IRS mulls limiting sole-proprietor loss deductions

About a quarter of all sole-proprietor businesses report losses on their tax returns, but many are doing so by understating income or overstating expenses, leading to billions of dollars in lost tax revenue, according to a new government report.

The Government Accountability Office said that about 5.4 million, or 25%, of all sole proprietors reported losses in 2006. Ninety-five percent (95%) deducted some or all of their losses against other income, deducting a total of $40 billion.

According to the IRS's most recent estimate, in 2001, 70% of sole-proprietor returns that reported losses had losses that were either fully or partially noncompliant with tax laws. About 53% of aggregate dollar losses reported in 2001 were noncompliant. Sole proprietors under-reported their net income by 57%, or $58 billion, for 2001.

IRS compliance programs address only a small portion of sole-proprietor expense noncompliance, the GAO noted. Despite investing nearly a quarter of all revenue agent's time in 2008, the IRS was able to audit only about 1% of the estimated noncompliant sole proprietors. One approach for limiting sole-proprietor loss noncompliance would impose a rule that limits losses that could be deducted from other income. The Internal Revenue Tax Code has a number of such limitations, the GAO noted. However, its report acknowledged that while loss limitation could reduce noncompliant losses, it would also limit the ability of sole proprietors to claim legitimate losses.

Another approach would improve the IRS's estimate of the extent to which activities not engaged in for profit, such as hobbies, are contributing to noncompliant sole-proprietor losses. Expenses associated with these activities are not deductible, but the IRS research on the causes of sole-proprietor noncompliance has not used the available data to estimate the extent of this type of noncompliance. Without such an estimate, the IRS could be missing an opportunity to reduce noncompliance, said the GAO.

The report recommended that the IRS estimate the extent of sole proprietors' not-for-profit activity noncompliance. However, the GAO did not recommend a loss-limitation rule because the trade-off between reducing non-compliant losses and allowing legitimate losses requires a policy judgment.