

# **Office of Management and Budget Clearance Package**

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## ***Cash Economy – Influencing Tax-Related Behaviors in the Cash Economy***

**Project PHL0039**

**Internal Revenue Service  
Small Business/Self-Employed Research and Analysis**

**January 8, 2007**

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## Office of Management and Budget Clearance Package

### Cash Economy – Influencing Tax- Related Behaviors in the Cash Economy Project PHL0039

#### I. Introduction

##### Background/Overview

The Internal Revenue Service (IRS) Communication, Liaison and Disclosure (CLD) requested assistance from IRS Small Business/Self-Employed Research in conducting research to determine how to influence tax-related behaviors of potentially non-compliant business owners, who receive income in cash, towards compliance.

In IRS testimony before the Committee on the Budget, United States Senate, February 15, 2006<sup>1</sup>, the following statements were provided:

- “The cash economy” is the largest source of the Tax Gap. Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due. Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously to a range from about 20 percent to about 68 percent, depending on the type of transaction. The term cash economy is defined to mean all taxable payments that are not reported to the IRS by third parties.”
- “These estimates suggest that the [cash economy] self-employed taxpayers who file returns but underreport their income (or self-employment) taxes) represent the single largest component of the tax gap, accounting for more than a third of the gap and over \$100 billion per year.” “The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy.”
- The statement recommended that “The IRS needs to conduct more and better research to identify the best approaches to reducing the cash economy Tax Gap and understanding the causes of noncompliance”.

Updating the figures for the above IRS testimony with the February, 2007 estimate for Tax Year 2001 Federal Tax Gap<sup>2</sup> yields the following:

- The annual gross tax gap is estimated at \$345 billion

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<sup>1</sup> Nina E. Olson, “Written Statement of Nina E. Olson, National Taxpayer Advocate Before the Committee on the Budget, United States Senate,” February 15, 2006, <http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf>.

<sup>2</sup> Tax Year 2001 Federal Tax Gap (Extended Version), Update February, 2007 [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf)

- The annual net tax gap is estimated at \$290 billion
- The cash economy is estimated at \$118 billion

In support of other compliance activities, the IRS is trying to determine how tax-related behaviors of business owners and independent contractors dealing in cash (otherwise referred to as the “cash economy”) can be influenced toward increasing compliance.

This research is important to the IRS CLD’s goals and to the mission of the IRS for the following reasons:

- It is anticipated that the IRS will learn about practitioners' relationships with their “cash economy” clients, which would benefit IRS CLD in their efforts to develop marketing and educational outreach strategies geared toward practitioners whose clients are small business owners and independent contractors who conduct their business in cash, as well as to the small business community through their related associations.
- In addition, the research has the potential of enabling the IRS to identify administrative and legislative tax law changes that might result in a dramatic shift toward compliance by one of the largest contributors to the tax gap – that part of the small business and independent contractor communities that is currently underreporting income.

Project PHL0039 has been designed to focus primarily on gathering some of the behavioral characteristics of this segment of the population needed by CLD to better understand taxpayer behavior in the cash economy. The IRS has engaged its federally-funded Research and Development Center (FFRDC), the MITRE Corporation, to conduct the focus group sessions and document the results.

## **Objectives of Data Collection**

The primary project objective is to gather data that can be analyzed to determine how best to influence the tax-related behaviors small business owners and independent contractors who receive income in cash, so they are more compliant. The Project Team will also provide the IRS Small Business/Self-Employed Communications, Liaison and Disclosure (CLD) organization with recommendations on developing ways to improve tax education and outreach.

## **II. Methodology**

FFRDC/MITRE will be using focus group interviews, a qualitative method, to collect data about attitudes and behavior from small business owners and independent contractors, and tax practitioners who support these two groups. Focus group interviews use interview and discussion techniques in a small group setting to capture qualitative information.

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## Sample Design

The selection of this segment of the taxpayer population was directed by the IRS CLD organization.

The sampling frame for focus group participants includes small business owners and independent contractors of the relevant segment (described in the Methodology section) who operate all or part of their business under cash terms, file an IRS Form 1040 Schedule C, and work within commuting distance of the focus group location. The sampling frame also includes tax practitioners who advise and assist small business owners and independent contractors in understanding and addressing their tax filing and reporting obligations, and whose clients file IRS Form 1040 Schedule C(s).

The **Telephone Screener (Attachment 2)** will provide the FFRDC with the type of small business owners, independent contractors, and tax practitioners that should be recruited for the two taxpayer categories in the focus groups.

## Data Collection Date

Data will be collected during the time period February through May of 2008; the availability of tax preparers during and after the annual tax season will determine the month in which members of this group can participate.

## Data to be collected

The study will collect data about the attitudes and behaviors of taxpayers who operate part or all of their business under cash terms, and file IRS Form 1040 Schedule C(s).

We plan to collect data by conducting 5 focus group interviews. The 5 focus groups will be conducted with participants representing the two taxpayer sub-segments described below:

- 1) Small business owners and independent contractors who operate part or all of their business under cash terms, file IRS Form 1040 Schedule C(s) and work within commuting distance of the focus group location.
- 2) Tax practitioners who advise and assist small business owners and independent contractors in understanding and addressing their tax filing and reporting obligations, and whose clients file IRS Form 1040 Schedule C(s).

## **How Data will be Used**

The data, findings and recommendations will be used to develop tax education strategies to educate and influence taxpayers similar to those in the focus groups studied.

## **How Data will be Analyzed**

The FFRDC will use the data collected via focus group session notes and audio recordings as a source for analysis. Themes will be extracted and summarized from the data, with an emphasis on attitudes and behavior toward the tax treatment of cash income by the taxpayers under study. The FFRDC will document its findings, develop qualitative conclusions based on the findings, and create recommendations for IRS CLD. These recommendations will consist of suggestions for devising tax education strategies to address the documented taxpayer attitudes and behavior.

The following information will be provided within 30 days after the close of the focus group data collection operations:

1. Findings: A brief summary of significant behavioral and attitudinal themes that were evidenced in the data collected.
2. Qualitative conclusions based on the documented findings.
3. Recommendations to IRS CLD for developing tax education strategies to address the findings.
4. Number of requests for taxpayer participation in the focus groups.
5. Number of taxpayers that participated in the focus groups.
6. Date the focus group data collection ended.
7. Cost: FFRDC costs, travel, and any other costs incurred as a direct result of the focus groups.

## **Who is conducting the research?**

The IRS federally-funded research and development center, or FFRDC (The MITRE Corporation), will conduct the interviews and will develop a report of the interview findings in support of the IRS Small Business/Self-Employed Research Program and CLD.

## **Location – region/city and facilities**

Locations will be in the following IRS administrative regions and cities:

- North Atlantic (New York and Philadelphia)
- South Atlantic (Atlanta)

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- Gulf States (New Orleans)

The facilities used will be government-leased meeting room spaces designed to accommodate focus group sessions of the type planned for this research study.

### **Stipend**

Each of the focus group members will be given a stipend of between \$75 (nighttime session) and \$100 (daytime session) for participating in the discussion.

### **Recruitment Efforts**

The focus group members will be recruited by working through points of contact with whom IRS has previously interacted, via the U.S. Chamber of Commerce, Small Business Forums, annual National Tax Forums and other recurring forums provided by the IRS CLD organization. These forums are designed to exchange information about tax policy, taxpayer and tax practitioners' needs, IRS initiatives, and tax education.

As a result of the tax forums, CLD has developed strong relationships with practitioner groups and with members of the small business community. For this reason and the fact that the IRS is using known points of contact to identify prospective participants, CLD anticipates that the interest in participating in this research will be sufficient to allow recruitment of adequate numbers of focus group members to conduct the study, while minimizing respondent burden.

### **Test Structure/Design**

The test structure will consist of a series of probing questions designed to engender discussion about the cash economy, and the attitudes and behavior of the focus group participants toward their tax obligations and reporting requirements.

### **Efforts to not Duplicate Research**

A literature survey was performed to ensure that this specific kind of focus group research study targeting small business owners and independent contractors dealing with cash income, and tax practitioners who advise these taxpayer groups, has not previously been conducted by IRS Research.

### **Moderator's Guide**

A moderator's guide imposes structure on the discussion. Our guide (Attachment 1) addresses the research study questions and provides a framework for the focus groups.

### III. Participant Criteria

The criteria for focus group participants include small business owners and independent contractors who conduct part or all of their business under cash terms, file an IRS Form 1040 Schedule C(s), and work within commuting distance of the focus group location, and tax practitioners who serve as tax advisors or tax preparers for these two groups.

### IV. Privacy, Security, Disclosure and Confidentiality

The IRS will ensure compliance with the Taxpayer Bill of Rights II. All participants will be treated fairly and appropriately. The security of the data used in this project and the privacy of taxpayers will be carefully safeguarded at all times. Confidentiality will be safeguarded. During the focus group and data collection process, taxpayers will be identified to IRS and FFRDC personnel by their first names only. In addition, no taxpayer names or business names will be mentioned in the focus group reports.

### V. Burden Hours

The FFRDC is required to have 12 participants confirmed for each focus group session. We assume that the FFRDC will have to contact up to five times the number of participants required to get 12 participants for each session. This would require the contractor to contact as many as 300 potential participants (12 confirmed participants x 5 times the number required x 5 focus group interviews = 300). Each contact would average 5 minutes per call.

The total burden resulting from the screening process would be approximately 25 hours (300 x 5 minutes per call divided by 60 minutes = 1500 minutes or 25 hours).

The total burden resulting from each focus group invitee completing a brief questionnaire on proposals for improving SB/SE tax compliance would be approximately 10 hours (60 invitees x 10 minutes per questionnaire equals 600 minutes; 600 minutes divided by 60 minutes/hour = 10 hours).

The focus group sessions are designed to consist of approximately 12 participants each. The sessions will require a commitment of 2 hours from each participant plus 1 hour for travel. The total burden for the session and travel time is approximately 180 hours (12 participants x 5 groups x 3 hours).

Five (5) focus group interviews will be conducted. We estimate the total burden time, including screening and questionnaires, at (215) hours.

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#### Estimated Burden Hours

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25 hours	For screening participants
10 hours	For participants to complete questionnaire
180 hours	For interview sessions plus travel
<b>215 hours</b>	<b>Total estimated burden</b>

## VI. Research Cost

The IRS funding allocated for this project is \$80,000.