Nonfiler Profiles, Fiscal Year 1993

by Laura R. Rosage and Karla M. Daronco

The Internal Revenue Service (IRS) initiated a multi-faceted strategy designed to "bring individual taxpayers back into the system," by having them file their required tax returns. This strategy involves a combination of expanded outreach and educational programs, as well as traditional methods of enforcement. It also includes an initiative designed to identify groups of individuals having common characteristics or "profiles" to enable the development of more effective organizational solutions to noncompliance. Data from the Enhanced Nonfiler Database, containing information on the 1.7 million taxpayers who filed more than 2.5 million delinquent tax returns in Fiscal Year (FY) 1993, can be used to identify these common characteristics.

Taxpayer "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. For the purposes of this article, the "profile" of taxpayers who file delinquent returns "voluntarily" is distinct from those who file as a result of enforcement activities. The data indicate that delinquent returns filed voluntarily tend to be smaller in terms of refund or balance due amounts. In contrast, delinquent returns secured through enforcement tend to have larger tax liabilities or balance due amounts. With knowledge of these and other common characteristics, the IRS is in a better position to improve its system of nonfiler detection and use of resources to effect filing compliance.

Background

The IRS has 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. This strategy, however, does acknowledge that all taxpayers are not alike -- they may have different tax issues, different compliance behaviors, and different demographic characteristics. Because of these differences, the same approach to tax administration may not be effective or even appropriate for all taxpayers. Since taxpayer profiles of noncompliance are based on statistics, they may illustrate the true characteristics of delinquent filers who come into the tax system. These characteristics may suggest ways to target taxpayers. For example, 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. It should be noted, however, that developing an effective treatment for market segments will not be an easy process. There will likely be a need to conduct additional studies to gather further information that describes the cause(s) of noncompliance with the tax laws.

One factor in developing a nonfiler market segment is the creation of a "profile" of the market segment to help determine the "best" strategies for improving compliance. The nonfiler profile can be based on such information as income level and amounts of deductions reported on taxpayers' delinquently-filed returns. Another aspect of the market segment analysis is to determine whether the delinquent return resulted from direct IRS enforcement activities, i.e., from reminder-to-file notices or one-on-one personal contact.

Starting in Fiscal Year 1992, additional nonfiler strategies were initiated to identify nonfilers and bring them back into the system. In order to study the effectiveness of the strategies, the Nonfiler Database was created for each fiscal year. This Database is a file with selected information, by taxpayer, from the Individual Master File (IMF) for returns filed one day or more after the return due date or extended due date. The returns on this file are classified into two segments: late filers and delinquent filers. A late filer is any individual return received one day or more after April 15 (or the extended due date), but less than 360 days. A delinquent filer is any individual return filed 360 days or more after the return due date.

Characteristics of Delinquent Filers

There were 2.5 million delinquent returns filed by 1.7 million individuals in FY 1993, an average of 1.5 returns per taxpayer. The number of delinquent returns filed by these 1,727,466 taxpayers shows the majority of delinquent taxpayers, 71 percent, filed only one delinquent return (Figure A). More than 18 percent of the delinquent filers filed two delinquent returns, while the remaining 11 percent of delinquent filers filed three or more delinquent returns. In fact, one delinquent taxpayer alone filed 27 delinquent returns in FY 1993. How many years late the 2,563,312 delinquent returns were varied (Figure B). More than 43 percent of the delinquent returns filed in FY 1993 were only one year late (at least one year, but less than two years late), while 41 percent were either two or three years late [1].

The distinction between returns that are filed as a direct result of IRS enforcement (hereafter referred to as submitted through "enforcement") and those that are "voluntarily" filed without any IRS enforcement activity is very

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Figure A

Delinquent Individual Income Tax Returns: Number of Returns Filed Per Taxpayer, Fiscal Year 1993

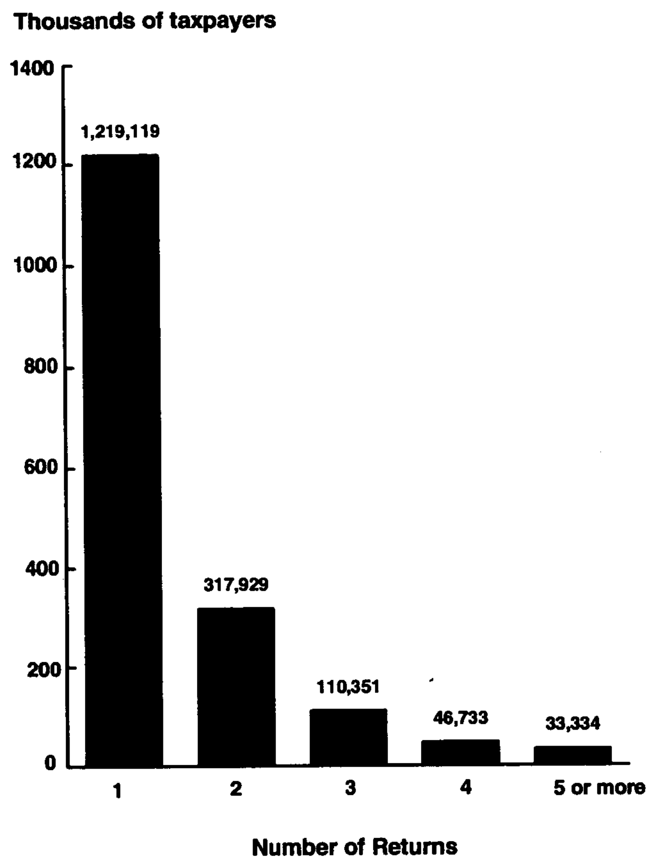
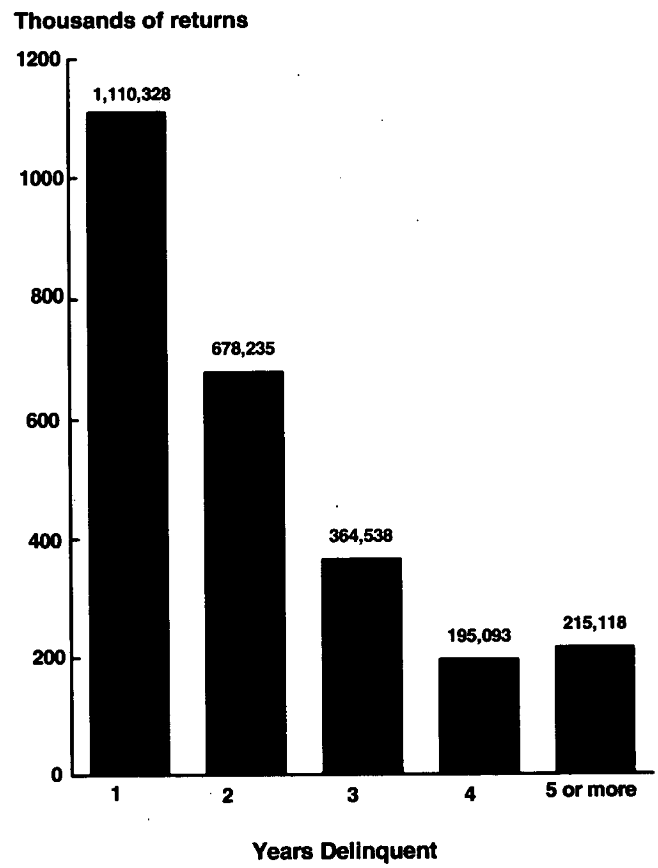


Figure B

Delinquent Individual Income Tax Returns: Number of Years Late, Fiscal Year 1993



important in the analysis of delinquent returns[2]. The data show that delinquent returns are 1.6 times as likely to be secured through enforcement as those voluntarily filed.

The delinquent returns in FY 1993 (Figure C) are classified into three groups: returns with refunds, those with a balance due, and "even" returns (in general, with neither a refund or balance due) [3]. 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 tax credit. The data show that 979,733, or more than 38 percent, of the delinquent individual income tax returns processed in FY 1993 were refund returns. These taxpayers were owed a total of nearly $1.0 billion. However, of the total delinquent refund returns, 198,521, or 20 percent, were returns with "barred refunds," i.e., refunds that could not be made because of the statute of limitations [4]. Barred refunds totaled $0.2 billion [5]. Only 165,532, or 6 percent, were "even" returns and 1,418,047, or more than 55 percent, had a balance due. The amount of tax outstanding on balance due returns totaled almost $3.8 billion; refunds (excluding barred refunds) amounted to $0.8 billion. The net result was a balance due of nearly $3.0 billion on delinquent returns filed in FY 1993.

As would be expected, delinquent returns for which a refund was due (including barred refunds) are more likely to be voluntarily filed, rather than submitted through enforcement efforts (Figure D). More than 62 percent of the delinquent refund returns were voluntarily filed, while only 38 percent were filed due to enforcement activity. Likewise, 60 percent of "even" returns were voluntarily

Figure C

Delinquent Individual Income Tax Returns by Type of Return, Fiscal Year 1993

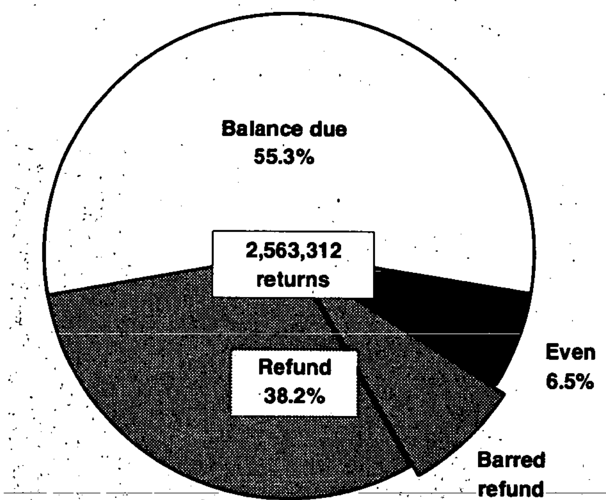
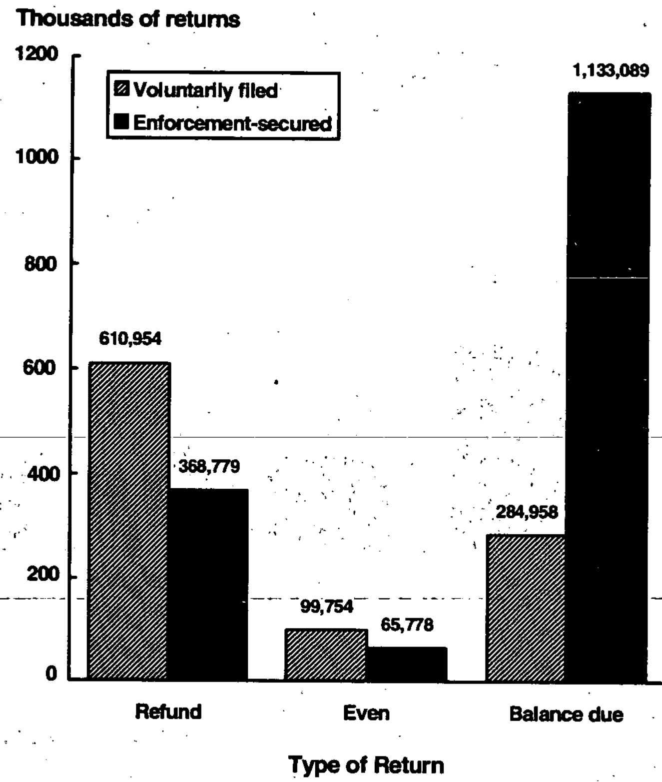


Figure D

Delinquent Individual Income Tax Returns by Method of Securing Returns and by Type of Return, Fiscal Year 1993



filed and 40 percent were submitted through enforcement. In contrast, balance due returns were submitted through enforcement almost four times as often as they were filed voluntarily. In FY 1993, almost 80 percent of balance due delinquent individual income tax returns were submitted through enforcement, and only 20 percent were filed voluntarily. This difference is partially due to the large number of IRS-created "Substitute for Returns" (SFR), which are only resorted to for taxpayers which IRS believes to have an outstanding balance due return [6]. In fact, SFR's make up 47 percent of the total number of delinquent returns secured through enforcement.

A comparison of delinquent individual income tax returns can also be made by the size of the refund and balance due (Figure E). In general, while refund returns were fewer, they were also smaller in terms of the amounts involved compared to balance due returns. In FY 1993, more than half of the delinquent returns due refunds fell within the smallest size category of under $500. The remaining refund returns fell between $500 but under $1,000 and $1,000 or more (22 and 27 percent respectively). In contrast, only 20 percent of the balance due returns fell in the under $500 size category and only 18 percent had a balance due between $500 but under $1,000. However, more than three-fifths of the balance due returns fell in the $1,000 or more category. This was more than one-third of the total delinquent returns processed in FY 1993. In total, the average refund claimed on all delinquent refund returns was $988, while the average balance due for all delinquent balance due returns was $2,676.

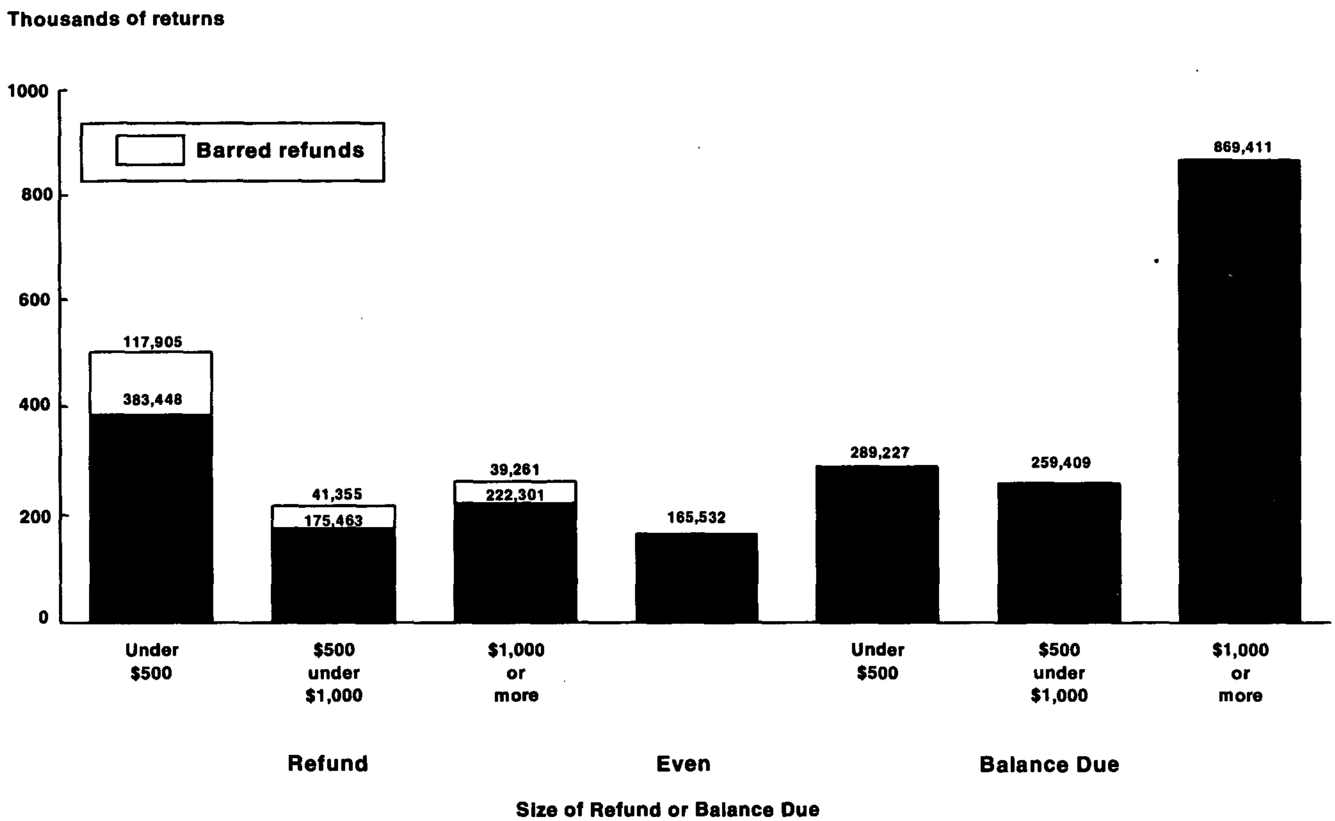
The distinction of whether a delinquent taxpayer is a first-time filer or an "established" filer is also important in the analysis of delinquent returns [7]. First-time filers who are delinquent may benefit from additional outreach or educational programs, whereas traditional enforcement methods may be more effective for established filers who are delinquent and aware of their requirement to file on time. In regard to the 338,031 Tax Year 1991 delinquent returns filed in FY 1993, only 9 percent of the delinquent filers had filed an individual income tax return for thefirst time, while more than 91 percent (308,656) were established filers.

Income Characteristics

A chief characteristic of delinquent returns is the difference in the types of income reported, which often depended on the type of return. More than eight in ten of

Figure E

Delinquent Individual Income Tax Returns by Type of Return and Size of Refund or Balance Due, Fiscal Year 1993



all delinquent refund returns showed wages and pensions (Figure F). Wages and pensions are combined here because many delinquent taxpayers mistakenly reported their pension income on the wage line of their individual income tax returns. Since the returns were not edited for mistakes which did not affect calculations for total tax, wages and pensions could not be separated. Almost 29 percent reported interest income and more than 14 percent reported income from a nonfarm sole proprietorship (Schedule C) [8].

By comparison, based on the delinquent returns filed in FY 1993, delinquent balance due returns generally were:

- less likely to have wages and pensions (34 percent),
- less likely to have interest income (17 percent),
- and more likely to have sole proprietorship (Schedule C) income (25 percent); in other words, were more likely to have been filed by self-employed taxpayers.

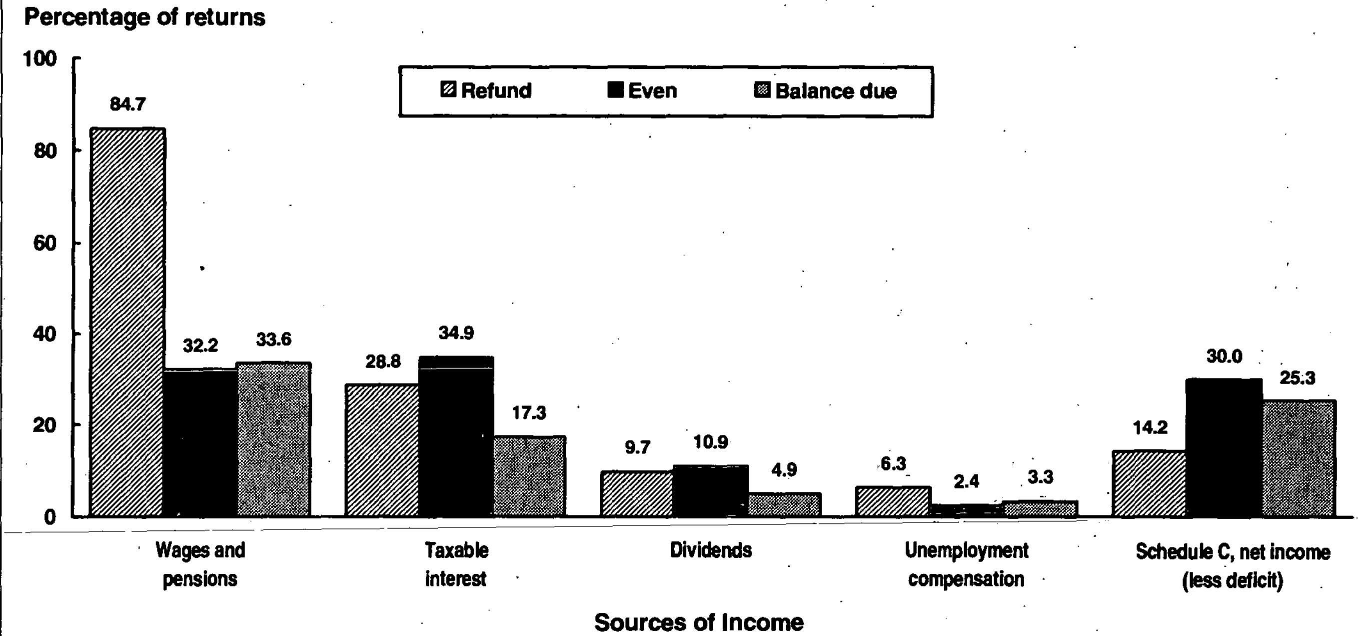
Other Characteristics of Delinquent Filers

A distribution by filing status (i.e., the marital status categories recognized under the tax code) shows that almost 45 percent of the delinquent individual income tax returns in FY 1993 were filed by taxpayers claiming single status, while less than 31 percent were joint returns [9]. As would be expected, head of household and married filing separately occurred less frequently, 15 and 10 percent, respectively. Less than one-tenth of 1 percent claimed widow(er) filing status (Figure G).

Delinquent returns were also distributed by the age of the primary taxpayer (Figure H) [10]. (In the case of joint returns of husbands and wives, the age of the primary taxpayer was that of the taxpayer whose name was listed first on the tax return, usually the husband.) Taxpayers in the older age groups are more likely to be aware of their requirement to file an income tax return, thus educational

Figure F

Delinquent Individual Income Tax Returns: Sources of Income by Type of Return, Fiscal Year 1993



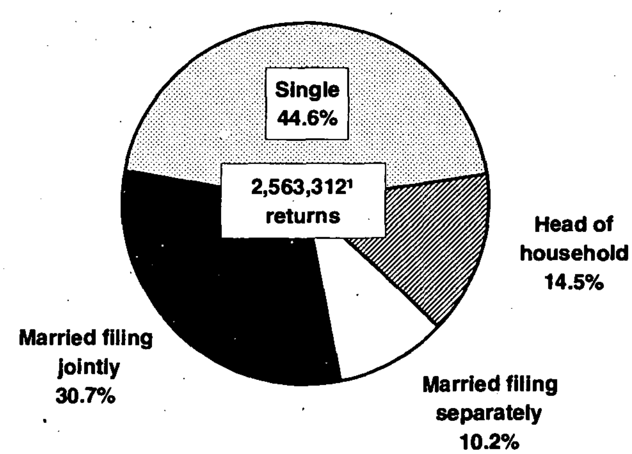
NOTE: Data exclude Substitutes for Returns. However, income on such returns would mostly be salaries and wages.

programs would probably have little effect on them; whereas enforcement efforts may have a larger impact. The majority of delinquent returns in these older age groups were filed as a result of IRS enforcement (Figure I). More than 70 percent of the returns filed by taxpayers between the ages of 41 and 61 were secured through enforcement. In contrast, only 14 percent of the delinquent returns filed by taxpayers under 22 years of age and less than 43 percent of those filed by taxpayers age 22 through 30 were secured through enforcement.

While the delinquent returns of older taxpayers are more likely to be enforcement-secured, the age of the taxpayer is not the determining factor. The ages between 41 to 61 are often prime earning years for many taxpayers, and IRS targets its enforcement efforts on those taxpayers who are likely to have large tax liabilities. The average "total positive income" (TPI) (in general, income computed without regard to losses) for FY 1993 delinquent taxpayers by age group shows taxpayers aged 51 to 61 had the largest average (Figure J) [11]. Those aged 41 to 50 had the next highest average. As might be expected, taxpayers 21 and under had the smallest average.

Figure G

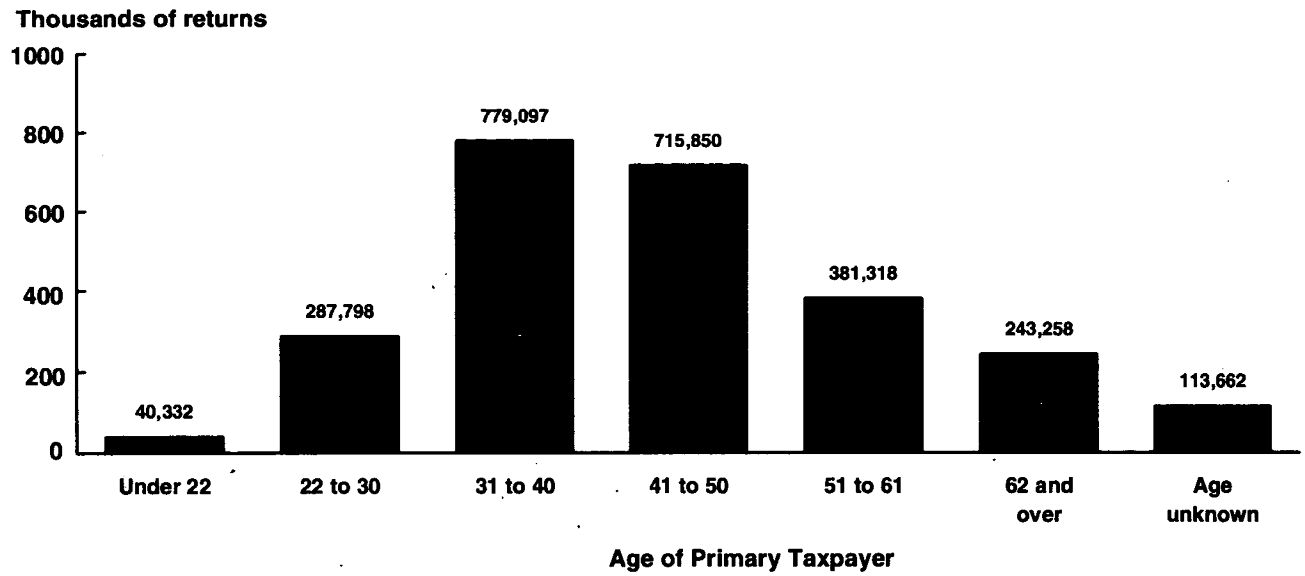
Delinquent Individual Income Tax Returns by Filing Status, Fiscal Year 1993



[1]Includes qualifying widows or widowers who comprised less than 0.1 percent of the total.

Figure H

Delinquent Individual Income Tax Returns by Age of Primary Taxpayer, Fiscal Year 1993



NOTE: Primary taxpayer on joint returns of husbands and wives was the taxpayer whose name was noted first on the tax return, usually the husband.

Figure I

Delinquent Individual Income Tax Returns by Age of Taxpayer and Method of Securing Return, Fiscal Year 1993

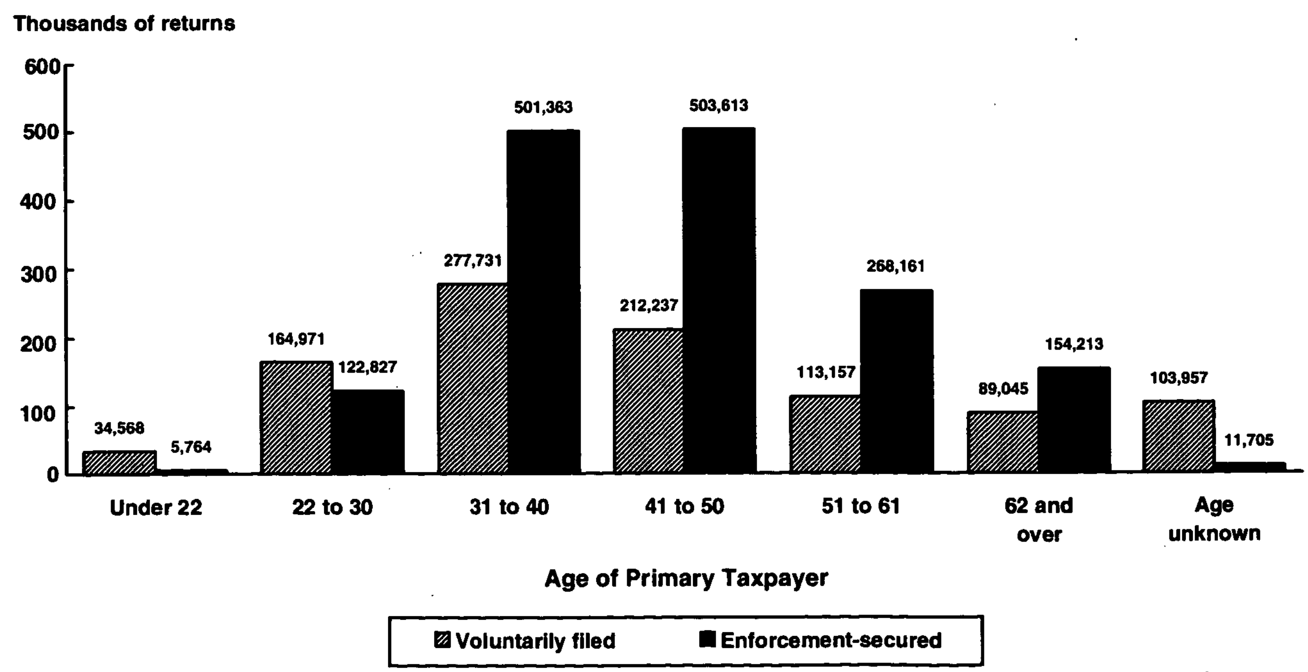
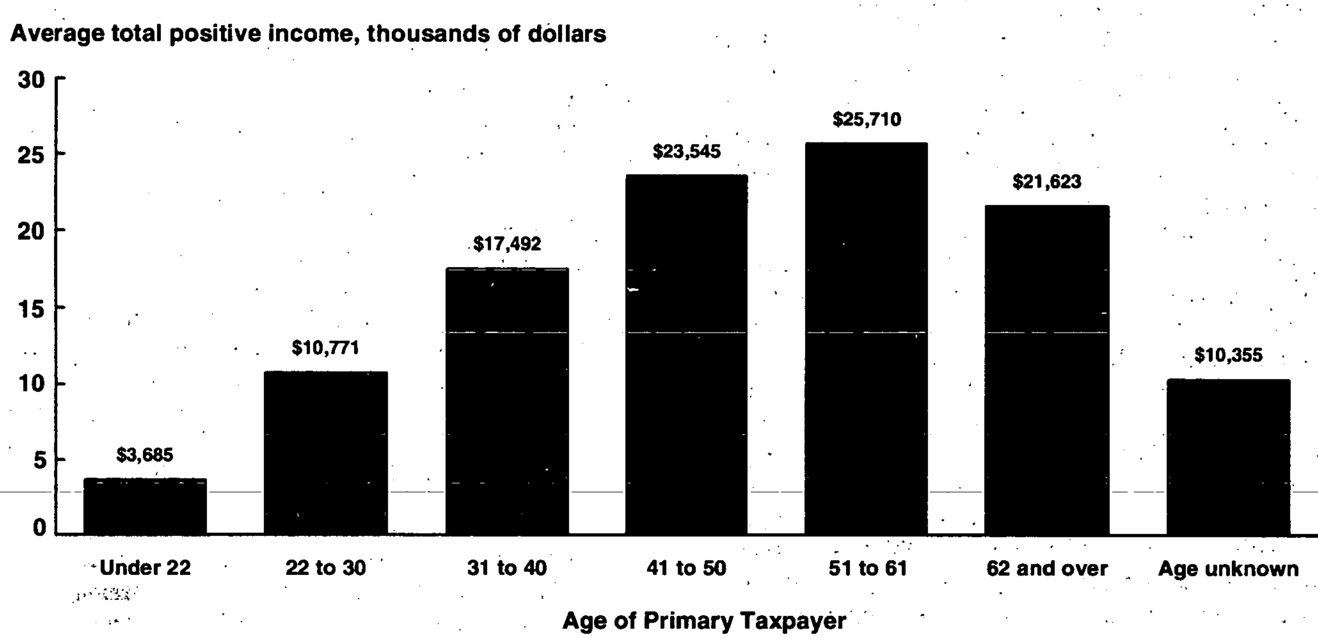


Figure J

Delinquent Individual Income Tax Returns: Average Total Positive Income (TPI) by Age of Primary Taxpayer, Fiscal Year 1993



Summary

Taxpayer profiles allow IRS to identify group patterns of noncompliance and measure trends [12]. One goal of the Service is to tailor approaches to these groups to bring them "back into the system." The decision not to file on time can cause economic losses to both the nonfiler and 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. By developing profiles of nonfiler market segments, 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 Fiscal Year 1993 and are based on the population of 2,563,312 returns received during that year that were filed 1 year or more late. The population includes 743,213 "substitutes for returns" (SFR's), for which there was little information beyond tax and balance due. While the data provide an accurate picture of those nonfilers who eventually filed one or more delinquent returns either voluntarily or through enforcement, they do not provide any insight into those nonfilers who have not filed a delinquent return. As a result, there is a segment of the nonfiler population for which this profile has no information.

One of the IRS strategies requires that Statistics of Income (SOI) obtain data with which to develop profiles of nonfilers. Although the Nonfiler Database contains a wealth of information, it may not contain the specific return line items necessary to develop sufficiently descriptive profiles of nonfilers. Thus, additional information was requested from the IRS Individual Returns Transaction File (IRTF) and the Information Returns Master File (IRMF) to create the Enhanced Nonfiler Database. This Database contains information for all of the 2.5 million delinquent individual returns processed in FY 1993.

An important caveat is that the ability to profile nonfilers using the Enhanced Nonfiler Database is based entirely on the delinquent returns that are filed. In essence, only "what comes in" can be analyzed, hence, it is necessary to note that the universe of "unknown" nonfilers not in the system has not been measured. Data for the Database on "unknown" nonfilers can be captured only after they file. "Unknown" refers to those individuals for whom the IRS has no tax account in its system of data files.

Explanation of Selected Terms

Delinquent filer. - Any individual return filed 360 days or more after the return due date.

Individual Master File (IMF). - This data file, compiled and maintained at the IRS National Computing Center in Martinsburg, West Virginia, contains tax accounts for all individual taxpayers. Identifying information, such as name, address, and social security number, as well as tax information, e.g., "adjusted gross income" or tax balance due, is recorded there. The file is updated periodically with changes to the taxpayer accounts.

Individual Returns Transaction File (IRTF). - This file contains taxpayer return information as transcribed directly from each income tax return; data from it are input to the Individual Master File. IRTF files are created for each tax year. Unlike the IMF, they are not updated.

Information Returns Master File (IRMF). - This data file contains data from Forms W-2, *Wage and Tax Statement;* Forms 1099-INT, *Interest Income*; Forms 1099-MISC, *Miscellaneous Income*; and any other "information returns" issued to taxpayers by employers or other payers for a given calendar year. IRS uses this information to verify income and deductions reported on income tax returns. This file contains over 1 billion information returns per year.

Late filer. - Any individual return received one day or more after April 15 (or the extended due date), but less than 360 days.

Notes and References

[1] The database includes returns that are at least one year or more late. Returns that are more than one year late, but less than two years late are counted as being delinquent one year; returns that are two years late, but less than three years late are counted as being delinquent two years, and so on.

[2] The IRS has information on many individuals for whom a return for a given tax year has not been filed. This information may be from third parties who filed "information returns" (such as Form 1099-INT, *Interest Income*), 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 indicated a filing requirement should have been met.

[3] A refund return includes those for which the taxpayer elects to credit an overpayment for one tax year to the estimated tax due for the next tax year, as well as an overpayment refunded directly 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.

[4] For refund returns that are received by the IRS three or more years after the due date (or the extended due date) of the return, the refund amount is "barred," meaning that the taxpayer cannot receive the refund amount. As stated in section 6511(a) of the Internal Revenue Code, "...a claim for a credit or refund of an overpayment of any tax imposed in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within two years from the time the tax was paid."

[5] The total amount for barred refunds is calculated differently from the total amount for all other refund returns. All other refund dollar amounts are calculated by summing the amount refunded to the taxpayer by IRS. Barred refunds cannot be calculated in this way because the actual amount refunded to the taxpayer is zero. Consequently, the total amount of barred refunds is calculated by summing the difference between the tax settlement amount (i.e., the tax liability) and the sum of prepayment amounts and credits. This is the total amount of tax prepayments that would have been refunded to delinquent taxpayers had their returns been filed within three years. This total is conservative in that it does not include any refundable earned income tax credit for which the delinquent taxpayers may otherwise have been entitled.

[6] 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 single filing status, 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 is then issued for the outstanding amount. 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. In Fiscal Year 1993, the number of SFR assessments was 743,213; this does not

include the actual number of returns the taxpayer filed after an SFR assessment notification.

[7] For this analysis, a first time filer is a taxpayer who was "established" as a taxpaying entity on the IRS Master File in Fiscal Year 1993, meaning that the IRS had no previous record on the Individual Master File for that particular individual. Returns posted with an invalid social security number (SSN) were excluded because a new entity is created for invalid SSN's since the invalid number is unique. An "established" filer is a taxpayer who has filed in a previous year and has already established an entity on the Master File.

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

[9] The percentage of returns claiming single status is higher than would be expected because the calculation includes SFR returns (see Footnote 6). SFR's are always generated with a filing status of single.

[10] IRS receives age information for all taxpayers from the Social Security Administration for use in tax administration.

[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 individual income tax return and accompanying schedules.

[12] See also Daronco, Karla M., "Nonfiler Profiles, Processing Year 1991," *Statistics of Income Bulletin*, Summer 1993, Volume 13, Number 1.