
Self-Employed Nonfilers: The Accuracy of "Enforcement-Secured" Returns

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The Taxpayer Compliance Measurement Program (TCMP) is a system created to measure the success of the Internal Revenue Service (IRS) in fulfilling its tax collection mission [1]. For this purpose, two nationwide surveys were conducted to measure nonfiling of individual income tax returns. The first TCMP individual survey was conducted for Tax Year 1979. The survey sample was primarily limited to leads on nonfiling provided by information returns received by the IRS. Therefore, those individuals not subject to information return reporting [2] (including tax withholding) were largely undetectable and were not included in the estimate of 2.6 million nonfilers for that year [3].

The more recent TCMP individual nonfiler survey was a random stratified sample of approximately 24,000 individual apparent nonfilers for Tax Year 1988 [4]. The sample was constructed by matching a list of all existing social security numbers or SSN's (approximately 313 million), less those listed on the Death Master File (35 million), against all those who filed a tax return in 1989 [5]. The SSN's that matched were eliminated, leaving 100 million SSN's for which there was no matching return. These became the potential nonfilers. A stratified sample of 24,000 SSN's was drawn from the 100 million, for further investigation to determine if these potential nonfilers had sufficient income to file tax returns. Approximately 3,500 delinquent returns of individuals with SSN's included in the sample were then secured through collection efforts [6].

These 3,500 returns were then sampled for further examination. They were first stratified into three segments: total tax on the return either zero or unreported, total tax reported \$1 to \$1,999, and total tax reported \$2,000 or more. The sample selection rate was 54 percent when the total tax reported ranged from \$1 to \$1,999, and 100 percent for the remaining strata, resulting in more than 2,200 returns being selected for audit. These returns, when weighted, represented ap-

proximately 3.5 million nonfilers, wage earners and self-employed. The results of their subsequent examinations provide the basis for the statistics in this paper [7].

Because the self-employed have sources of income not subject to "information reporting" (and tax withholding), there is a concern that those who fail to file an income tax return may escape detection. Even when their returns are secured, it is difficult to determine how accurate they are unless they can be audited. For purposes of this paper, an individual taxpayer (or couple, if the tax return was a joint return) was considered self-employed if, after examination, it was determined that he or she had gross receipts from a business or profession reported on a Schedule C, *Profit or Loss from Business* (Sole Proprietorship); farm income on a Schedule F, *Profit or Loss from Farming* (Sole Proprietorship); or self-employment tax on a Schedule SE, *Self-Employment Tax*. An estimated 1.5 million, or 43 percent, of the 3.5 million nonfilers from whom delinquent returns for Tax Year 1988 were secured were self-employed.

■ Characteristics of Self-Employed Nonfiler Returns

Although the Internal Revenue Service was able to secure returns from nonfilers, this does not mean that the income and deductions reported on these returns were accurate. Overall, more than 36 percent of the returns secured from wage earners (taxpayers all of whose income is from wages) were adjusted during IRS audit. However, nearly 87 percent of the returns secured from self-employed nonfilers were similarly adjusted.

■ Total Income

While average total income before statutory adjustments reported on returns secured from wage earners

was almost \$18,500, the average for a self-employed nonfiler was little more than \$15,000, with income ranging from a negative \$0.9 million to a positive \$5.1 million. However, after examination, the average total income for wage earners increased to slightly over \$19,000, while the average income of the self-employed nonfiler rose to nearly \$21,000. In total, wage earners reported \$38.2 billion of income on their returns, as filed. After examination, the amount rose to \$40.0 billion, resulting in a difference of \$1.8 billion and a "voluntary reporting percentage" (VRP) of 95.4.

VRP is a compliance measure, calculated by dividing an income or deduction item, as reported by the taxpayer on the return, by the corrected amount, as determined by the IRS examiner; then, multiplying by 100 [8]. If deductions or credits are overreported, the VRP will exceed 100; if they are understated, the VRP will be less than 100. The self-employed reported only \$22 billion of the \$30 billion total income that examination uncovered, resulting in a difference of \$8 billion and a lower VRP of 72.8.

Because the self-employed have income not subject to "information reporting" (i. e., statements provided to IRS and the taxpayer on amounts paid out or withheld), they can more easily understate their income than can wage earners, whose income is reported on Forms W-2. Before examination, 44 percent of the self-employed reported a total income (which includes sole proprietorship business and farm profits) ranging from \$1,001 to \$10,000 (Table 1). Almost 13 percent of the self-employed nonfilers reported total income of \$1,000

or less; this category includes all those whose total income was negative. For 21 percent, the income range was \$10,001 to \$20,000, and slightly more than 16 percent reported income between \$20,001 and \$50,000. Less than 6 percent had income above \$50,000.

This distribution changed after audit (Table 1): After "in-depth examinations" for compliance research purposes, the percentage of self-employed with total income of \$1,001 to \$10,000, decreased to 33 percent. Only 9 percent actually had a total income of \$1,000 or less (or a total loss). For 24 percent, the income range was \$10,001 to \$20,000, while for more than 27 percent the income range was between \$20,001 and \$50,000. This 27 percent represents a 69 percent increase over what was originally reported on the return. Finally, more than 7 percent had total income above \$50,000.

Although the VRP for the total income of self-employed individuals was only 72.8, it was even lower when only considering nonfarm sole proprietorship (Schedule C) net income or loss. Self-employed nonfilers reported a net total of almost \$10 billion in nonfarm sole proprietorship income. However, after examination, the figure rose to nearly \$16 billion, an increase of \$6 billion and a VRP of 62.1.

It should be noted that unreported gross receipts are difficult to detect, but overstated business expenses are more noticeable upon examination. Thus, the change in net income on Schedule C is due both to an understatement of receipts, as well as an overstatement of expenses. This is also true of farm profits reported on Schedule F.

Table 1. Self-Employed Nonfilers: Number of Returns by Size of Total Income, Before and After Examination

[All data are estimates based on samples.]

Size of Total Income Before Examination	Size of Total Income After Examination											
	Total		\$1,000 or less*		\$1,001 to \$10,000		\$10,001 to \$20,000		\$20,001 to \$50,000		Over \$50,000	
	# of Returns [1]	% of Total [2]	# of Returns [3]	% of Total [4]	# of Returns [5]	% of Total [6]	# of Returns [7]	% of Total [8]	# of Returns [9]	% of Total [10]	# of Returns [11]	% of Total [12]
Total	1,454,951	100	128,700	8.8	474,357	32.6	352,520	24.2	396,530	27.3	102,844	7.1
\$1,000 or less*	187,455	12.9	128,700	8.8	35,191	2.4	14,025	1	7,979	0.5	1,560	0.1
\$1,001 to \$10,000	638,086	43.9	-	-	437,861	30.1	106,223	7.3	93,059	6.4	943	0.1
\$10,001 to \$20,000	308,608	21.2	-	-	1,305	0.1	232,272	16	70,681	4.9	4,350	0.3
\$20,001 to \$50,000	238,876	16.4	-	-	-	-	-	-	224,811	15.5	14,065	1
Over \$50,000	81,926	5.6	-	-	-	-	-	-	-	-	81,926	5.6

* Includes total loss.

NOTE: Detail may not add to totals because of rounding.

Overall, the self-employed reported a farm net loss of \$64 million. After examination this amount rose to a positive \$556 million, a difference of \$620 million. Even though VRP cannot be calculated when comparing a negative amount to a positive amount, Table 2 shows that the self-employed are not "voluntarily reporting" their farm income.

In total, more than 55 percent of the secured returns from self-employed nonfilers had an increase in "total income" due to examination. Slightly more than 40 percent had no change in income, and only 4 percent realized a small decrease.

■ Itemized Deductions

While income is generally understated on delinquent returns, itemized personal deductions are commonly overstated. However, because the self-employed have a greater opportunity to understate their income due to the lack of information reporting, their itemized deductions are generally not as overstated as those of wage earners. In fact, for the secured returns of self-employed nonfilers, total itemized deductions were understated by 1.5 percent. The self-employed claimed \$3,590.5 million in itemized deductions, but were allowed nearly \$3,646.6 million after examination, resulting in a difference of \$56.1 million and a total VRP of 98.5.

These totals, however, can be misleading. Deductions aid to minimize total taxable income and, consequently, the total amount of tax due. However, a taxpayer may not need to claim the total amount of deductions to which he or she is entitled in order to offset the tax. Taxpayers may simply claim the standard deduction or a partial total for itemized deductions sufficient (in combination with deductions for personal exemptions and tax credits) to reduce the tax to zero. More than 79,000 of the self-employed nonfilers were able to increase their total deductions enough to offset an increase in total tax liability resulting from audit. Only 2,000 (1.9 percent) of these claimed a business loss before audit, but reported a profit after audit, and the total income of nearly 64,000 (80.6 percent) increased after examination. In addition, there were nearly 14,000 (17.5 percent) who increased the amount of total itemized deductions claimed, despite a decrease in total income as a result of examination.

■ Exemptions

The number of personal exemptions a taxpayer is able to claim directly affects the amount of his or her tax liability. As in the case of deductions, wage earners were more likely to overstate their exemptions than the self-employed. In total, wage earners claimed nearly 3.2 million exemptions, worth \$6.2 billion, before examination and 2.9 million, worth \$5.7 billion, after examination. The resulting VRP was 108.9, or a net overstatement of 8.9 percent. Most of this overstatement was due to the claiming of 37 percent more dependent children living at home than were allowable. This difference accounted for 92 percent, or \$461 million, of the \$501 million in exemption overstatements.

Although the self-employed claimed more exemptions than wage earners on delinquent returns, their exemptions were measurably more accurate. Self-employed nonfilers claimed 3.5 million exemptions, worth \$6.8 billion, before examination, but were allowed 3.4 million exemptions, worth \$6.6 billion after examination. The corresponding VRP was 102.8. This overstatement was due primarily to the claiming of 7 percent more for dependent children at home than they were entitled to. This situation accounts for 79 percent or \$148 million of the \$187 million overstatement.

■ Filing Status

Of all the return items that could affect a taxpayer's total tax liability, filing status (i.e., the marital status categories recognized under the tax code) was one of the most accurately reported. Only 2 percent of the total self-employed secured returns had a change in filing status. Of those changed after audit, most claimed head of household status, when they should have claimed they were either single or married filing separately. Thus, after examination, 33 percent of the self-employed claimed single filing status; 54 percent, married filing jointly; only 10 percent, married filing separately; and less than 3 percent, head of household status.

■ Total Income Tax

Since return items used to calculate total income tax were changed as a result of examination, it follows

Table 2. All Individual Income Tax Return Nonfilers: Selected Income, Deduction, and Tax Payment Items Before and After Examination, Self-Employed and Others, and Voluntary Reporting Percentages (VRP)
 [All data are estimated based on samples--money amounts are in millions of dollars.]

Selected income, deduction and tax payment items	Total Nonfilers			Self-Employed			All other					
	Before exam (1)	After exam (2)	Increase (3)	VRP 1/ (4)	Before exam (9)	After exam (10)	Increase (11)	VRP (12)	Before exam (5)	After exam (6)	Increase (7)	VRP (8)
Total income (less loss) 2/	60,335.7	70,501.7	-10,166.0	85.6	22,183.5	30,490.3	-8,306.8	72.8	38,152.2	40,011.3	-1,859.1	95.4
Salaries and wages	42,521.0	42,925.0	-404.0	99.1	9,940.1	10,260.4	-320.3	96.9	32,580.5	32,664.7	-84.2	99.7
Other than salaries and wages	17,815.0	27,576.6	-9,761.6	64.6	12,243.4	20,229.9	-7,986.5	60.5	5,571.6	7,346.6	-1,775.0	75.8
Taxable interest and dividends	3,037.0	3,310.0	-273.0	91.8	999.1	1,136.5	-137.4	87.9	2,038.8	2,173.6	-134.8	93.8
Schedule C business income 3/	9,896.7	15,968.8	-6,072.1	62.0	9,916.0	15,976.5	-6,060.5	62.1	-19.3	-9.7	-9.6	7/
Schedule D net gain (less loss) 4/	5,528.0	6,204.0	-676.0	89.1	5,222.3	5,688.1	-465.8	91.8	305.7	516.0	-210.3	59.2
Schedule E income (less loss) 5/	1,006.9	1,554.5	-547.6	64.8	408.2	467.9	-67.7	7/	1,066.6	1,146.3	-79.7	93.0
Schedule F income (less loss) 6/	-69.7	550.2	-619.9	96.2	-64.3	555.7	-620.0	7/	-5.4	-5.4	0.0	100.0
Unemployment compensation	349.4	363.1	-13.7	96.2	153.1	144.2	8.9	106.2	196.4	218.8	-22.4	89.8
Other income (less loss) 8/	-5113.6	-4146.4	-967.2	123.3	-5143.3	-5122.2	-21.1	100.4	29.8	975.8	-946.0	3.1
Reimbursed employee business expenses	102.9	47.7	55.2	215.7	17.4	19.8	-2.4	87.9	85.5	27.9	57.6	306.5
Itemized deductions 9/	7,251.6	6,503.3	748.3	111.5	3,590.5	3,646.6	-56.1	98.5	3,661.1	2,856.6	804.5	128.2
Medical and dental expense	356.3	327.4	28.9	108.8	106.9	93.3	13.6	114.6	249.4	234.1	15.3	105.5
Taxes paid deduction	1,716.1	1,619.3	96.8	106.0	827.6	826.9	0.7	100.1	888.5	792.5	96.0	112.1
Contributions	614.4	489.6	124.8	125.5	198.7	193.7	5.0	102.6	415.8	295.9	119.9	140.5
Home mortgage interest	3,421.1	3,205.3	215.8	106.7	1,989.5	2,099.0	-109.5	94.8	1,431.6	1,106.3	325.3	129.4
Other interest	509.2	440.1	69.1	115.7	252.8	247.6	5.2	102.1	256.4	192.5	63.9	133.2
Casualty or theft loss	16.5	0.9	15.6	1,833.3	3.0	0.8	2.2	375.0	13.5	0.02	13.5	67,500.0
Miscellaneous	509.4	307.8	201.6	165.5	161.3	134.6	26.7	119.8	348.1	173.3	174.8	200.9
Personal exemptions	12,962.1	12,274.4	687.7	105.6	6,808.5	6,621.6	186.9	102.8	6,153.6	5,652.8	500.8	108.9
Self	6,194.2	6,198.6	-4.4	99.9	2,777.5	2,767.1	10.4	100.4	3,416.7	3,431.6	-14.9	99.6
Spouse	2,454.6	2,444.5	10.1	100.4	1,547.3	1,547.1	0.2	100.0	907.3	897.4	9.9	101.1
Children at home	3,991.6	3,382.3	609.3	118.0	2,274.1	2,125.7	148.4	107.0	1,717.5	1,256.6	460.9	136.7
All other 10/	321.7	249.0	72.7	129.2	209.6	181.7	27.9	115.4	112.1	67.2	44.9	166.8
Tax payments 11/	6,503.5	6,505.2	-1.7	100.0	1,815.1	1,814.8	0.3	100.0	4,668.4	4,690.4	-22.0	99.5
Earned income credit 12/	254.6	126.5	128.1	201.3	162.0	89.7	72.3	180.6	92.6	36.8	55.8	251.6

1/ Voluntary reporting percentage (VRP) is a compliance measure, calculated by dividing the amount reported on the return before examination by the amount after examination, then multiplying by 100.
 2/ The sum of all sources of income or loss, before reduction by statutory adjustments.
 3/ Net income (less loss) from nonfarm sole proprietorships.
 4/ Net capital gain (less loss).
 5/ Total net income (less loss) from rents, royalties, partnerships, and S Corporations.
 6/ Farm net income (less loss).
 7/ Not computed because of negative amount before examination.
 8/ Comprised mostly of deduction for "net operating losses" carried forward from prior years.
 9/ Includes itemized deductions not shown separately.
 10/ Includes dependent children, parents, and others.
 11/ Comprised of income tax withheld, estimated tax payments, payments with request for extension of filing time, excess social security taxes withheld, credit for Federal tax paid on gasoline and special fuels, and credit for taxes paid by regulated investment companies.
 12/ Includes earned income credit used to reduce income and other taxes to zero, as well as the excess credit which was refundable.

that the amount of total income tax also changed. Before audit, the self-employed reported almost \$5.0 billion in total tax; however, after examination, this number increased 37 percent, to more than \$6.8 billion. This was partially due to the fact that more than 101,000 of the 170,000 self-employed who reported they had no tax liability before they were examined had a tax balance due afterwards. In total, more than 56 percent (816,000) of the returns secured from self-employed nonfilers reported an increase in total income tax, after examination. (Only 2 percent reported a decrease; there was no change in the reported tax on the remaining 42 percent.) While tax increased by \$100 or less for 4 percent of the self-employed, nearly 22 percent reported increases between \$100 and \$1,000, and more than 30 percent had increases of more than \$1,000 (Table 3).

■ Type of Return

The secured delinquent returns were classified into three types: "balance due," if the taxpayer owed taxes before any remittances with the returns were credited; "refund," if prepayments (e.g., taxes withheld or estimated tax payments) and refundable earned income credits exceeded the tax liabilities, and "even," for returns where there were no tax liabilities or no prepayments or refunds due or where prepayments exactly matched tax liabilities. Figure A compares these types of returns, before and after examination.

Before examination, more than 68 percent (994,000) of the returns secured from self-employed nonfilers showed a balance due. Another 25 percent were refund returns and 7 percent were "even." Those self-

employed taxpayers whose returns showed a balance due owed more than \$3.4 billion, while taxpayers filing for refunds were owed almost \$0.4 billion. The resulting total net tax balance due from self-employed nonfiler returns before examination was, therefore, estimated at \$3.0 billion.

After examination, however, the numbers tell a different story. Because of increases in income and decreases in deductions, more than 82 percent (1,200,000) of the secured self-employed returns were reclassified as balance due returns. Only 14 percent of the nonfilers were due refunds, and only 4 percent were "even." The total balance due increased more than 50 percent from \$3.4 billion to more than \$5.1 billion, while total refunds claimed dropped from \$0.4 billion to \$0.2 billion. The result was a total net balance due after examination of \$4.9 billion, more than one-and-a-half times the amount reported on the returns as originally filed.

■ Occupation

Initially, the taxpayer's occupation was coded only from what was entered on his or her delinquent return. Approximately two-thirds of the self-employed nonfilers did not provide their occupations on their returns when filed. Of those returns where occupation was available, "retired" was most frequent, at 8.3 percent of the total self-employed population. Although this is not normally an income generating activity, this was the largest single occupation reported on secured returns. It should also be noted that taxpayers with this occupation are not likely to be full-time self-employed.

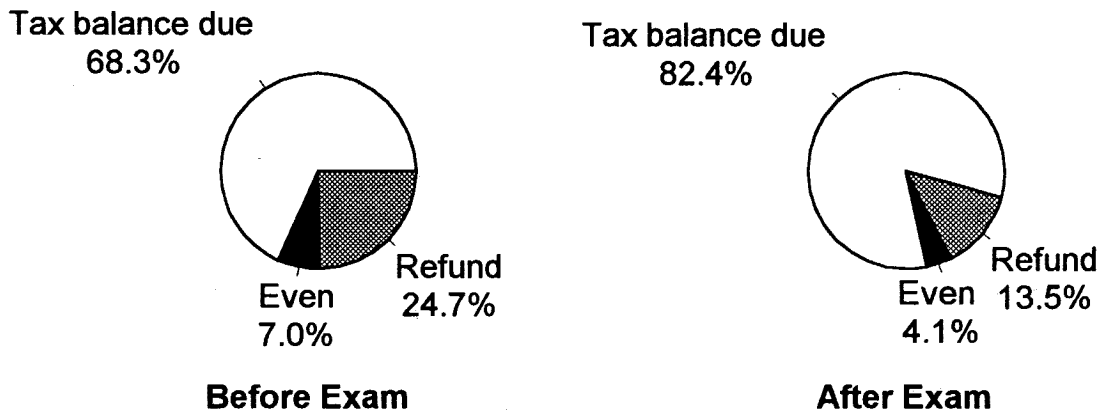
Table 3. Self-Employed Nonfilers: Number of Returns, by Size of Total Tax Before and After Examination

[All data are estimates based on samples.]

Size of Total Tax Before Examination	Size of Total Tax After Examination									
	Total		No Total Tax		\$1 to \$1,000		\$1,001 to \$10,000		Over \$10,000	
	# of Returns	% of Total	# of Returns	% of Total	# of Returns	% of Total	# of Returns	% of Total	# of Returns	% of Total
	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]
Total Returns	1,454,951	100	80,631	5.6	445,754	30.6	848,855	58.3	79,711	5.5
No Total Tax	170,529	11.7	69,621	4.8	25,355	1.7	71,258	4.9	4,292	0.3
\$1 to \$1,000	582,054	40	-	-	420,399	28.9	157,931	10.9	3,724	0.3
\$1,001 to \$10,000	656,180	45.1	11,010	0.8	-	-	617,317	42.4	27,853	1.9
Over \$10,000	46,191	3.2	-	-	-	-	2,349	0.2	43,842	3

Note: Detail may not add to totals because of rounding.

Figure A.--Returns of Self-Employed Nonfilers by Tax Status Before and After Examination, Tax Year 1988



Leading occupations after retired persons, were those in constructions trades (5.9 percent), mechanics and repairers (2.1 percent), management-related occupations (2.0 percent) and occupations in transportation and material-moving (1.6 percent).

During the examination phase, tax examiners were required to code the occupation of the "primary taxpayer" (i.e., if the return is a joint return, the spouse with the larger income), regardless of the occupation that may have been entered on the return. Because the occupations of all the self-employed nonfilers were identified during examination, the results are slightly different from those based on the returns as filed. The largest occupation group for the self-employed nonfilers became handlers, equipment cleaners and laborers (17.5 percent). Construction trades were second (13.5 percent), followed by mechanics and repairers (7.8 percent); retired persons (7.2 percent); and occupations in insurance, securities, real estate, and business service sales (5.8 percent) (Figure B).

Many laborers; construction workers; mechanics; and real estate, insurance, securities, and business services salespersons were not only noncompliant in filing their income tax returns, but also tended to be inaccurate in what they reported. After examination, tax increased for those in construction trades alone by a net amount of nearly \$283 million. Tax of handlers, equipment cleaners, and laborers increased by a net \$252

million, while the taxes owed by mechanics and repairers increased by nearly \$191 million (Figure C).

Many states or local jurisdictions require a license before a person can practice certain trades. Using listings of licensed occupations and professions from several states, licensing requirements were identified for 30 occupations. Based on these lists, 105,000 (7.2 percent) of the estimated 1,455,000 nonfilers identified as self-employed, before examination, would have been subject to some sort of licensing requirement. Before examination, they reported a total balance due of \$255 million and claimed refunds totaling almost \$96 million, resulting in a net balance due of \$159 million.

However, after examination, it was determined that there were actually 223,000 (15.3 percent) who were in occupations subject to a licensing requirement. The total balance due on this larger number was \$867 million, while refund claims totaled only \$59 million, resulting in a net balance due of \$808 million, 16.4 percent of the \$4,930 million net tax due by all self-employed nonfilers whose returns were secured.

The IRS is currently working with many state and local licensing agencies through FedState agreements to make filing a required income tax return a condition of license renewal. Through this initiative and other educational and enforcement programs, the Service hopes to persuade nonfilers to file required income tax returns and become compliant taxpayers in the future.

Figure B. Ten Most Frequent Occupations of Self-Employed Nonfilers After Examination, Tax Year 1988

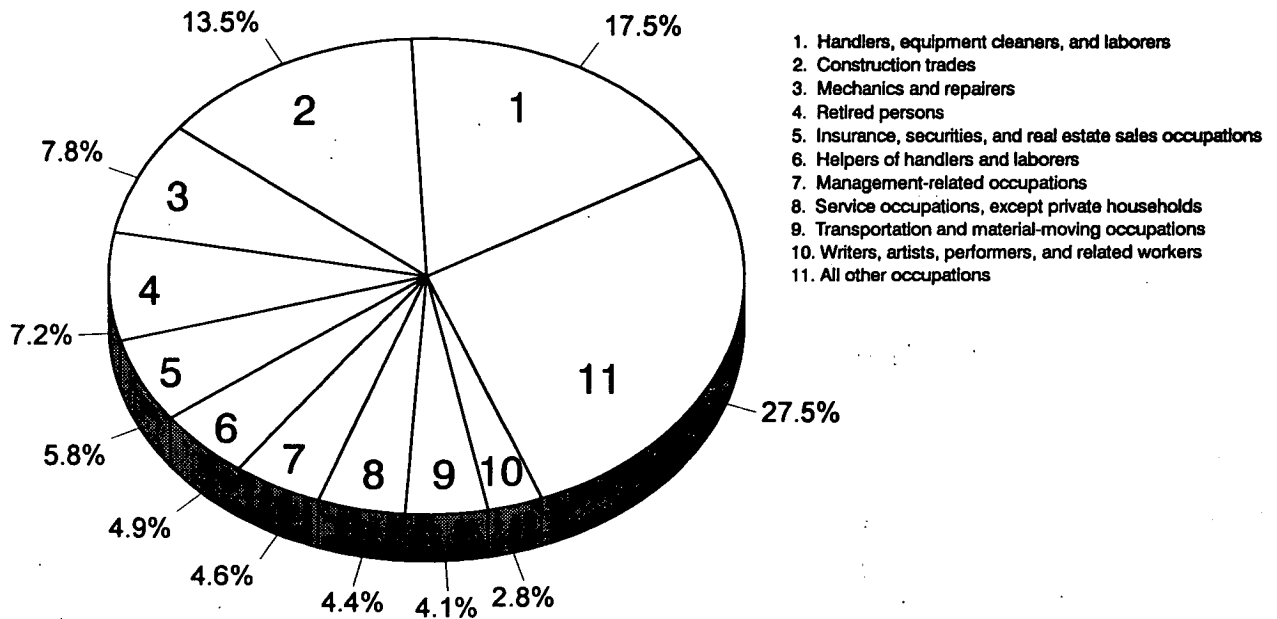
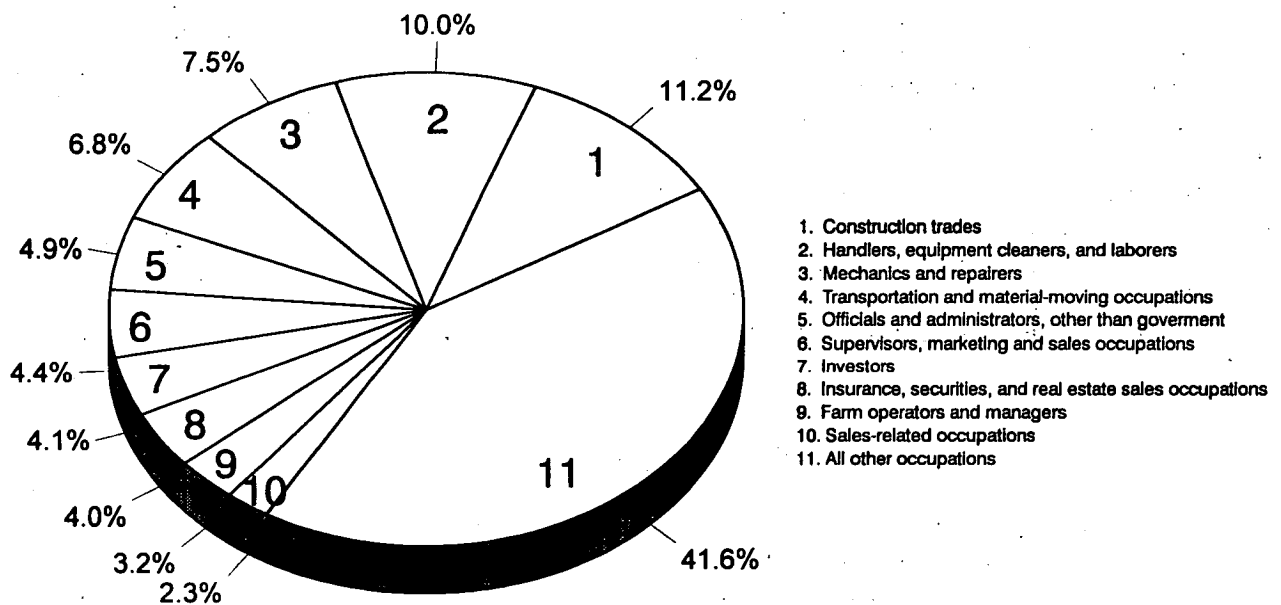


Figure C. Ten Most Frequent Occupations of Self-Employed Nonfilers with the Largest Tax Increase After Examination, Tax Year 1988



■ Footnotes

- [1] The Service's objectives in conducting the 1988 Nonfiler TCMP survey were to obtain information for the continuing development and improvement of the system to identify noncompliant taxpayers; to estimate the total number of nonfilers, those who were unknown to the IRS, as well as those for which the Service had an investigative lead developed from information returns; to estimate the value of the tax owed by these nonfilers; to develop profiles of the various types of nonfilers, in order to evaluate alternative strategies for dealing with delinquent taxpayers; and to measure the accuracy of secured delinquent returns.
- [2] Information reporting is the process by which employers and other financial entities report wages and other monies paid out to taxpayers on Form W-2, *Wage and Tax Statement*; Form 1099-MISC, *Miscellaneous Income*; and the like. These reports are sent to the payee for his or her records and for use in tax return preparation, as well as to the Internal Revenue Service, for comparison with what is subsequently reported by the taxpayer on his or her income tax return.
- [3] See Graeber; Michael J.; Nichols, Bonnie L; and Sparrow, D. Arthur (1992), "Characteristics of Delinquent Returns," *The IRS Research Bulletin*, Research Division, Internal Revenue Service.
- [4] There was also a TCMP study of timely-filed individual income tax returns for Tax Year 1988. For information on the reporting compliance of self-employed individuals who filed their returns on time, see Christian, Charles W. (1992), "Compliance of Sole Proprietors--Findings From 1988 TCMP Phase III, Cycle 10," *The IRS Research Bulletin*, Research Division, Internal Revenue Service.
- [5] The Death Master File, obtained from the Social Security Administration, is an incomplete list of deceased individuals with SSN's.
- [6] For the characteristics of the 3,500 secured returns, see Rosage, Laura R. (1993), "Self-Employed Nonfilers, 1988," *Statistics of Income Bulletin*, Summer 1993, 13, 1, Internal Revenue Service.
- [7] Taxpayer Compliance Measurement Program examinations are normally much more extensive than the normal operational audits. In normal operational audits, examiners concentrate only on those issues for which there is the greatest likelihood of a substantial error having a bearing on tax liability. However, since TCMP examinations are designed to provide statistics for use in tax administration research, all potential issues, i.e., unreported income, overstated deductions, and credits, as well as any other discrepancies, such as reporting occupation or industrial activity code, are all verified.
- [8] For more detailed information on the development of additional compliance measures for individual income tax returns, see Ho, Chih-Chin and Sattler, Carol E. (1992), "Developing Measures of Reporting Compliance for Individual Tax Returns," *The IRS Research Bulletin*, Research Division, Internal Revenue Service. ■