TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Service Faces Challenges in Addressing the Growth of Peer-to-Peer Payment Application Use

April 22, 2021

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HIGHLIGHTS: The Internal Revenue Service Faces Challenges in Addressing the Growth of Peer-to-Peer Payment Application Use

Final Audit Report issued on April 22, 2021 **Report Number 2021-30-022**

Why TIGTA Did This Audit

This audit was initiated due to growth of peer-to-peer (P2P) payment applications as a means of transferring money between users on virtual platforms. The *de Minimis* reporting thresholds of $20,000 and 200 transactions that trigger information return reporting present challenges to how effectively the IRS is able to identify potential noncompliance. The overall objective of this audit was to evaluate the effectiveness of the IRS's efforts to identify unreported income transferred through these systems.

Impact on Taxpayers

In Calendar Year 2008, Congress passed the Housing and Economic Recovery Act of 2008, which added Internal Revenue Code (I.R.C.) Section (§) 6050W. Through the third-party information reporting provisions of I.R.C. § 6050W, Congress intended to "narrow" the Tax Gap by increasing voluntary compliance by business taxpayers and to help the IRS determine whether business tax returns are correct and complete. If the IRS is unable to effectively identify noncompliance, taxpayers may begin using P2P payment applications to conduct business, skirt third-party reporting, and avoid paying taxes on income.

What TIGTA Found

The growth of P2P payment applications has greatly enhanced the flow and transfer of funds, making it easier and cheaper to send payments from one person to another. However, the technology presents additional tax compliance challenges in that the payments are not always reported to the IRS and can be hard to detect during an IRS examination. The limited reporting requirements of I.R.C. § 6050W present challenges for the IRS in identifying unreported business income facilitated by P2P payment applications. TIGTA judgmentally selected eight P2P payment applications and found that seven of them do not to meet the current definition of a third party settlement organization and therefore are not required to file Form 1099-K, *Payment Card and Third Party Network Transactions*. However, three P2P companies filed 950,965 Forms 1099-K involving $198.6 billion of payments in Tax Year 2017, which included amounts below the reporting thresholds.

The IRS did not always take compliance actions on nonfilers of tax returns and underreporters related to P2P payments even when information reporting was available. In total, 169,711 taxpayers potentially did not report up to $29 billion of payments received per Form 1099-K documents issued to them by three P2P payment application companies.

While the IRS can identify potential underreporting and nonfiling issues by matching information presented on a taxpayer's income tax return with third-party information return documents filed with the IRS, such as Forms 1099-K, taxpayers using P2P payment applications may not always receive a Form 1099-K. Absent a Form 1099-K, they are still required to report any taxable income on their income tax return. Although it is possible for the IRS to uncover underreported income received via P2P payment applications during the course of an examination, [redacted]

What TIGTA Recommended

The IRS should: 1) work with the Treasury Office of Tax Policy to consider pursuing regulatory change that clarifies the third party settlement organization designation, including defining guarantee of payment provisions, under I.R.C. § 6050W; 2) as resources become available, consider establishing a compliance initiative project using Form 1099-K payments associated with P2P payment applications identified by this audit; and 3) consider requiring the completion of the Internet use and e-commerce income activity minimum income probe for all individual business, corporate, and other business taxpayers, including those designated "limited scope."

IRS management agreed with the first and third recommendations but disagreed with the second because they do not believe there is a demonstrated compliance problem that warrants a compliance initiative project.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 22, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

Michael E. McKenney

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Faces Challenges in Addressing the Growth of Peer-to-Peer Payment Application Use (Audit # 201930019)

This report presents the results of our review to evaluate the effectiveness of the Internal Revenue Service's efforts to identify unreported income transferred via peer-to-peer payment systems. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Background

The growth of peer-to-peer payment applications (P2P) has greatly enhanced the flow and transfer of funds between users on virtual platforms. P2P payment applications allow users to send money from a mobile device through a linked bank account or credit/debit card. Business taxpayers can use P2P payment applications to make or receive payments, while individual taxpayers can use P2P payment applications to make payments for goods or services. See Appendix II for an illustration of a P2P payment application used to conduct business.

An example of a P2P payment application is *Square Up*, which acts as an intermediary between a buyer and seller by transferring funds between accounts in settlement of a service or purchase. *Square Up* operates through a piece of hardware that attaches to various mobile devices and allows merchants to conduct credit card transactions anywhere.

Some taxpayers may not report income received via P2P payment applications if they do not believe the Internal Revenue Service (IRS) has received an information return, such as a Form 1099-K, *Payment Card and Third Party Network Transactions*.[1] The IRS's Tax Gap analyses indicate that information reporting is associated with higher voluntary compliance.[2] The estimated net misreporting percentage for income amounts subject to substantial information reporting is 5 percent. When income is subject to little or no information reporting, the net misreporting percentage is 55 percent. Consequently, reporting of gross receipts could be expected to improve if more P2P payments were subject to information reporting.

In Calendar Year 2008, Congress passed the Housing and Economic Recovery Act of 2008, which added Internal Revenue Code (I.R.C.) Section (§) 6050W.[3] Through the third-party information reporting provisions of I.R.C. § 6050W, Congress intended to "narrow" the Tax Gap by increasing voluntary compliance by business taxpayers and to help the IRS determine whether the related business tax returns are correct and complete. I.R.C. § 6050W requires an annual filing by Payment Settlement Entities that are defined as one of the following:

(1) Merchant Acquiring Entity – the bank or organization that has the contractual obligation to make payment to participating payees in settlement of payment card transactions.

(2) Third Party Settlement Organization (TPSO) – the central organization that has the contractual obligation to make payment to participating payees of third-party network transactions. Such transactions represent those that are settled over a third-party network. The law defines these networks as any agreement or arrangement that (1) involves the establishment of accounts with a central organization by a substantial number of people meeting set criteria,[4] (2) provides for standards and mechanisms for

[1] See Appendix III for Form 1099-K. The Form 1099-K assists the IRS in matching gross payments to the gross sales/receipts reported on tax returns.

[2] See Appendix VII for a glossary of terms. IRS, Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013* p. 3 (Rev. 9-2019).

[3] Pub. L. No. 110–289, 122 Stat. 2654, enacted July 30, 2008.

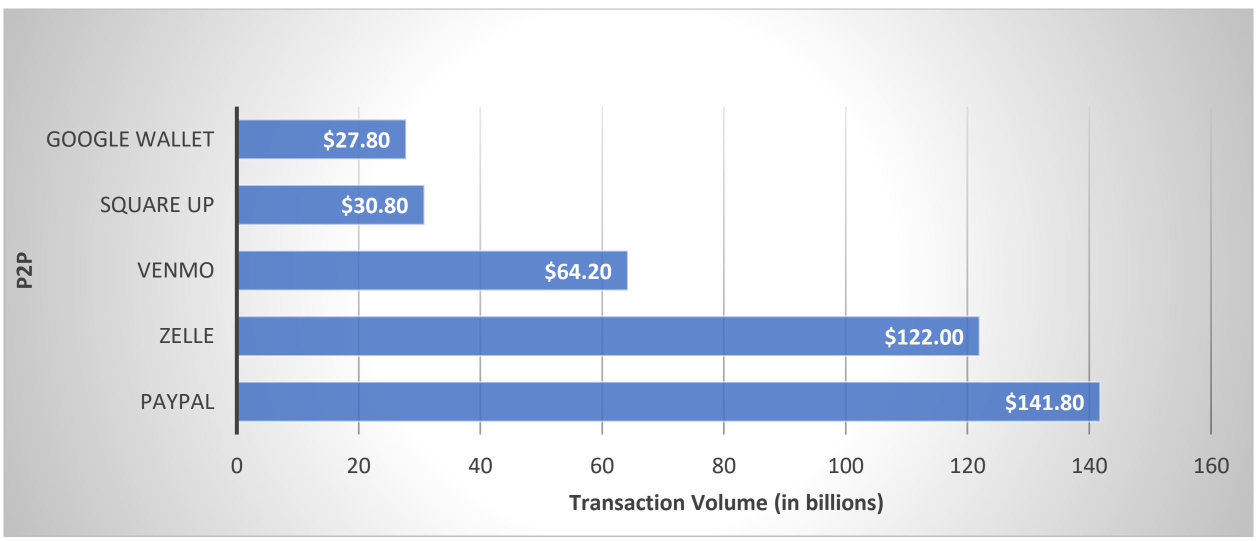
[4] These persons, which are defined as individuals, trusts, estates, partnerships, associations, companies, or corporations, must (1) be unrelated to that organization, (2) provide goods or services, and (3) have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement.

settling such transactions, and (3) guarantees payment for those providing goods or services.[5]

TPSOs satisfy their I.R.C. § 6050W annual filing requirements by filing a Form 1099-K, *Payment Card and Third Party Network Transactions*. However, pursuant to I.R.C. § 6050W, TPSO payment reporting via Form 1099-K is only required when total transactions with a participating payee exceed 200 and gross payments exceed $20,000, annually. Further, several P2P payment applications [redacted] criteria of a TPSO under I.R.C. § 6050W and related Treasury Regulations, as they do not guarantee payment for those providing goods or services. Consequently, payments made to providers of goods and services [redacted]

Downloads of P2P payment applications have surpassed mobile banking applications. In Calendar Year 2015, the top three finance applications downloaded in the United States were mobile banking applications created by Chase, Bank of America, and Wells Fargo. By Calendar Year 2018, Square Up, PayPal, and Venmo were the top three downloads in the finance application category. Figure 1 shows the total dollars users transferred via five P2P payment applications during Calendar Year 2018.

Figure 1: Calendar Year 2018 P2P Payment Application Transaction Volume by Provider



Source: Forbes.com, Venmo Versus Zelle: Who's Winning The P2P Payments War?

As Figure 1 shows, users transferred nearly $142 billion through PayPal, $122 billion through Zelle, and $64 billion through Venmo.

[5] Although the term "guarantee" is not defined in the statute or regulations, the IRS Office of Chief Counsel has issued private letter rulings in response to taxpayer submissions requesting rulings as to whether they are considered TPSOs under the Code.

Results of Review

While the innovation of P2P payment systems has made it easier and cheaper to transfer money, [redacted]

While the IRS can identify potential underreporting and nonfiling issues by matching income tax returns and associated third-party information return documents (such as Forms 1099-K), businesses using P2P payment applications may not always receive such forms. Even if taxpayers do not receive a Form 1099-K or other information, taxpayers are still required to report any taxable income on their income tax return. Although it is possible for the IRS to uncover underreported income received via P2P payment applications during the course of an examination, [redacted]

Reporting Requirement Limitations for Peer-to-Peer Payment Applications Create Barriers to Tax Enforcement

The effectiveness of the IRS's efforts to identify unreported business income facilitated through P2P payment applications is limited by the reporting requirement of I.R.C. § 6050W. Specifically:

- Some P2P payment applications [redacted]
- Form 1099-K filing requirements [redacted]

Some P2P payment applications appear not to meet definition of a TPSO

[redacted] The feature of a third-party payment network is a critical one. Such a network requires an arrangement:

(1) Through which a substantial number of service providers (unrelated to the TPSO) establish accounts with that TPSO and have agreed to settle transactions for the provision of goods and services.

(2) That provides standards and mechanisms for settling transactions.

(3) Which guarantees the persons providing goods or services payment for providing these goods or services.

We judgmentally selected eight P2P payment applications to evaluate their terms of use documents to determine whether they met the requirements to issue information returns under I.R.C. § 6050W.[6] As reflected in Figure 2, we found that these P2P payment applications [redacted] We determined that seven of the eight P2P payment applications do not likely meet the [redacted] Specifically:

- [redacted] did not appear to meet the guaranteed payment requirement.
- [redacted] was designated for personal use only.[7]

The [redacted] P2P payment application would be a circumstantial determination based on the nature of the individual transactions involved.

Figure 2: P2P Payment Application TPSO Determinations

Payment Application	TPSO	Reason
[redacted]	Unknown	Could be considered a TPSO for transactions for the provision of goods and services, but given the multiple ways that [redacted] may be used in a transaction (*i.e.*, different [redacted] platforms), a definitive conclusion cannot be made without additional information.
[redacted]	No	Personal use only, not permitted to use as a payment method for purchases of goods and services.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.
[redacted]	No	Not a TPSO because of lack of guarantee of payment.

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of P2P payment applications' Terms of Use.

However, three of the eight payment application companies issued Forms 1099-K for Tax Year (TY) 2017 when the I.R.C. § 6050W transaction criteria (200 transactions and gross payments exceed $20,000) was met.[8]

The IRS Office of Chief Counsel has issued five private letter rulings concerning the TPSO designation under I.R.C. § 6050W to five non-P2P companies.[9] However, these rulings are binding only with respect to the taxpayers that requested them. Each private letter ruling is limited to the facts of the taxpayer's specific situation on which the IRS Office of Chief Counsel was asked to provide an opinion and does not go beyond that to provide additional clarity. As such, these private letter rulings are not binding guidance for others as a citation of authority,

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[6] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

[7] While designated for personal use only, anecdotal evidence suggests that the application is used to conduct business.

[8] [redacted]

[9] A private letter ruling is a "written statement issued to a taxpayer" in response to a request they made. This document "interprets and applies tax law to a specific set of facts applicable to that taxpayer." They are issued to taxpayers in response to written requests made by them. Businesses often use private letter rulings to confirm that specific transactions will not ultimately result in tax violations.

and they do not provide the necessary legal clarification for the term guarantee. It is also burdensome in terms of cost and time for taxpayers seeking private letter rulings in order to gain clarification of the law and regulations with respect to TPSOs.

Of these five private letter rulings, four were deemed TPSOs by the IRS Office of Chief Counsel because they met all the requirements under I.R.C. § 6050W, including guaranteed payment for providing goods or services. These four companies are considered TPSOs and are required to comply with the provisions of I.R.C. § 6050W. The private letter rulings noted that the contractual agreement between taxpayer and customers included a guarantee that customers will be paid for their provision of goods and services after the taxpayer receives payment from payers.

Given that the TPSO designation is dependent on the payment guarantee and because I.R.C. § 6050W does not define the term, the IRS Office of Chief Counsel has relied on private letter ruling documentation to provide one. Because many P2P payment applications do not consider themselves a TPSO under the law, they do not issue Forms 1099-K. This situation can give rise to both intentional and unintentional income reporting avoidance by some businesses accepting payments via P2P payment applications.

Form 1099-K filing requirements do not apply to all users of P2P payment applications

The *de Minimis* threshold under I.R.C. § 6050W results in some payment information not being reported and presents challenges to the IRS's ability to identify potential noncompliance. As noted previously, under I.R.C. § 6050W, the thresholds that trigger TPSO reporting are participating payees that receive:

- Over $20,000 in gross payment volume.
- The payments are with respect to 200 or more separate third-party network transactions in a calendar year.

If a business accepting payments via a TPSO-designated P2P payment application exceeds these thresholds, the P2P companies will send them and the IRS a Form 1099-K that reports gross payment volume. Further, businesses using P2P payment applications that are TPSOs required to file Forms 1099-K [redacted]

The impact on taxpayer compliance caused by the reporting thresholds and how P2P payment application companies classify themselves under I.R.C. § 6050W is likely to be substantial. As we described previously, income reporting compliance is much higher when there is information reporting. Based on this relationship between information reporting and compliance, businesses that do not meet the high thresholds of Form 1099-K issuance are much more likely to misreport their income on their tax return than those businesses that receive a Form 1099-K.

The following figures demonstrate the extent of the P2P transactions and the potential tax noncompliance from underreporting by users of P2P payment applications. Figure 3, Figure 4, and Figure 5 reflect the Forms 1099-K filed by three P2P payment application companies that (based on our review of their business activities) appear not to have any filing obligations as a TPSO because they do not appear to meet the Treasury Regulation definition of a TPSO. These

P2P companies also report transactions that do not even meet the TPSO filing thresholds, *i.e.*, 200 transactions per year in excess of $20,000.

To illustrate the effect of the $20,000 reporting threshold and how payers classifies themselves under I.R.C. § 6050W, we compared the Form 1099-K issuance history of three P2P payment applications that reported, solely within their discretion, on amounts below these thresholds. Figure 3 demonstrates how many Forms 1099-K the three P2P payment application companies filed for TY 2017, which includes 149,006 Forms 1099-K which were beneath the filing threshold of $20,000.[10]

Figure 3: Form 1099-K Filed by Three P2P Payment Application Companies for TY 2017

	Number of Forms 1099-K	%	Total Amount	%
Forms 1099-K Filed At or Above the Reporting Threshold (>$20,000)	766,159	81%	$197,629,342,027	99%
Forms 1099-K Filed Beneath Reporting Threshold ($500 - $19,999)	149,006	16%	$966,321,147	<1%
Total Forms 1099-K Issued by Three P2P Applications	950,965	100%	$198,601,788,509	100%

Source: TIGTA analysis of data obtained from the Information Returns Master File.

Figure 3 shows the significant magnitude of P2P taxable transactions by providing the reported payments of three P2P payments applications and shows the extent of noncompliance, which would have existed, had these three P2P companies not issued Forms 1099-K. As noted previously, we judgmentally selected eight P2P payment application companies and determined that they are not likely to even be considered TPSOs based on our review and are thus not even required to file Forms 1099-K. However, we found that three of these P2P payment application companies filed 950,965 Forms 1099-K involving $198.6 billion of payments in TY 2017. Considering this payment information is only from three P2P payment application companies, it is likely that there is significantly more than $966 million not being reported by P2P payment applications because of payments that fall under the thresholds.

IRS Tax Gap studies estimate that when third parties do not provide information to the IRS, 55 percent of income is misreported.[11] Projecting that figure to the numbers from Figure 3, if these P2P companies had not issued the Forms 1099-K, there would have been an estimated $531 million of underreported payments for Forms 1099-K.[12] The Form 1099-K high reporting thresholds of $20,000 and 200 transactions per year for TPSOs are unlike any of the requirements to report business income to the IRS, such as the Form 1099-MISC, *Miscellaneous Income*, for which there is no minimum transaction requirement and the threshold for reporting

[10] I.R.C. § 6041(a) generally requires persons engaged in a trade or business and paying rents, salaries, compensations, and other gains, profits, and income of $600 or more to report the payment (to the IRS and the recipient) on Form 1099-MISC, *Miscellaneous Income*.

[11] IRS, Publication 1415, p. 13 (Rev. 9-2019).

[12] This is 55 percent of the $966 million.

business payments is anything in excess of $600. Reducing the information reporting gaps due to I.R.C. § 6050W would require legislative action.

Figure 4 demonstrates how many Forms 1099-K the three P2P payment application companies would not have issued for TY 2017 if the companies followed the TPSO 200 separate transactions threshold in I.R.C. § 6050W.

Figure 4: Form 1099-K Issuances by Three P2P Payment Application Companies to Taxpayers That Did Not Meet the I.R.C. § 6050W Transaction Threshold

	Number of Forms 1099-K	Total Amount
Less Than 200 Transactions Threshold	16,259	$1,003,501,770

Source: TIGTA analysis of data obtained from the Information Returns Master File.

If these three P2P payment applications had strictly followed 200 annual transaction requirement under I.R.C. § 6050W for TPSOs, the IRS would not have been provided payment information for these 16,259 taxpayers receiving payments over $1 billion.

In a prior TIGTA report on the gig economy, the IRS agreed with a TIGTA recommendation that the IRS Office of Chief Counsel work with the Department of the Treasury Office of Tax Policy to pursue regulatory or legislative change relating to the third-party reporting thresholds established in I.R.C. § 6050W.[13] As a result, the IRS Office of Chief Counsel provided proposed legislative language at the request of IRS Legislative Affairs in May 2019, for use during meetings with members of Congress. The proposed language supports reducing the reporting threshold for TPSOs under I.R.C. § 6050W from $20,000 and 200 transactions per payee to $1,000, without regard to the number of transactions. When we asked Legislative Affairs about the status, they stated that the Department of the Treasury approved and included it in the legislative proposals that are included in its annual budget submission, but Congress has not yet acted on this proposal.

Using the data from the three P2P payment application companies, Figure 5 demonstrates the impact of reducing the dollar amount threshold to $1,000 regardless of the number of transactions. For our three P2P payment application companies alone, the IRS received an additional 130,890 Forms 1099-K reporting nearly $1 billion in payments.

Figure 5: Form 1099-K Issuances by Three P2P Payment Application Companies to Taxpayers That Did Not Meet the I.R.C. § 6050W Transaction and Dollar Thresholds

	Number of Forms 1099-K	Total Amount
$1,000 to $20,000 Reporting Threshold	130,890	$952,837,558

Source: TIGTA analysis of data obtained from the Information Returns Master File.

[13] TIGTA, Ref. No. 2019-30-016, *Expansion of the Gig Economy Warrants Focus on Improving Self-Employment Tax Compliance* (Feb. 2019).

Similar to Figures 3 and 4, Figure 5 shows the number of Form 1099-K documents issued by the three selected P2P companies for recipients that were below the current $20,000 or less monetary threshold, but greater than or equal to the $1,000 floor proposed to Congress. This information is intended to demonstrate both the potential extent of noncompliance if these transactions had not been reported, as well as the potential scope of unreported transactions by other P2P application companies that choose not to report such transactions. There is an increased risk of reporting noncompliance by users of P2P payment applications because of the activity not reported to the IRS due to confusion regarding TPSO designation and high thresholds in the information return reporting requirements. Expanding the information reporting requirements for P2P payment applications could help reduce the Tax Gap.

Due to the various reporting requirements in the law, the risk of businesses using P2P payment applications to accept payments and underreport income is high. Ultimately, third-party reporting of taxpayer payments (or transactions) significantly affects whether or not the IRS can identify and address the noncompliance. Clarifying regulations and expanding third-party information reporting to the IRS will increase voluntary tax compliance. Given that an approved legislative proposal to reduce the reporting threshold to $1,000 has already been made to Congress, we are not making a recommendation at this time in regards to the *de Minimis* thresholds.

After we issued our draft report to the IRS, the American Rescue Plan Act of 2021 was signed into law.[14] The Act changes the threshold for reporting significantly by requiring reporting by TPSOs of a gross amount of $600 or more paid to a single payee in a calendar year, effective for calendar years beginning after December 31, 2021.

Recommendation 1: The IRS Office of Chief Counsel should work with the IRS and the Department of the Treasury Office of Tax Policy to consider pursuing regulatory change that clarifies TPSO designation, including defining guarantee of payment provisions, under I.R.C. § 6050W.

> **Management's Response:** IRS management agreed with this recommendation and the IRS Office of Chief Counsel will work with the IRS and the Department of the Treasury Office of Tax Policy to consider pursuing regulatory change that clarifies TPSO designation, including defining guarantee of payment provisions, under I.R.C. § 6050W.

Tax Enforcement Actions Addressing Compliance of Peer-to-Peer Payment Application Users Could Be Expanded

While there is an enhanced risk of reporting noncompliance pertaining to P2P income due to high thresholds in the information return reporting obligations, there is also the risk of underreported and unreported P2P income even when information reporting exists. It is important for the IRS to have a strategy to identify and address this noncompliance to reduce the Tax Gap and increase taxpayer understanding of the related tax reporting requirements.

One approach the IRS uses to identify underreported and unreported income involves matching information documents submitted by third parties against taxpayer filing data. The Automated

[14] Pub. L. 117-2, H.R. 1319, March 2021.

Underreporter and Business Underreporter programs can identify and work cases of noncompliance when the taxpayer received a Form 1099-K but did not report the income earned or did not file an income tax return. However, the IRS may not identify or work all individual and business taxpayers that receive Forms 1099-K and fail to fully report income.

Not all taxpayers using P2P payment applications comply with filing and payment requirements, even when receiving an information return

The IRS has various means of addressing potential underreporting and nonfiling issues caused by variances between taxpayer returns and associated third-party information return documents such as Forms 1099-K. In these cases, compliance efforts most commonly involve the issuance of a letter to the taxpayer. However, there are still taxpayers that fail to comply.

A prior TIGTA report estimated that the IRS was unable to address 134,089 individual taxpayers with approximately $11.9 billion of Form 1099-K transactions among nine gig economy payers for TYs 2012 through 2015.[15] Consequently, the IRS potentially missed an opportunity to assess almost $481 million in self-employment taxes in this area alone. More recently, TIGTA issued another report on Form 1099-K compliance.[16] This report determined whether the IRS appropriately identified and addressed taxpayers with underreported or unfiled Form 1099-K income across all areas. TIGTA did this by matching TY 2017 Form 1099-K individual and business recipients against the associated TY 2017 income tax returns.

To understand and evaluate the P2P component of the Form 1099-K noncompliance from the previous TIGTA audit, we analyzed the data related to the nonfilers and underreporters connected to the three judgmentally selected P2P companies previously identified. Figure 6 shows TY 2017 Form 1099-K filings by the three selected P2P companies, as a portion of all Form 1099-K documents issued to unique businesses or individuals.[17]

Figure 6: TY 2017 Form 1099-K Peer-to-Peer Recipients From Three P2P Payment Application Companies

Form 1099-K Business Recipients	Form 1099-K Business Recipients Attributable to Select P2P Companies	Select P2P Companies Form 1099-K Percentage (Business)	Form 1099-K Individual Recipients	Form 1099-K Individual Recipients Attributable to Select P2P Companies	Select P2P Companies Form 1099-K Percentage (Individuals)
3,349,296	265,061	8%	2,622,703	514,878	20%

Source: TIGTA analysis of the IRS Information Returns Master File.

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[15] TIGTA, Ref. No. 2019-30-016, *Expansion of the Gig Economy Warrants Focus on Improving Self-Employment Tax Compliance* (Feb. 2019). In its response to the TIGTA report, the IRS agreed to determine examination and outreach opportunities to address noncompliance in the gig economy but disagreed with the extent of the noncompliance. However, TIGTA had provided the IRS with a detailed, step-by-step methodology guide for the figures, and IRS officials offered no questions, comments, or concerns.

[16] TIGTA, Report No. 2021-30-002, *Billions in Potential Taxes Went Unaddressed From Unfiled Returns and Underreported Income by Taxpayers That Received Form 1099-K Income* (Dec. 2020).

[17] Each individual or business received at least one Form 1099-K.

Figure 6 shows that the three selected P2P payment applications represent 8 percent and 20 percent of all Form 1099-K documents issued to unique businesses and individuals, respectively. Because many P2P payment applications are not required to file these information returns, the number of taxpayers actually generating revenue through this sector is likely significantly higher.

Further analysis of the P2P underreporter and nonfiler data provided additional insight into the extent of noncompliance by taxpayers in the area when information return reporting is available to them. The IRS also did not always take compliance actions on nonfilers of tax returns and underreporters related to P2P payments even when information reporting was available. For purposes of this report, we defined underreporting taxpayers as those that had more than $10,000 worth of underreported Form 1099-K payments, and nonfilers were defined as those that failed to file a tax return despite receiving Form 1099-K payments (no income threshold). Figure 7 shows individual and business taxpayers that received Form 1099-K payments and potentially underreported income or did not file a tax return to report income.

Figure 7: TY 2017 Form 1099-K Underreporters and Nonfilers From Three P2P Payment Application Companies

Individual Taxpayers	Number of Forms 1099-K	%	Form 1099-K Payments	%
Underreporters	27,337	29%	$2,694,182,097	19%
Nonfilers	65,544	71%	$11,459,436,391	81%
Totals	92,881	100%	$14,153,618,488	100%

Business taxpayers	Number of Forms 1099-K	%	Form 1099-K Payments	%
Underreporters	5,227	7%	$2,941,606,452	20%
Nonfilers	71,603	93%	$11,979,887,306	80%
Totals	76,830	100%	$14,921,493,758	100%

Source: TIGTA analysis of data used in a prior TIGTA report (Report No. 2021-30-002).

In total, 169,711 taxpayers potentially did not report up to $29 billion of payments received per Form 1099-K documents issued to them. The underreported Form 1099-K payments and Form 1099-K payments that were never reported to the Government because the taxpayers never filed a tax return would likely be mitigated by associated expenses. For example, using the IRS's Statistics of Income data for individual nonfilers based on average net income for individual nonfilers, we can assume deductions of approximately 73 percent and using a threshold of $50,000 in Form 1099-K payments results in 25,961 taxpayers receiving $10.3 billion in payments. This would result in potential net income for these taxpayers of $2,782,131,353. For business nonfilers, this same Statistics of Income data reflect average deductions of approximately 93 percent and using the same $50,000 threshold results in 36,284 taxpayers receiving $11 billion in payments. This would result in potential net income for these taxpayers of $787,826,569. The IRS has not provided estimated expense ratios for underreporters. However, this shows that taxpayers may not be reporting income despite third-party reporting.

Consequently, the potential for noncompliance or the exploitation of various loopholes (*e.g.*, reporting thresholds, open filing requirements, start dates) is more likely when information reporting is not available.[18]

As mentioned previously, this information does not reflect the complete underreporting or nonfiling totals of the entire P2P sector. It does, however, provide some insight into the noncompliance potential that exists, especially among companies that allow for personal cash transfers and do not have the information reporting requirements of entities classified as TPSOs. Among P2P payment applications that issued Form 1099-K documents, reporting requirements were usually triggered once the recipient exceeded $20,000 in transaction value and 200 aggregate transactions. Due to these legal guidelines, underreporting risk also exists for those that remain below the legal reporting thresholds (see Figure 4 as an example).

If such a high potential for underreporting and nonfiling exists, even when information returns are available, it is likely that taxpayers are using P2P payment applications to take advantage of the lack of reporting requirements. Moreover, the enforcement limitations could be a signal to users that the P2P sector is not closely monitored for compliance.

We found numerous examples, in the press and online forums, of taxpayers accepting payment via P2P payment applications that do not issue Form 1099-K returns or are not required to do so. [redacted] The services themselves covered a wide range of industries, from lawn care to childcare. [redacted] In the absence of information, the IRS lacks the ability to bring such taxpayers into compliance. In the case of taxpayers that fail to report P2P income, despite the existence of an associated Form 1099-K, the IRS does have probable cause. Working these cases has the potential to uncover other types of P2P payment application income facilitated by companies that do not have the same requirements.

With respect to these findings, TIGTA's report on Form 1099-K underreporters and nonfilers issued in Fiscal Year 2021 made seven recommendations to help improve the identification, creation, and work selection processes for the nonfiler and underreporter programs using Forms 1099-K.[19] Because this is an expanding part of the economy that appears to have unique tax noncompliance risks, the IRS should consider making it the subject of a compliance initiative project as resources become available.

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, should consider establishing a compliance initiative project, as resources become available, using Form 1099-K payments associated with P2P payment applications, including but not limited to those identified by this audit.

[18] To calculate potential net income, we applied the applicable statistic of income percentages (26.95% and 7.15%, respectively) only to individual and business nonfilers that received over $50,000 of Form 1099-K payments.

[19] TIGTA, Report No. 2021-30-002, *Billions in Potential Taxes Went Unaddressed From Unfiled Returns and Underreported Income by Taxpayers That Received Form 1099-K Income* (Dec. 2020).

Management's Response: IRS management disagreed with this recommendation. They do not believe there is a demonstrated compliance problem that warrants a compliance initiative project.

Office of Audit Comment: While IRS management agreed that the identification of potential unreported income transferred via P2P payment applications has inherent challenges, they stated that they have mechanisms in place to effectively identify noncompliance. The IRS also cited its field examinations as a compliance program that addresses unreported income when an information return is not issued. Specifically, the minimum income probes an examiner completes during field examinations.

Our reports clearly show the compliance risk that P2P payment applications pose to tax administration. The most recent IRS Tax Gap study estimates that when third parties do not provide information to the IRS, 55 percent of income is misreported. P2P payment applications [redacted] while operating within the virtual economy. Businesses may [redacted] and, like unreported cash receipts, may be hard to detect during an IRS examination.

Further, we showed the significant magnitude of P2P taxable transactions by providing the reported payments of three P2P payments applications. Over 169,700 taxpayers potentially did not report up to $29 billion of payments received per Form 1099-K documents from P2P payment applications issued to them. This shows that taxpayers may not be reporting income despite third-party reporting and the potential for noncompliance or the exploitation of various loopholes (*e.g.*, reporting thresholds, open filing requirements, start dates) is more likely when information reporting is not available.

Policies, Procedures, and Techniques Are Available to Assist Examiners With Uncovering Unreported Income

Tests for unreported income during IRS examinations are a key part of a process designed to verify that the correct amount of tax is reported. To assist examiners in conducting audits properly, the IRS has a number of policies, procedures, and techniques in place at the national and local (division and group) levels. As a result, the audit process helps remedy the noncompliance that can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

The IRS relies on its examiners to ensure that audits are properly conducted. Throughout the Internal Revenue Manual (IRM), examiners are instructed to properly document, in audit files, all aspects of their work during audit planning, testing of income and expense items, and closing of audits.[20] This documentation is important because it provides the principal evidence that

[20] IRM 4.10.9 (Aug. 11, 2014).

procedures were followed and is further emphasized in management directives, newsletters, training materials, and quality measurement standards.

Examiners are explicitly instructed to consider gross income during all income tax return examinations.[21] As part of this consideration, minimum income probes are completed (in most cases) regardless of the type of return filed by the taxpayer. The minimum income probes are designed as a set of analytical tests intended to determine whether the taxpayer accurately reported income. If the taxpayer is underreporting income, the probes should result in the identification of at least a portion of the understatement. Minimum income probes for an individual "business" return would include:[22]

- Financial status analysis: Prepare a financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities. This step must be completed on all examinations to determine the scope of the examination.
- E-Commerce and/or Internet Use: Determine if there is Internet use and e-commerce income activity. This step is required if the audit is not designated as "limited scope."

IRS audit workpaper documentation requirements are inadequate for oversight

We analyzed a population of 46,018 examinations that were closed in Fiscal Year 2018. Of these cases, we judgmentally sampled the following two subpopulations that included individual income tax returns with income from Schedule C, *Profit or Loss From Business*, or Schedule E, *Supplemental Income and Loss:*

- 4,058 cases involving taxpayers that operated in heavily cash-based transactions industries, without considering whether a Form 1099-K was issued to the taxpayer under examination.
- 118 cases involving taxpayers that operated in heavily cash-based transactions industries and had Form(s) 1099-K issued to them from one of the three platforms reviewed [redacted]

Using these subpopulations, we randomly selected a sample of 268 cases from the first subpopulation and a sample of 86 taxpayers from the second. We ordered the physical copies of our sampled cases in March 2020 and did not receive them.[23] In April 2020, we were advised that our requests could not be completed due to closures of IRS campuses caused by the COVID-19 pandemic. In order to complete our case review, we relied on the case file information in the Correspondence Examination Automation Support (CEAS) system.[24] Using the electronic workpapers on the CEAS system, we could review only 168 of the 268 cases selected in the first sample but all 86 of the cases selected in the second sample. While IRS

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[21] IRM 4.10.4.3 (Aug. 9, 2011).

[22] See Appendix V for the complete list of minimum income probes.

[23] When a request for an examination case with a document locator number is made using the Integrated Data Retrieval System, the request is printed and sent to the Files area in the appropriate IRS campus. However, the Integrated Data Retrieval System is not designed to track specific requests to identify whether an examination case has been located, sent to the requester, or received by the requester. A requester may have to wait for a significant period of time for an examination case or for a paper response indicating an examination case has been previously sent to another IRS employee (the response should include that employee's contact information).

[24] The CEAS system is a web-based application that stores electronic RGS cases and supports case retrieval, assignment, transfers, and closures from the group and includes functionality for online manager case reviews.

guidelines require that audit work and conclusions be supported in the administrative paper case files, workpapers are not currently required to be stored in the Report Generation Software (RGS) and the CEAS system.[25] As a result, the information we were able to review was limited in many cases.

IRS procedures require examiners to use the RGS and the CEAS system for examinations of Forms 1040, *U.S. Individual Income Tax Return*; Forms 1120, *U.S. Corporation Income Tax Return*; and Forms 1065, *U.S. Return of Partnership Income*, to compute corrected tax, penalties, and interest; generate examination reports and supporting schedules; and post examination results and archive cases.[26] However, IRS procedures pertaining to workpapers (documenting issues) state that all information critical to the case or that supports an adjustment must be included in the paper case file, including lead sheets, supporting workpapers, and any other pertinent documents. Whenever possible, examiners are encouraged to include all information critical to the case or that supports an adjustment in the RGS system electronic case file as well.[27]

Examination officials stated that they have initiated efforts to require all case documents to be completed electronically. They have disseminated digitization procedures, including procedures on how documents should be converted to electronic format and named accordingly. In July 2019, the IRS started testing electronic case creation with two field groups and expanded to 14 field groups in February 2020. They are currently working to expand the use of electronic case files nationwide.

Given the growth in the development and use of P2P applications, the IRS Examination function should consider including an Internet and e-commerce evaluation on limited scope examinations

For our two samples, we reviewed the available case file workpapers and focused on these two items:

(1) A financial status analysis, in the form of a T-Account, to estimate whether there are sufficient funds to cover the taxpayer's expenses. The IRM suggests that a T-Account workpaper provides a quick and easy format for documenting indications of a potential understatement.[28]

(2) E-commerce considerations to determine how the taxpayer used the Internet to conduct business. To evaluate compliance, we looked for documentation that suggested the examiner conducted Internet searches and documented the results.

Overall, we found that the IRS Examination function is generally completing financial analysis; however, given the growth in the P2P payment application sector, the IRS should consider expanding the minimum income probe to include Internet and e-commerce activities on limited scope examinations.

[25] The software program used in the IRS's audit process to: 1) compute corrected tax, interest, and penalties and to generate audit reports; 2) create various forms and letters; 3) allow tax examiners and reviewers to document their actions and findings; and 4) process and archive audit results.

[26] IRM 4.10.15.2 (Sept. 2018).

[27] IRM 4.10.9.7.7 (Aug. 2014).

[28] Per IRM 4.10.4.3.3.1(5) (Aug. 9, 2011), sources of funds are on the left side of the T-Account and expenditures of funds are on the right side. Total sources are compared with total expenditures.

During our case reviews, we found that 64 of 96 examiners (who documented Internet and e-commerce activity) did so using a detailed E-business workbook which is preloaded into Examination's electronic workpapers (others may also have used the workbook but did not save it in the RGS, as saving it in the RGS is not currently required). Although the IRM does not specifically require examiners to use it during audits, we found the spreadsheet to be designed well, automated, and easily accessible.

Notably, the E-business workbook also solicits answers to the items needed to make accurate preliminary financial analysis. In terms of benefits, the additional steps may lead to potentially increased revenue from audits through the identification of unreported income or overstated expenses that might otherwise go undetected, without increasing burden to compliant sole proprietors.

When we inquired about this workbook, the IRS indicated that it has developed a new minimum income probe workbook that includes an e-commerce consideration. We obtained a copy of this workbook and noted that it contains minimum income probe lead sheets for (1) nonbusiness returns, (2) individual business returns, (3) corporations and other business returns, (4) nonfiled returns, and (5) limited-scope examinations. Each lead sheet contains links to separate workbooks needed to carry out the probes required by the type of audit. Of the lead sheets included, only those required for individual business returns, nonfiled returns, and corporations/other business returns contained links to an e-commerce lead sheet as they are the only types of examinations that require such a consideration.

After the preliminary financial analysis, 33 (20 percent) of the 168 cases involving taxpayers that did not receive a Form 1099-K and 11 (13 percent) of 86 taxpayers that did receive a Form 1099-K were designated as "limited scope" audits. We noted previously that minimum income probes related to Internet use and e-commerce activities are not required for limited scope audits.

With the continuous growth in the P2P payment applications, the determination of a taxpayer's digital/online footprint is a key step that could yield important information about a taxpayer under audit. If an examiner fails to identify a taxpayer's digital/online presence, there is heightened potential to overlook a risky area (*e.g.*, does the taxpayer accept payments online via P2P payment applications). Based on the available guidance, an examiner could prematurely limit the scope of an audit without knowing whether a taxpayer uses digital platforms to process commercial transactions, possibly overlooking vital areas containing unreported income. Because the information in the CEAS system that we were able to review was limited, it is unclear whether examiners complete these searches or not.

Guidance requiring the inclusion of Internet use and e-commerce activity income probe for all examinations, including those designated "limited scope" or "nonbusiness," could help identify a taxpayer's online presence and assist examiners in identifying unreported P2P payment application income. Given the volume of business and individual nonfiler and underreporter taxpayers with Form 1099-K payments that were not identified or created by the IRS's nonfiler programs or identified but not worked by the IRS, coupled with the high threshold triggering third-party reporting, the IRS needs a strategy to address the growth in the use of P2P payment applications. If the IRS is unable to effectively identify noncompliance, taxpayers may begin using P2P payment applications to conduct business, skirt third-party reporting, and avoid paying taxes on income.

Accepting payments for goods and services via P2P payment applications is similar to accepting cash. In addition to addressing cases of known noncompliance within its nonfiler/underreporter programs, the IRS should develop an action plan to address the underpayment of tax on business income that is commonly attributed to the receipt of cash but may be moving into P2P payment applications. Currently, the IRS does not have specific focus on the P2P sector. With the risk of underreported income, it is important that the IRS have a strategy to identify and address noncompliance in this area to reduce the Tax Gap and increase taxpayer understanding of tax reporting requirements.

Recommendation 3: The Commissioner, Small Business/Self-Employed Division, should consider requiring the completion of the Internet use and e-commerce income activity minimum income probe for all individual business, corporate, and other business taxpayers, including those designated as limited-scope examinations.

> **Management's Response:** IRS management agreed with this recommendation and will clarify guidance to require completion of the minimum income probe during limited-scope examinations for all individual business, corporate, and other business taxpayers.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the effectiveness of the IRS's efforts to identify unreported income transferred via P2P payment systems. To accomplish our objective, we:

- Determined, through online research and interviews of IRS officials, whether the IRS has an effective program to identify unreported income by taxpayers using global online payment businesses.
- Determined the limitations regarding the reporting requirements of P2P payment applications. We assessed whether selected P2P payment applications should be considered TPSOs under the law and be required to file Forms 1099-K as a result (when applicable). To do so, we reviewed legal guidance, user agreements, private letter rulings associated with TPSO designations, newspaper articles, and P2P application websites to support our position in discussions with the IRS Office of Chief Counsel.
- Judgmentally selected a sample of eight P2P payment applications to determine whether they met the requirements to issue information returns under I.R.C. § 6050W. To do so, we reviewed their terms of use documents and conferred with the IRS Office of Chief Counsel.
- Obtained and analyzed all Individual Master File and Business Master File underreporters and nonfilers based on Form 1099-K data. Underreporting taxpayers were identified as those that had a difference of $10,000 or more between the gross total of all Form 1099-K documents issued to them and the amount reported on the return they filed. Once obtained, we isolated the nonfilers and underreporters attributable to three P2P companies we reviewed: [redacted] We also analyzed this Form 1099-K filing data, comparing the impact on filing of various income and transaction thresholds.
- Evaluated the effectiveness of the Examination function in uncovering unreported P2P income within the context of an examination. We analyzed a population of 46,018 examinations closed in Fiscal Year 2018. We selected two judgmental samples (based on the likelihood of cash-based transactions) and focused on the steps examiners took to identify unreported income received from P2P payment applications.[1]
  - From a subpopulation of 4,058 cases involving taxpayers that operated in heavily cash-based transactions industries, without considering whether a Form 1099-K was issued to the taxpayer under examination, selected a sample of 168 cases.
  - From a subpopulation of 118 cases involving taxpayers that operated in heavily cash-based transactions industries and had Form(s) 1099-K issued to them from one of the three platforms reviewed [redacted], selected a sample of 86 cases.

[1] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

- Reviewed the selected cases for financial status analysis and e-commerce evaluation documentation. We ordered physical copies of our sampled cases but did not receive them due to closures of IRS campuses caused by the COVID-19 pandemic. For the purposes of the review, we relied on information in the CEAS system which is limited.

Performance of This Review

This review was performed with information obtained from the Small Business/Self-Employed Division Examination function and the Office of Chief Counsel at the IRS National Headquarters in Washington, D.C., during the period of July 2019 through August 2020. We ordered the physical copies of our sampled cases in March 2020 and did not receive them. We were advised that our follow-up requests were not satisfied due to closures of IRS campuses caused by the COVID-19 pandemic. Our audit work was limited to the sampled cases for which the examiners completed electronic workpapers. We reviewed the electronic workpapers on the CEAS system. With exception of this scope limitation, 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.

Major contributors to the report were Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Christina Dreyer, Director; Tim Greiner, Audit Manager; and Shalin Basnayake, Lead Auditor.

Validity and Reliability of Data From Computer-Based Systems

During this review, we obtained the data extracted and analyzed by another audit to understand and evaluate the P2P component of general Form 1099-K noncompliance.[2] Before relying on these data, we verified that appropriate data reliability assessments had been completed by the other audit team. In addition, we obtained extracts from the 2018 Audit Information Management System Closed Exam Data table in the Data Center Warehouse. To rely on these data, we ensured that the appropriate data elements were included. We also evaluated the data by 1) performing electronic testing of the required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) confirming the methodology used to pull the data with the IRS. We also performed an analysis to ensure the validity and reasonableness of our data. Based on the results of our tests, we believe the data are sufficiently reliable for the purposes of this report.

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

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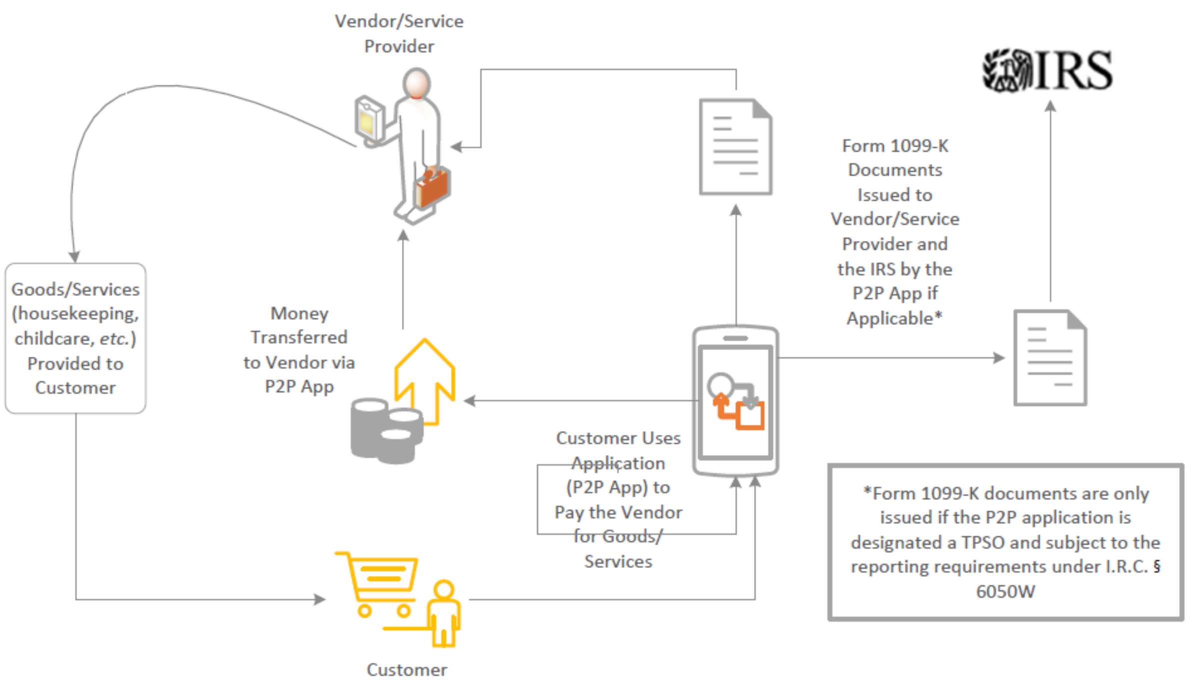
[2] TIGTA, Report No. 2021-30-002, *Billions in Potential Taxes Went Unaddressed From Unfiled Returns and Underreported Income by Taxpayers That Received Form 1099-K Income* (Dec. 2020).

following internal controls were relevant to our audit objective: IRS policies, procedures, and practices to identify, select, and process work selection of individual and business underreporters and nonfilers with Form 1099-K P2P income. We evaluated these controls and procedures by reviewing source material, interviewing IRS management, and performing analysis on IRS individual and business underreporter and nonfiler taxpayer data.

Appendix II

Business Transaction Using Peer-to-Peer Payment Application and Form 1099-K Issuance Process



Appendix III

Form 1099-K, *Payment Card and Third Party Network Transactions*

☐ VOID ☐ CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	FILER'S TIN	OMB No. 1545-2205	**Payment Card and Third Party Network Transactions**
	PAYEE'S TIN	2020	
	1a Gross amount of payment card/third party network transactions $	Form 1099-K	
Check to indicate if FILER is a (an): Payment settlement entity (PSE) ☐ Electronic Payment Facilitator (EPF)/Other third party ☐ — Check to indicate transactions reported are: Payment card ☐ Third party network ☐	1b Card Not Present transactions $	2 Merchant category code	**Copy 1 For State Tax Department**
	3 Number of payment transactions	4 Federal income tax withheld $	
PAYEE'S name	5a January $	5b February $	
Street address (including apt. no.)	5c March $	5d April $	
	5e May $	5f June $	
City or town, state or province, country, and ZIP or foreign postal code	5g July $	5h August $	
PSE'S name and telephone number	5i September $	5j October $	
	5k November $	5l December $	
Account number (see instructions)	6 State	7 State identification no.	8 State income tax withheld $ $

Form **1099-K** www.irs.gov/Form1099K Department of the Treasury - Internal Revenue Service

Appendix IV

Internet Use and Probe for E-Business Lead Sheet Example

E-Commerce Lead Sheet

Internet Use and Probe for E-Business Activity

Conclusion: *(Reflects the final determination on the issue)*

Examiners are required to determine Internet Use and Probe for E-Commerce Activity as part of the Minimum Income Probes under . IRM 4.10.4.3.7

Audit Steps: (Document audit steps taken or to be taken)	Reference
Internet Use 1. Use Google or another Internet search engine to complete a basic search on taxpayers name, business name, phone number and address. The purpose is to determine if your taxpayer uses the Internet to advertise or has e-commerce sales activities. Some examples of e-commerce activities are the business' website(s), advertising on Facebook, Craigslist, blogs, or other social media. An address check provides directions and a listing of all businesses at that address. Examiners are to keep in mind that our internal subscription services, such as Accurint, is the starting point to locate addresses of people and businesses and to locate assets. The Internet is where we look to find e-commerce activities. **Interview taxpayer** and **examine records** to detect online accounts for banking, investing, bill paying, auctions, bartering, gambling, online sales and services. Ask the taxpayer about website ownership and affiliations.	

2. E-Commerce: Determine if the taxpayer has a website(s):

Cursory Review of Tax Return:

Business listed on tax return includes a dot such as ".com" Note: There are many domain name extensions in addition to ".com" so look for the dot, ".", in the name.

Check for deductions claimed for Internet related services such as website design / maintenance, depreciation for computers, or fees paid to Internet Service Provider.

Taxpayer disclosed or examiner noted:

Website address listed on correspondence, business card, literature, phone books, signs on vehicles, or signs at business location. Did the Internet Search identify a website?

Examination of Records: deductions paid to Internet service providers, e-payment providers, web related expenses such as design or maintenance, etc.

3. Does the taxpayer have one or more websites?

If a website is located, SAVE IT and use the Website Review Lead Sheet to analyze and document your findings.

4.During the interview ask the taxpayer about BOTH personal and business Internet use. Including involvement with:	**Yes or No**
a) Online Banking	
b) Online Payments	

5. Involvement in the following? Refer to Exam Aids to complete audit steps if identified.	**Yes or No**
a) Electronic Records	
b) Electronic Currency (e.g., Bitcoin)	
c) Online Auctions Sales	
d) Online Retail Sales	
e) Online Services	
f) Online Bartering	
g) Online Gambling	

6. Perform a risk analysis.

If you have performed the minimal income probes and there is no evidence of e-commerce activities, then you can stop there. If the taxpayer is engaged in e-commerce activities, then you will want to first evaluate risk.

Determine whether to pursue an Internet Income issue based on relative dollar and tax impact. Include income tax and SE tax in the analysis. Consider whether the taxpayer is engaged in a viable business. If not material, you are done - move on to another issue.

Source: IRS.

Appendix V

Minimum Income Probes: Individual Business Returns (Examination Field Employees)

Minimum Income Probes	Description
Financial Status Analysis	Prepare a financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities.
Interview	Conduct an interview with the taxpayer (or representative) to gain an understanding of the taxpayer's financial history, identify sources of nontaxable funds, and establish the amount of currency the taxpayer has on hand. Consider possible bartering income as part of the minimum income probes.
Tour of Business	Tour the business site and review of the Internet website to gain familiarity with the taxpayer's operations and internal controls and identify potential sources of unreported income. A tour of the physical business site is not required for office audit cases but may be conducted if appropriate and with manager approval.
Internal Control	Evaluate internal controls to determine the reliability of the books and records (including electronic books and records), identify high-risk issues, and determine the depth of the examination of income.
Reconciliation of Income	Reconcile the income reported on the tax return to the taxpayer's books and records. An analysis of the Information Return Processing information in the file should also be completed to ensure that all business and investment activities reflected on the Information Return Processing documents are properly accounted for on the tax return.
Testing Gross Receipts	Test the gross receipts by tying the original source documents to the books.
Bank Analysis	Prepare an analysis of the taxpayer's personal and business bank and financial accounts (including investment accounts) to evaluate the accuracy of gross receipts reported on the tax return.
Business Ratios	Prepare an analysis of business ratios to evaluate the reasonableness of the taxpayer's business operations and identify issues needing a more thorough examination.
E-Commerce and/or Internet Use	Determine if there is Internet use and e-commerce income activity.

Source: IRM 4.10.4.3.3.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

April 8, 2021

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris
Commissioner, Small Business/Self-Employed Examination

SUBJECT: Draft Audit Report – The Internal Revenue Service Faces Challenges in Addressing the Growth of Peer-to-Peer Payment Application Use (Audit # 201930019)

Thank you for the opportunity to review and comment on the subject draft audit report. The Peer-to-Peer (P2P) payment application allows users to send money from mobile devices through a linked bank account or credit/debit card. The use of these payment applications on virtual platforms has grown over the years to far exceed the traditional mobile banking applications. The IRS has faced some enforcement challenges because many P2P payment applications were not required to issue Forms 1099-K, *Payment Card and Third Party Network Transactions*, reporting payments made on behalf of users because Internal Revenue Code (IRC) section 6050W only required a third party settlement organization to report payment information if the payee received over $20,000 in gross payment volume with respect to 200 or more separate third party network transactions in a calendar year. The American Rescue Plan Act of 2021, signed into law on March 11, 2021, changes the threshold for reporting significantly, requiring reporting by third party settlement organizations of a gross amount of $600 or more paid to a single payee in a calendar year, effective for calendar years beginning after December 31, 2021.

The identification of potential unreported income transferred via P2P payment applications has inherent challenges, but the IRS has mechanisms in place to effectively identify non-compliance. TIGTA acknowledges in this report, as well as in prior reports, that "[t]he Automated Underreporter (AUR) and Business Underreporter (BUR) programs can identify and work cases of noncompliance when the taxpayer received a Form 1099-K but did not report the income earned or did not file an income tax return." Therefore, to the extent that P2P companies are legally required to issue a Form 1099-K, the SB/SE Examination post-processing compliance programs do in fact identify and work the discrepancies related to those P2P payors as appropriate based on available resources. Additionally, we have compliance programs in place via our field examinations to identify and address unreported income when an information return is not issued.

We are concerned TIGTA has not considered the results of the compliance efforts taken by the IRS, particularly in the underreporter programs. The BUR program pursued 3,456 Form 1099-K discrepancies in TY 2017 which addressed $2.5 billion gross Form 1099-K payments. Only 22% of the discrepancies (representing $550 million) were determined to result from underreporting of income, leading to $31 million in tax assessments so far. While the AUR program does not track Form 1099-K payments in the same manner as the BUR program, it does track assessments when at least 50% of the underreported amount is attributable to Form 1099-K. The AUR program pursued over 72,000 tax year 2017 underreporters in this category with Form 1099-K gross payments of $31.6 billion, resulting in an underreporter discrepancy of $28.3 billion but assessments of only 6% ($673 million) of the proposed tax.[1] This low assessment rate illustrates that there are valid explanations, such as businesses sharing terminals in processing payments, reporting of the income by related businesses, or reporting of the income on a different line item of the return, that eliminate many discrepancies. Moreover, proceeds reported on Form 1099-K may not be taxable. Given our existing resource constraints and the opportunity costs inherent in prioritizing this 1099-K issue over higher-priority work that is likely to yield greater tax assessments, the IRS does not believe there is a demonstrated compliance problem that would warrant further examination resources.

This conclusion is further supported by the results of our AUR soft notice test and our extensive communication and outreach efforts to educate gig workers on their filing and payment obligations, undertaken in response to a prior TIGTA review on the gig economy. The initial results of our soft notice test reflect a lower self-correct rate than other soft notice efforts. Additionally, the profile completed by our research function found only 29% of gig workers have gross earnings greater than $5,000 before reducing those earnings by allowable business expense deductions. We have found that most gig workers have average expenses of 84% of gross income and many actually claim business losses. These results do not justify the resource cost of the extensive compliance efforts.

In its current report, TIGTA states our examiners *generally* complete a financial analysis using the minimum income probe during examinations and examiners effectively used examination tools to solicit facts needed to accurately perform preliminary financial analyses. TIGTA also observed that our established procedures for the examination of income are effective in reinforcing the requirement to perform and document the financial analysis to identify underreported or unreported income. TIGTA concluded,

[1] Examination of tax year 2017 returns is still in process and final business results are subject to change.

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however, that examiners did not always perform the financial analysis because some reviewed cases did not include workpapers documenting the financial analysis. We believe TIGTA's conclusion is unsupported. As TIGTA acknowledges, due to COVID-19 pandemic, in many instances it was unable to obtain and review the official administrative paper case files, instead relying solely on electronic records that contain only a subset of the documents and workpapers from the administrative file. Therefore, the review of electronic records cannot be used to draw conclusions regarding the contents of the official administrative case files.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or Scott Irick, Director, Examination, Small Business/Self-Employed Division.

Attachment

Attachment

RECOMMENDATION 1:
The IRS Chief Counsel should work with the IRS and Treasury Office of Tax Policy to consider pursuing regulatory change that clarifies TPSO designation, including defining guarantee of payment provisions, under I.R.C. § 6050W.

CORRECTIVE ACTION:
Counsel will work with the IRS and Treasury Office of Tax Policy to consider pursuing regulatory change that clarifies TPSO designation, including defining guarantee of payment provisions, under I.R.C. §6050W.

IMPLEMENTATION DATE:
February 15, 2022

RESPONSIBLE OFFICIAL:
Associate Chief Counsel, Procedure & Administration

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

RECOMMENDATION 2:
The Commissioner, SB/SE Division, should consider establishing a compliance initiative project, as resources become available, using Form 1099-K payments associated with P2P payment applications, including but not limited to those identified by this audit.

CORRECTIVE ACTION:
The IRS does not believe there is a demonstrated compliance problem which warrants a Compliance Initiative Project (CIP). Business results, for tax year 2016, indicate that when the AUR program pursues a return where at least 50% of the discrepancy is from the Form 1099-K, only 2% of the tax proposed ultimately is assessed. For the BUR program, business results for tax year 2016 indicate that only 23% of the tax proposed is ultimately assessed when 100% of the discrepancy is attributable to Form 1099-K. This low assessment percentage results from shared terminals, reporting of the income by related businesses, and reporting of the income on another line item of the return. In addition, proceeds reported on Form 1099-K may not be taxable. Lastly, during our field examinations, the examiner investigates potential income from all sources, including P2P payors, when completing the minimum income probe.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 3:
The Commissioner, SB/SE Division, should consider requiring completion of the internet use and e-commerce income activity minimum income probe for all individual business, corporate, and other business taxpayers, including those designated as limited-scope examinations.

CORRECTIVE ACTION:
The IRS will clarify guidance to require completion of the minimum income probe during limited scope examinations for all individual business, corporate, and other business taxpayers.

IMPLEMENTATION DATE:
November 15, 2022

RESPONSIBLE OFFICIAL:
Director, Examination Field and Campus Policy, Small Business/Self-Employed Division

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

Appendix VII

Glossary of Terms

Term	Definition
Audit Information Management System	The Audit Information Management System is a computer system used by the Small Business/Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.
Automated Underreporter	The Automated Underreporter program matches items reported on an individual's income tax return to information supplied to the IRS from outside sources to determine if the taxpayer's tax return reflected the correct amounts, ensuring that the tax amount is correct.
Business Master File	The IRS database that maintains transactions or records of business tax accounts.
Business Underreporter	The Business Underreporter program matches items reported on a business's income tax return to information supplied to the IRS from outside sources to determine if the taxpayer's tax return reflected the correct amounts, ensuring that the tax amount is correct.
Data Center Warehouse	Provides data and data access services and a centralized storage, security, and administration of files. Also develops uniform and user-friendly interfaces for users to access data.
Document Locator Number	A 14-digit number assigned to each return or payment received, consisting of a file location code, tax class, document code, Julian date, blocking series, serial number, and tax year.
Fiscal Year	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.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Information Returns Master File	An IRS database that stores income and withholding data reported to the IRS from payers and employers.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Tax Gap	The gross Tax Gap is the amount that is owed by taxpayers before collections from IRS enforcement actions and other late taxpayer payments are taken into account.
Tax Year	The 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.

Appendix VIII

Abbreviations

CEAS	Correspondence Examination Automation Support
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
P2P	Peer-to-Peer
RGS	Report Generation Software
TIGTA	Treasury Inspector General for Tax Administration
TPSO	Third Party Settlement Organization
TY	Tax Year

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Ben Franklin Station

Washington, D.C. 20044-0589

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