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Business Income and the Tax Gap

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The Internal Revenue Service recently completed a National Research Program (NRP) reporting compliance study of individual taxpayers for tax year 2001. The study involved random selection of about 46,000 returns for review. The examinations generally concluded in the fall of 2004.

IRS designed the NRP to measure reporting compliance and determine the tax gap. The tax gap is the difference between the amount of tax that taxpayers should pay for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with the tax laws.

The largest component of the tax gap comes from unreported and underreported income. Non-filing and underpayment of tax comprise the rest of the tax gap. NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income — underreported receipts and overstated expenses.

While the NRP data tell IRS quite a bit about the tax gap there is one critical unknown piece. The data do not reveal how much of the gap is attributable to willful non-compliance or carelessness and how much is the result of a lack of understanding by the taxpayer of his or her full tax obligation.

In an effort to assist small businesses and self-employed taxpayers to better understand their reporting, filing and payment obligations, the IRS designed a series of fact sheets to identify issues discovered during the NRP process and provide detailed educational information.

This first fact sheet addresses the issue of income and how to determine gross income for a small business or self-employed taxpayer. A later fact sheet will provide information about a factor contributing to underreported income — overstated expenses.

Business Income, Gross Receipts or Sales

If there is a connection between any income received and a business, the income is business income. A connection exists if it is clear that the payment of income would not have been made if the business did not exist and operate.

Small business owners and self-employed taxpayers must report on their tax returns all income received from their businesses unless specifically excluded by law. In most cases, business income will be in the form of cash, checks and credit card charges.

But business income can be in other forms, such as property or services. The following list includes some examples of other forms of income, such as:

- Bartering
- Real estate rents
- Personal property rents
- Interest and dividend income
- Canceled debt
- Promissory notes
- Lost income payments
- Damages
- Economic injury payments
- Kickbacks

All income earned is taxable. Directing payment of income to a third party does not remove the reporting and payment requirements for small businesses and self-employed taxpayers.

Cost of Goods Sold

Some businesses may make or buy goods to sell. If so, these businesses may deduct the cost of goods sold (COGS) from their gross receipts. To determine these costs, the value of inventory at the beginning and end of the year must be calculated.

There are several factors that go into determining COGS including:

- Inventory at the beginning of the year
- Purchases less cost of items withdrawn for personal use
- Labor costs (generally applies to manufacturing and mining operations)
- Materials and supplies (generally a manufacturing cost)
- Other costs (generally applies to manufacturing and mining operations)
- Inventory at the end of the year

Inventory, net purchases, cost of labor, materials and supplies, and other costs are added together. Inventory at the end of the year is subtracted from this total to determine COGS.

Gross Income

To calculate gross income, first determine net receipts (gross receipts minus returns and allowances) and minus the cost of goods sold. Returns and allowances include cash or credit refunds made to customers, rebates and other allowances off the actual sales price. Then add any other income, including fuel tax credits. Gross income must be determined first before deducting business expenses.

Tools to Use

There are tools available to assist small business owners and the self-employed track and report income such as the use of:

- A formal set of books and records with strong internal controls
- Accounting/financial computer software and
- Separate bank accounts for business and personal income and expenses

Small businesses and self-employed taxpayers greatly benefit by accurately recording and

reporting all income. Insufficient recordkeeping could cause income to be over-reported and too much tax paid or too little income reported and too little tax paid.

The Small Business and Self-Employed One-Stop Resource is a Web based tool. It contains a wealth of information to educate business owners and the self-employed on their unique tax filing and reporting obligations.

Another Web based tool is the Online Learning and Educational Products section of IRS.gov which allows business owners to view a streaming video of an IRS Small Business Workshop, order the Small Business Workshop on DVD, take an IRS course, or complete an online, self-directed version of a workshop taught live around the country.

These tools can help to more accurately determine income and expenses as well. There are benefits beyond accurate income and expense reporting to be gained. Formalized financial records will help small businesses when it is time to apply for loans or efforts to obtain capital for expansion.