firms that are noncompliant because their sales are predominantly transacted in cash will also have a small share of their receipts subjected to information reporting.

We test these predictions using newly available confidential data from the Internal Revenue Service (IRS), consisting of the universe of sole proprietors' tax returns (Form 1040, Schedule C) and the information reports about these sole proprietors from tax years 2004 to 2012.[3] The empirical analysis suggests that the aggregate effect of the Form 1099-K on reported receipts was small, but also confirms the prediction of the theory: approximately 10% of Schedule C firms report their gross receipts within 5% of the gross amount on the 1099-K's they receive. We estimate that Form 1099-K caused up to 30% of taxpayers in this particular group to start filing Schedule C. For firms in this group that had already been filing Schedule C, 1099-K caused increases in reported receipts of up to 24%, although these firms also increased their reported expenses by as much as 13%.

We conduct additional analysis to deepen our understanding of the results. First, we examine different reasons a firm might bunch where reported receipts are equal to or just above the 1099-K amount. Bunching may occur because firms believe that reporting receipts above the 1099-K amount avoids triggering an audit by contradicting third-party information, or because all or virtually all of a firm's receipts are subjected to credit-card information reporting (as may be the case with exclusively online businesses). However, for various reasons we would expect it to be unusual to observe reported receipts equal *exactly* to the 1099-K amount.[4] Based on their reported sectors (which isolates firms that are likely accepting some cash) and the types of entities issuing their 1099-K's (which isolates firms that are likely online-only), we conclude that both of these potential drivers of bunching in response to Form 1099-K are supported by the data. Businesses that were previously subjected to information reporting under Form 1099-MISC[5] were less likely to bunch where receipts approximately equal 1099-K amounts, but those that did bunch displayed similar increases in their reported receipts and expenses. We fail to find any substantive differences based on whether the taxpayer used a paid preparer, and no evidence that the Form 1099-K caused firms to begin using a paid preparer.

Taxpayers also bunch where reported receipts are exactly equal to reported expenses, and firms bunching at where receipts equal the gross 1099-K amount are disproportionately likely to do so. We also find that the subset of taxpayers that received Form 1099-K but did not file in previous years were much more likely to report expenses exactly equal to receipts, consistent with our claim that increased reporting of receipts (on the intensive and extensive margin) was accompanied by offsetting increases in expenses. Finally, we examine the composition of expenses to see precisely where taxpayers increased expense reporting to offset increased receipts reporting, and find increases occurred primarily in the "Other Expenses" line item.

This paper contributes to the academic literature examining tax administration, enforcement and compliance, as detailed in Slemrod and Gillitzer (2013), and expands this literature to investigate the effects of information reporting on sole proprietors. The paper also contributes to a nascent but rapidly growing empirical literature on tax systems, especially that considering the role of information in business taxation (e.g., Pomeranz, 2015; Almunia and Lopez Rodriguez, 2014; Carrillo et al., 2014; Naritomi, 2014; Best et al. 2015; Bachas and Soto, 2015). A common theme in much of this work and in our own findings is that it is important to consider a business's decision to report receipts and expenses jointly. In addition, policymakers are likely to find these results useful when considering a further expansion of information reports or changing the requirements around existing returns. Finally, the results can be used by the IRS to better target audits toward taxpayers receiving 1099-K who are relatively unlikely to be reporting truthfully.

2. Background and institutional details

The tax authority's lack of information is a ubiquitous problem in tax enforcement, and one that is especially pervasive for smaller businesses where formal records of financial transactions are often not well maintained. They also frequently accept payments in difficult-to-monitor cash, exacerbating the tax enforcement problem (Gordon and Li, 2009). Indeed, Morse et al. (2009, 39) assert, based on extensive interviews with small business owners and their accountants, that income source is "by far the most important determinant of tax compliance… Taxpayers report cash income less accurately than income subject to third party reporting."

The introduction of Form 1099-K is part of a recent trend in the United States and elsewhere toward expanding third-party information reporting, providing tax authorities with relatively objective information from a third party, thereby increasing the likelihood of detecting

[1] Throughout the paper we use the terms "taxpayer", "small business", and "firm" to refer to the taxpayers receiving the 1099-K. Schedule C – "Profit of Loss From Business (Sole Proprietorship)"filers are traditionally thought of as owners of small businesses, but in reality the income of some rather large entities is reported on Schedule C. There are a variety of definitions for "small business" in the literature, and not all taxpayers in our sample will fit these definitions. Throughout our paper, our entities of study can most accurately be called "Schedule C Filers".

[2] Firms could also stop accepting payment cards, incent cash payments by offering discounts for using cash, or take action to avoid certain thresholds that trigger 1099-K reporting. We are limited by our data in our ability to detect these responses. However, any such actions taken by firms would limit the impact of 1099-K on reported receipts and net incomes, and they would have an ambiguous effect on the tendency to report receipts equal to 1099-K amounts.

[3] Note that a more complete analysis of the initiative's impact would require a review of audit data, but such audit data will not be available in the near future. Note also that many non-Schedule C entities also receive the 1099-K, and these are absent from our analysis. In total, 34% of the 7.4 million valid, non-duplicate 1099-K's are matched to a Schedule C.

[4] For example, if firms allow customers to include sales taxes with their payment card, the sales tax amount will be reported on 1099-K, but, will not be included in gross receipts. Similarly, if firms allow customers to return goods purchased with a payment card, it may also cause a discrepancy making it so the 1099-K amount cannot equal true receipts exactly. Finally, the purchase of gift cards by credit card that are not ultimately redeemed, redeemed in a different period that purchased, or purchased at a store other than where redeemed, can result in a discrepancy between 1099-K receipts and true receipts.

[5] Form 1099-MISC is provided to independent contractors providing a service, and requires that payments of $600 or more for services provided in a given year be reported to the IRS by the entity purchasing the service.

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