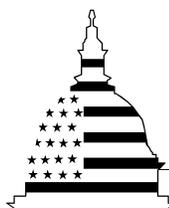


June 2006

CAPITAL GAINS TAX GAP

Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed



GAO

Accountability * Integrity * Reliability



Highlights of GAO-06-603, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

For tax year 2001, the Internal Revenue Service (IRS) estimated a tax gap of at least \$11 billion from individual taxpayers misreporting income from capital assets (generally those owned for investment or personal purposes). IRS did not estimate the portion of this gap from securities (e.g., stocks, bonds, and mutual fund capital gains distributions).

GAO was asked for information on (1) the extent and types of noncompliance for individual taxpayers that misreport securities capital gains, (2) actions IRS takes to reduce the securities tax gap, and (3) options with the potential to improve taxpayer voluntary compliance and IRS's ability to address noncompliant taxpayers. For estimates of noncompliance, GAO analyzed a probability sample of examination cases for tax year 2001 from the most recent IRS study of individual tax compliance.

What GAO Recommends

To reduce securities capital gains noncompliance, GAO suggests that Congress consider requiring brokers to report adjusted basis to taxpayers and IRS and requiring IRS to work with the industry to develop cost effective ways to mitigate reporting challenges. GAO also recommends that IRS clarify its guidance on reporting capital gains and losses.

In commenting on a draft of this report, IRS agreed with our recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-603.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

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Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed

What GAO Found

GAO estimates that 38 percent of individual taxpayers with securities transactions misreported their capital gains or losses in tax year 2001. A greater estimated percentage of taxpayers misreported gains or losses from securities sales (36 percent) than capital gain distributions from mutual funds (13 percent). This may be because taxpayers must determine the taxable portion of securities sales' income whereas they need only add up their capital gain distributions. Among individual taxpayers who misreported securities sales, roughly two-thirds underreported and roughly one-third overreported. Furthermore, about half of these taxpayers who misreported failed to accurately report the securities' cost, or basis, sometimes because they did not know the basis or failed to adjust the basis appropriately.

IRS attempts to reduce the securities' tax gap through enforcement and taxpayer service programs, but challenges limit their impact. Through enforcement programs, IRS contacts taxpayers who may have misreported capital gains or losses and seeks to secure the correct tax amount. IRS also offers services to help taxpayers comply with capital gains tax obligations, such as guidance on how to determine securities' gains and losses. Challenges that limit these programs' impact include the lack of information on basis, which IRS needs to verify most gains and losses, and uncertainty as to whether taxpayers use or understand the guidance.

Expanding the information brokers report on securities sales to include adjusted cost basis has the potential to improve taxpayers' compliance and help IRS find noncompliant taxpayers. IRS research shows that taxpayers report their income much more accurately when it is reported to them and IRS. Basis reporting also would reduce taxpayers' burden. For IRS, basis reporting would provide information to verify securities gains or losses and to better target enforcement resources on noncompliant taxpayers. However, basis reporting would raise challenges that would need to be addressed. For instance, brokers would incur costs and burdens—even as taxpayers' costs and burdens decrease somewhat—and many issues would arise about how to calculate adjusted basis, which securities would be covered, and how information would be transferred among brokers. However, industry representatives said that many brokers already provide some basis information to many of their clients and some use an existing system to track and transfer basis and other information about securities. Many of the challenges to implementing basis reporting also could be mitigated. For example, many of the challenges could be addressed by only requiring adjusted basis reporting for future purchases, and by developing consistent rules to be used by all brokers. To the extent that actions to mitigate the challenges to basis reporting delay its implementation or limit coverage to only certain types of securities, the resulting improvements to taxpayers' voluntary reporting compliance would be somewhat constrained.

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United States Government Accountability Office
Washington, D.C. 20548

June 13, 2006

The Honorable Charles Grassley
Chairman
The Honorable Max Baucus
Ranking Minority Member
Committee on Finance
United States Senate

Every year, a gap arises between the tax amount that taxpayers pay voluntarily and on time and the amount they should pay under the law. For tax year 2001, the Internal Revenue Service (IRS) estimated a gross tax gap of \$345 billion.¹ IRS estimated that it would eventually recover \$55 billion of the gross tax gap through late payments and IRS enforcement efforts, leaving a net tax gap of \$290 billion.² The tax gap arises when taxpayers fail to comply with the tax laws, whether intentionally or unintentionally. Because of their noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who voluntarily and accurately pay their taxes. In light of the size of the tax gap and the nation's budget deficit, Congress has held several hearings seeking to identify how the gap can be reduced. Given its size, even small or moderate reductions in the net tax gap could yield substantial returns.

One type of noncompliance that contributes to the tax gap occurs when individual taxpayers do not accurately report gains or losses from transactions involving capital assets, which generally refers to property owned for investment or personal purposes, on their tax returns. Taxpayers generally determine their capital gains or losses by subtracting the basis, which is generally the price they paid for an asset, from the gross amount of proceeds they received from its sale. IRS estimated that for 2001, individual taxpayers' failure to accurately report their capital gains income

¹According to an IRS research official, in mid-2006, IRS plans to publish its final report on the 2001 tax gap that will include an updated tax gap estimate based on a refined methodology. It is possible that the updated tax gap figures could differ from the current estimates.

²Unless otherwise noted, references to the tax gap refer to the gross tax gap.

accounted for at least \$11 billion of the gross tax gap for that year.³ This amount is due to taxpayers understating their capital gains or overstating their capital losses, both of which reduced the amount of taxable income they reported. Although IRS has not estimated the amount of the capital gains tax gap attributed to specific types of capital assets, it has estimated that in recent years, securities transactions have accounted for the majority of individuals' capital gains and losses.⁴ Securities transactions include the sale of securities—stocks, mutual funds, bonds, and options—and capital gain distributions from mutual funds.⁵ Securities transactions may be executed through third parties, such as brokers.

To address your long-standing concerns about the tax gap, and particular concern about the tax gap from individual capital gains tax noncompliance for securities, this report responds to your request for information on (1) the extent of and primary types of noncompliance that cause individual taxpayers to misreport capital gains from securities, (2) actions IRS takes in attempting to reduce the individual capital gains tax gap for securities and any challenges that IRS faces with these actions, and (3) options with the potential to improve taxpayers' voluntary compliance for reporting securities gains and losses and IRS's ability to find noncompliance related to the individual capital gains tax gap for securities.

To provide information on the extent of and primary types of noncompliance that cause individual taxpayers to misreport capital gains from securities, we reviewed a probability sample of case files selected from the nearly 46,000 randomly selected individual tax returns from tax year 2001 that IRS reviewed or examined through the National Research Program (NRP), IRS's most recent study of individual taxpayer compliance. We used the results of our case file review along with data from IRS's

³The overall capital gains tax gap could be larger than \$11 billion because IRS did not estimate the portion of the combined \$48 billion tax gap attributable to capital gains for individual taxpayers who did not file tax returns or did not pay the taxes they reported on filed returns.

⁴IRS's most recent published studies of capital asset transactions were for tax years 1997 through 1999. See IRS Statistics of Income Bulletin, *Sales of Capital Assets Reported on Individual Tax Returns, 1999*, Summer 2003, Publication 1136 (Rev. 09-2003), and *Sales of Capital Assets Reported on Individual Tax Returns, 1998 and 1997*, Summer 2002, Publication 1136 (Rev. 08-2002).

⁵Options are contracts giving the purchaser the right to buy or sell a security at a fixed price within a specific period of time. Mutual funds pay capital gain distributions from their net realized long-term capital gains.

examinations of the tax returns from NRP to make estimates for the entire population of individual taxpayers. We present information on the extent of noncompliance by estimating the percent of noncompliant taxpayers. We did not estimate the portion of the capital gains tax gap specific to securities. We could not provide a meaningful estimate of the tax gap for securities because (1) of the 1,017 cases in our sample, we only received 849 complete cases by the time we completed our review, (2) the cases we received included too few taxpayers who misreported securities transactions (when selecting our sample, we could not determine which cases included misreported gains and losses from securities as compared to other types of capital assets), and (3) taxpayers misreported a wide range of dollar amounts from the transactions. Since our estimates are based on a sample, we express our confidence in our estimates as a 95 percent confidence interval, plus or minus the margin of error indicated along with each estimate in the report, which is the interval that would contain the actual population value for 95 percent of the samples we could have selected. To address the question of what actions IRS takes in attempting to reduce the individual capital gains tax gap for securities and related challenges, we reviewed documents from IRS's enforcement programs and IRS publications that address capital gains. We also interviewed IRS officials knowledgeable about the subject. To identify options with the potential to improve taxpayers' voluntary compliance for reporting securities gains and losses and IRS's ability to find noncompliance related to the individual capital gains tax gap for securities, we reviewed our prior reports, documents from IRS's enforcement programs, IRS publications that address capital gains, and industry reports on securities holdings and information reporting.⁶ We also spoke with IRS officials and representatives related to the securities industry. For further discussion of our scope and methodology, see appendix I. We conducted our review from June 2005 through May 2006 in accordance with generally accepted government auditing standards.

Results in Brief

For tax year 2001, an estimated 38 percent of individual taxpayers who had securities transactions failed to accurately report their capital gains or losses from the transactions (8.4 million out of 21.9 million taxpayers), often because they misreported the securities' cost basis. A greater

⁶Information reporting involves the filing of returns with IRS and taxpayers that contain information on certain transactions, such as information on gross proceeds that brokers report from securities sales.

percentage of taxpayers are estimated to have misreported gains or losses from their securities sales (36 percent) than misreported their capital gain distributions from mutual funds (13 percent). One reason for this difference could be because taxpayers must determine what portion of income from securities sales is taxable whereas taxpayers need only add up their capital gain distributions and enter the amounts on their tax returns. We were not able to determine the total amount of capital gains income from securities that taxpayers misreported or the securities tax gap because the cases we reviewed included too few misreported securities transactions and we did not receive other cases in time to include them in our review. However, we found that around half of taxpayers who did not accurately report their securities sales were estimated to have misreported at least \$1,000 of capital gains or losses. Also, around half of the taxpayers who misreported their gains or losses from securities sales did so because they failed to accurately report the securities' basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. Additionally, around 9 percent of taxpayers with securities sales misreported whether their gains or losses were short-term or long-term.

IRS attempts to reduce the individual capital gains tax gap for securities through enforcement and taxpayer service programs; however, various challenges limit the impact these programs have on reducing this tax gap. IRS uses enforcement programs to contact selected taxpayers it believes may have inaccurately reported capital gains or losses. IRS's automated enforcement programs largely rely on matching tax returns filed by taxpayers to information returns provided by brokers that report taxpayers' gross proceeds from securities sales. IRS also examines tax returns by reviewing taxpayers' records of their securities transactions. Additionally, IRS offers various taxpayer services intended to help taxpayers comply with capital gains tax obligations, such as publications describing how to determine tax liabilities from selling securities. The challenges that limit the impact these programs have on reducing the tax gap for securities include the relatively small portion of taxpayers with securities transactions that IRS contacts through its enforcement programs and the lack of information on the basis of securities sold, which IRS needs to verify most gains or losses, and the difficulty in communicating capital gains tax reporting requirements. Although IRS assesses additional taxes through its enforcement programs, neither IRS nor we know the extent to which these assessments reduced the 2001 capital gains tax gap for securities, in part because the gap itself is not known.

Expanding information reporting on securities sales to include cost basis has potential to improve taxpayers' voluntary compliance and help IRS find noncompliance related to the capital gains tax gap for securities. On one hand, some of this potential exists if IRS were to change its enforcement and taxpayer service programs, such as by examining more tax returns or enhancing guidance related to securities gains or losses. However, examinations can be costly, and taxpayers may not know about or use the guidance. On the other hand, basis reporting to taxpayers and IRS would help taxpayers to voluntarily comply and would reduce their burden in computing capital gains or losses. IRS research has repeatedly shown that taxpayers' compliance is strongly related to the extent to which their income is subject to information reporting. Basis reporting also would provide information to help IRS verify securities gains or losses and target enforcement resources to noncompliant taxpayers. However, such basis reporting would raise challenges and trade-offs. Many of the challenges can be mitigated to some extent. For example, tracking and reporting basis would increase brokers' costs, but decisions about the scope and details of the reporting could constrain the increase. Further, taxpayers' costs would be reduced, and many brokers already provide some form of basis information to taxpayers. The challenges arising when brokers do not know the basis for securities purchased in the past could be mitigated by only reporting basis for future purchases, which would somewhat delay the full impact that basis reporting would have on reducing the capital gains tax gap. Although IRS has broad authority to require information reporting for securities sales, it may not have the authority to require all of the actions that would be needed to implement cost basis information reporting.

This report includes matters Congress may want to consider to reduce the capital gains tax gap for securities. Specifically, Congress could require brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell and whether the gains or losses were short- or long-term, and direct IRS to work with brokers and related parties to develop rules that seek to cost effectively mitigate some of the challenges associated with requiring basis reporting. We are also making recommendations to IRS on clarifying guidance related to reporting capital gains and losses. In commenting on a draft of this report, the Commissioner of Internal Revenue agreed with our recommendations.

Background

Individual taxpayers generally realize gains or losses when they sell capital assets, which are generally defined as properties owned for investment or

personal purposes and outside the normal course of a taxpayer's trade or business. In recent years, IRS studies show that the majority of capital asset transactions and capital gains and losses were for securities transactions, including sales of corporate stock, mutual funds, bonds, options,⁷ and capital gain distributions from mutual funds.⁸ For example, in 1999, the latest year for which IRS published data on capital assets sales, an estimated 91 percent of capital asset transactions, 62 percent of capital gains, and 79 percent of capital losses were from securities transactions.⁹ Also, over the past two decades, individual ownership of securities assets held outside of retirement accounts has increased.¹⁰ According to the Federal Reserve Board, the percentage of families that own stock, mutual funds, and bonds outside of retirement accounts increased from 25 percent in 1983 to a high of 42 percent in 2001, before falling to 38 percent in 2004.¹¹

When taxpayers sell or otherwise receive income from securities, they must report the transactions on their federal income tax returns. For securities sales, taxpayers are to report the dates they acquired and sold the asset; sales price, or gross proceeds from the sale; cost or other basis of the sold asset; and resulting gains or losses on Schedule D to the individual

⁷Although by statute, futures contracts are not considered securities, we include them as securities for the purposes of this report because futures transactions are generally reported by brokers to IRS and we found 2 taxpayers through our file review who misreported such transactions. A futures contract is an agreement to buy or sell a specific quantity of a commodity or financial instrument at a specified price on a particular date in the future.

⁸Other types of capital assets include personal residences and other personal-use property; real property held for investment; collectibles, such as art, coins or precious metals; and interest in a partnership, S corporation, estate, or trust. Capital gains and losses for assets sold by partnerships, S corporations, estates, or trusts are generally taxed at the partner, shareholder, or beneficiary level. Non-business bad debts are treated as capital losses. All or part of the net gains from certain other transactions may be treated as capital gains, including involuntary conversions from destruction, theft, condemnation, or eminent domain; other depreciable real property or personal property used in a business; land used in a business, including farmland; timber; livestock; patents; and copyrights.

⁹Includes futures transactions.

¹⁰References to capital assets in this report refer to assets held outside of retirement accounts.

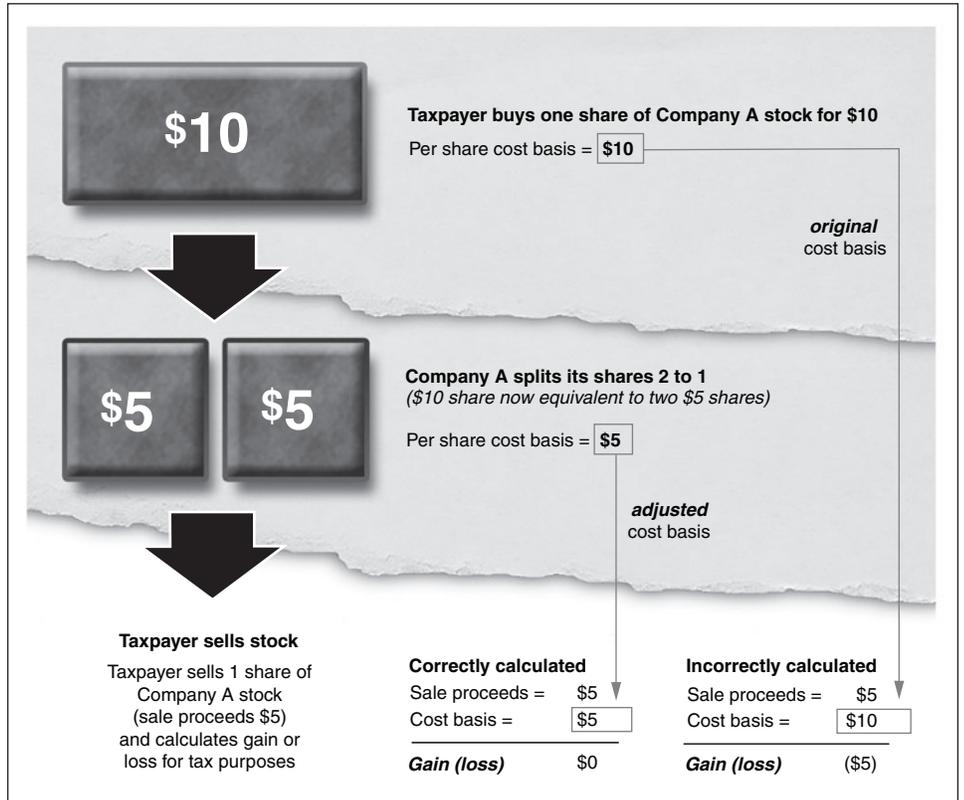
¹¹The Federal Reserve Board surveys U.S. families' holdings of financial assets in its triennial Surveys of Consumer Finances. See Robert B. Avery, Glenn B. Canner, Gregory E. Elliehausen, and Thomas A. Gustafson, *Survey of Consumer Finances, 1983*, Federal Reserve Bulletin, vol. 70 (September 1984), and Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, Federal Reserve Bulletin, vol. 92 (February 2006).

tax return—Form 1040. Taxpayers are to report this information separately for short-term transactions and long-term transactions. Taxpayers also are to report the total amount of their capital gain distributions from mutual funds, which are always considered to be long-term transactions. Taxpayers are to report their overall gains or losses from securities sales, capital gain distributions, and other capital gains on the Form 1040 tax return itself.

Generally, a taxpayer's gain or loss from a securities sale is simply the difference between the gross proceeds from the sale and the original purchase price, or original cost basis.¹² However, before taxpayers can determine any gains or losses from securities sales, they must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits, nontaxable dividends, or nondividend distributions. For example, figure 1 shows how a taxpayer would need to adjust the basis of a stock following a stock split to accurately determine the resulting capital gain or loss when the stock is sold. In this example, if the taxpayer fails to properly adjust the basis of the stock to account for the split, he or she will incorrectly report a capital loss from the sale.

¹²The original cost basis of a security can also include costs of purchase, such as sales commissions.

Figure 1: Example of How Failure to Adjust Basis Can Lead to Misreporting a Capital Gain or Loss from a Securities Transaction



Source: GAO.

Taxpayers who buy and sell the same stock or mutual fund shares at various times can determine basis in a number of ways. Taxpayers can specifically identify the groups of shares they want to sell. For example, if a taxpayer buys a group of 10 shares of stock in one year for \$1 per share and another group of 10 shares of the same stock in the next year for \$2 per share, and then sells 10 shares of the stock, the taxpayer can choose to sell the stocks with either the \$1 or \$2 cost basis.¹³ If taxpayers cannot identify which shares they sold among many they bought on varying occasions,

¹³Taxpayers who specifically identify groups of shares sold among multiple groups held must inform their brokers which shares to sell, and brokers are to provide written confirmation of taxpayers' decisions.

they must report the basis of the securities they purchased first as the basis of the sold shares. Except for mutual fund shares, taxpayers cannot use the average cost of securities they purchased at various times to determine basis.

When taxpayers sell securities through a broker, that broker is required to file Form 1099-B with IRS and the taxpayers to report a description of the security, sales date, number of shares sold, and gross proceeds from the sale, along with other information.¹⁴ Brokers are not required to report the cost or other basis of the sold security or, with the exception of regulated futures contracts, the resulting gain or loss from a security sale. Capital gain distributions from mutual funds are to be reported on Form 1099-DIV.¹⁵

The rate at which income from securities is taxed depends on how long taxpayers held a security before sale and taxpayers' regular income tax rates. Securities assets sold after being held for 1 year or less are considered short-term and taxed at the taxpayers' regular income tax rates. Assets sold after being held for more than 1 year are considered to be long-term and are generally taxed at maximum rates of 5 percent or 15 percent, depending on the taxpayer's regular income tax rates.¹⁶ Capital gain distributions from mutual funds are always taxed as long-term gains. Taxpayers can deduct capital losses against their capital gains, and any excess losses can be deducted against ordinary income up to a limit of \$3,000 (\$1,500 for married taxpayers filing separately), beyond which the

¹⁴Congress established the requirement that brokers report proceeds in the Tax Equity and Fiscal Responsibility Act of 1982—Pub. L. No. 97-248 (1982). Other information that can be reported on Form 1099-B includes the security's Committee on Uniform Security Identification Procedures number; gross amounts received through bartering; federal income tax withheld; classes of stock exchanged, such as preferred or common stock; and profit or loss for regulated futures contracts. Brokers may send a substitute for Form 1099-B if it meets IRS requirements for substitutes.

¹⁵A number of other dividends and distributions are also reported on Form 1099-DIV.

¹⁶The Jobs and Growth Tax Relief Reconciliation Act of 2003—Pub. L. No. 108-27 (2003)—established maximum tax rates for long-term gains at 5 percent for income otherwise taxed in the 10 percent and 15 percent marginal income tax brackets and 15 percent for income otherwise taxed at higher rates, effective for assets sold or exchanged on or after May 6, 2003, and before January 1, 2009. These rates were extended for assets sold or exchanged before January 1, 2011 in the Tax Increase Prevention and Reconciliation Act of 2005—Pub. L. No. 109-222 (2006).

losses can be carried over to offset capital gains or ordinary income in future tax years.

**Individual Taxpayers
Frequently
Misreported Their
Capital Gains or Losses
from Securities Sales,
Often Because They
Misreported the
Securities' Basis**

Thirty-eight percent of individual taxpayers who had securities transactions misreported their securities gains or losses for tax year 2001. A greater percentage of taxpayers misreported their securities sales (36 percent) than misreported their capital gain distributions (13 percent), and most of the misreported securities transactions exceeded \$1,000 of capital gain or loss. Taxpayers often misreported their capital gains or losses from securities sales because they failed to accurately report the securities' basis.

**Individual Taxpayers
Frequently Misreported
Their Capital Gains or
Losses from Securities Sales**

For tax year 2001, individual taxpayers frequently misreported their capital gains or losses from the securities they sold. Overall, an estimated 8.4 million of the estimated 21.9 million taxpayers with securities transactions misreported their gains or losses.¹⁷ Table 1 shows the estimated percentages of taxpayers who misreported their securities sales and capital gain distributions, overall and by the securities' holding period.

¹⁷We are 95 percent confident that from 7.3 million to 9.5 million taxpayers misreported securities transactions and from 20.3 million to 23.5 million taxpayers had securities transactions.

Table 1: Estimated Percentage of Individual Taxpayers with Securities Transactions Who Misreported the Gain or Loss from One or More Transaction, Tax Year 2001

Type of transaction	Estimated percentage of taxpayers who misreported their transactions		
	Short-term transactions	Long-term transactions	All transactions ^a
Securities sales	28	31	36
Capital gain distributions	N/A ^b	13	13
All securities ^c	28	32	38

Source: GAO analysis of IRS data and examination case files.

Note: Percentage estimates have sampling errors of (+/-) 7 percent or less.

^aFor securities sales, "all transactions" includes those for which we could not determine whether the holding period was short-term or long-term.

^bCapital gain distributions are always considered long-term transactions.

^c"All securities" includes taxpayers who misreported both securities sales and capital gain distributions.

Table 1 shows that a higher estimated percentage of taxpayers misreported a securities sale than a capital gains distribution. Overall, an estimated 7.3 million out of an estimated 20.3 million taxpayers misreported their securities sales compared to the estimated 1.2 million out of an estimated 9.1 million taxpayers who misreported their capital gain distributions.¹⁸ One reason taxpayers may misreport securities sales more frequently is that taxpayers must compute the portion of their sales proceeds that constitutes a gain or loss, whereas taxpayers need only add up their capital gain distributions from information returns they receive and enter the amounts on their tax returns. Table 1 also shows that individual taxpayers are estimated to have misreported their short-term securities sales about as often as their long-term sales. In addition, our analyses showed the following:

- Of those taxpayers who misreported securities sales, an estimated 97 percent misreported gains or losses from the sales of stocks and mutual funds while an estimated 5 percent misreported bonds, options, or futures.¹⁹

¹⁸We are 95 percent confident that from 6.2 million to 8.3 million taxpayers misreported securities sales, from 18.7 million to 21.9 million taxpayers sold securities, from 0.66 million to 1.7 million taxpayers misreported capital gain distributions, and from 7.8 million to 10.4 million taxpayers had capital gain distributions.

¹⁹Some taxpayers misreported both stocks and mutual funds and bonds, options or futures. Estimates have sampling errors of (+/-) 5 percent or less.

-
- Individual taxpayers misreported securities sales more frequently than other types of income, such as wages and salary, dividend income, and interest income. Respectively, an estimated 10 percent, 17 percent, and 22 percent of taxpayers with these types of income misreported the income.²⁰

We were not able to estimate the capital gains tax gap for securities because the cases we reviewed included too few misreported securities transactions and taxpayers misreported a wide range of dollar amounts from the transactions, among other reasons (see app. I). However, we were able to determine the direction of the misreporting. For securities sales, an estimated 64 percent of taxpayers underreported their income from securities (i.e., they understated gains or overstated losses) compared to an estimated 33 percent of taxpayers who overreported income (i.e., they overstated gains or understated losses).²¹ For both underreported and overreported income, some taxpayers misreported over \$400,000 in gains or losses. Also, as shown in table 2, around half of taxpayers who did not accurately report their securities sales were estimated to have misreported at least \$1,000 of capital gains or losses (that is, taxpayers not in the less than \$1,000 categories).²²

²⁰Estimates have sampling errors of (+/-) 2 percent or less.

²¹Figures do not sum to 100 percent because some taxpayers misreported securities sales in a way that had no effect on the amount of income from the sales, for example, in cases where taxpayers only misreported the securities' holding periods. Estimates have sampling errors of (+/-) 9 percent or less.

²²By comparison, from 49 percent to 96 percent of taxpayers that misreported their capital gain distributions were estimated to have misreported between \$0 and \$1,000 of income.

Table 2: Distribution of the Estimated Amount of Net Misreported Capital Gains Income From Securities Sales by Misreporting Taxpayers, Tax Year 2001

Net misreported amount	Percentage of misreporting taxpayers
Overreporting taxpayers	
Less than \$1,000 ^a	19
\$1,000 to \$9,999	15
\$10,000 and greater	5
Underreporting taxpayers	
Less than \$1,000	27
\$1,000 to \$9,999	19
\$10,000 and greater	14

Source: GAO analysis of IRS data and examination case files.

Notes: Percentage figures do not sum to 100 because of rounding. Percentage estimates have sampling errors of (+/-) 8 percent or less.

^aCategory includes taxpayers that misreported securities sales in a way that had no effect on the gain or loss from the sales.

In terms of income levels, the distribution of taxpayers who misreported gains or losses from securities sales and capital gain distributions did not vary greatly from the income level for all individual taxpayers for tax year 2001, as shown in table 3.

Table 3: Estimated Distribution of Individual Taxpayers Who Misreported Capital Gains or Losses from Securities Transactions and All Individual Taxpayers by Adjusted Gross Income, Tax Year 2001

Adjusted gross income	Percentage of misreporting taxpayers	Percentage of all individual taxpayers
Less than \$25,000	51	46
\$25,000 to \$49,999	20	25
\$50,000 to \$99,999	20	20
\$100,000 or greater	9	9

Source: GAO analysis of IRS data and examination case files.

Notes: For misreporting taxpayers, estimates have sampling errors of (+/-) 8 percent or less. For all individual taxpayers, estimates have sampling errors of (+/-) 0.3 percent or less.

Misreported Basis Was a Primary Type of Noncompliance That Caused Taxpayers to Inaccurately Report Their Capital Gains or Losses from Securities Sales

Based on information in the files we reviewed, a primary type of noncompliance that caused taxpayers to inaccurately report their capital gains or losses from securities sales in tax year 2001 was misreporting the basis of the securities they sold. Table 4 shows the estimated frequency of the types of noncompliance that caused taxpayers to misreport capital gains or losses from their securities sales.²³

Table 4: Estimated Frequency of Types of Noncompliance That Caused Individual Taxpayers to Misreport Capital Gains or Losses from Securities Sales, Tax Year 2001

Type of noncompliance	Estimated percentage of misreporting taxpayers
Misreported basis of security sold	49
Failed to report sale	44
Misreported sale proceeds	12
Misclassified holding period	9
Other	9

Source: GAO analysis of IRS data and examination case files.

Notes: Estimates in this table do not include the results of our review for four cases where we could not determine the type of noncompliance that caused taxpayers to misreport securities sales. The “Other” category includes taxpayers who misclassified capital income as other types of income or vice versa or made mathematical errors. Some taxpayers misreported more than one security sale or misreported a sale because of more than one type of noncompliance. Percentage estimates have sampling errors of (+/-) 9 percent or less.

For taxpayers who misreported basis, a greater percentage failed to accurately report basis for long-term securities holdings (35 percent of taxpayers who misreported securities sales) than for short-term holdings (21 percent).²⁴ Taxpayers who failed to report securities sales altogether did not report short-term and long-term securities sales at a similar rate (20 percent and 22 percent, respectively, of taxpayers who misreported securities sales).²⁵

Although we were able to determine the percentage of taxpayers who failed to accurately report their securities sales because they misreported

²³For taxpayers who misreported capital gains distributions, from 48 percent to 89 percent were estimated to have failed to report the distributions altogether.

²⁴Estimates have sampling errors of (+/-) 8 percent or less.

²⁵Estimates have sampling errors of (+/-) 8 percent or less.

basis (49 percent), we could not develop reliable estimates on the reasons for this type of misreporting because most of the NRP examination case files did not provide sufficiently descriptive information. However, of the 133 taxpayers who misreported basis from the 849 case files we reviewed, we were able to determine that 32 taxpayers misreported basis for the following reasons:

- Taxpayers did not have records of their securities purchases (16 taxpayers). Although during examinations, IRS was able to obtain basis records for some of these taxpayers from their brokers, for 9 taxpayers, basis records could not be obtained. For these taxpayers, IRS examiners considered basis to be zero and treated all gross proceeds amounts as capital gains.
- Taxpayers used original cost basis instead of adjusted cost basis (6 taxpayers).
- Taxpayers did not understand how to determine basis (5 taxpayers).
- Taxpayers reported basis information that was incorrectly determined by a tax return preparer (4 taxpayers).²⁶
- One taxpayer reported inaccurate basis information provided by a broker.

Of taxpayers who failed to report their securities sales altogether, an estimated 28 percent were estimated to have failed to report capital losses.²⁷ By not reporting losses, these taxpayers potentially failed to offset other capital gains or deduct their losses against other types of income they reported. Likewise, some of these taxpayers who failed to report capital losses exceeding \$3,000 did not carry over these losses to offset capital gains or other income in future tax years. Although in most cases we could not determine why taxpayers did not report these losses, some taxpayers

²⁶Of all taxpayers who misreported a securities transaction, an estimated 52 percent used a tax return preparer with a sampling error of (+/-) 9 percent or less. Of all individual taxpayers, an estimated 56 percent used a tax return preparer for tax year 2001 with a sampling error of (+/-) 0.4 percent or less. We recently reported that some tax return preparers make serious errors when completing returns. See GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, [GAO-06-563T](#) (Washington, D.C.: Apr. 4, 2006).

²⁷Estimate has a sampling error of (+/-) 13 percent or less.

told IRS examiners that they did not know they had to report losses. In addition, IRS officials said some taxpayers might not report their capital losses because they worry that their returns will be examined if they overstate their losses. Also, the officials told us that taxpayers might want to avoid the burden of filing a Schedule D or the cost of paying someone to prepare their returns in cases where filing Schedule D would make the difference between self preparing and using a paid preparer.

As also shown in table 4, taxpayers failed to accurately report their securities sales because they misreported the amount of their sale proceeds (12 percent) or misclassified the securities' holding period (9 percent). However, the case files did not contain enough information to explain why taxpayers made these errors. Also, the responsible officials we interviewed at IRS could not provide explanations for why taxpayers might have made these errors.

IRS Attempts to Reduce the Individual Capital Gains Tax Gap for Securities through Enforcement and Taxpayer Service Programs, but Various Challenges Limit Their Impact

IRS uses both enforcement and taxpayer service programs in attempting to reduce the individual capital gains tax gap for securities. IRS checks the accuracy of tax returns through its enforcement programs and contacts taxpayers who may have inaccurately reported their securities gains or losses. IRS also offers service programs to provide taxpayers with assistance in fulfilling their capital gains tax obligations. However, these programs face challenges that limit their impact on reducing the capital gains tax gap for securities. Although IRS assesses additional taxes for securities income through its enforcement efforts, neither IRS nor we know the extent to which these assessments reduced the 2001 capital gains tax gap for securities.

IRS Attempts to Reduce the Individual Capital Gains Tax Gap for Securities through Enforcement and Taxpayer Service Programs

Consistent with its overarching philosophy that a combination of enforcement and service efforts are essential to tax compliance, IRS attempts to reduce the individual capital gains tax gap for securities through its programs that enforce the tax laws and that seek to help taxpayers voluntarily comply with the laws. IRS uses its enforcement programs to check the accuracy of filed tax returns and contacts taxpayers who have potentially made errors or inaccurately reported capital gains

information on their returns.²⁸ Aspects of IRS's enforcement programs related to capital gains income for securities appear in table 5.²⁹

Table 5: IRS Enforcement Programs and Types of Securities Capital Gains Tax Noncompliance They Can Detect

IRS program	Capable of detecting
Math Error	Data reported inconsistently between Schedule D and Form 1040
Automated Underreporter (AUR)	Inaccurately reported gross proceeds from securities sales and capital gain distributions
Automated Substitute for Return (ASFR)	Taxpayers who received proceeds from securities sales but did not file tax returns
Examination	All forms of capital gains noncompliance for securities

Source: IRS.

Math Error, AUR, and ASFR are automated enforcement programs. IRS uses the Math Error program to check filed tax returns for internal inconsistencies or mathematical errors, and contacts taxpayers, including when the errors result in a tax change. Through AUR, IRS computers match the amounts of capital gains proceeds that taxpayers report on their tax returns and that brokers report on information returns. If this matching indicates that taxpayers may have underreported their sale proceeds for securities and IRS cannot resolve the discrepancies based on available information, IRS may send notices asking taxpayers to explain the discrepancies or pay any taxes assessed. When IRS determines through ASFR that taxpayers for whom IRS received information returns on the sale proceeds for securities failed to file tax returns, it may create tax returns for the taxpayers and assess tax liabilities.

During examinations, IRS uses information from third parties as well as from taxpayers to determine if taxpayers have accurately reported their

²⁸Taxpayers can appeal additional taxes that IRS assesses.

²⁹For a more complete discussion of these programs, see GAO, *Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, [GAO-03-378](#) (Washington, D.C.: Jan. 31, 2003).

capital gains or losses.³⁰ Examiners also may use other resources, such as online services, to help them determine the basis of taxpayers' securities. IRS assesses additional taxes if it determines that taxpayers have underreported their capital gains income from securities.

IRS's taxpayer service programs provide taxpayers with information, support, and assistance to help them understand and fulfill their capital gains tax obligations for securities. For example, IRS produces publications that explain how to report capital gains or losses and provide examples of how to determine adjusted basis.³¹ IRS also provides Web-based information and telephone, written, or face-to-face assistance at Taxpayer Assistance Centers on how to accurately report capital gains and losses.

Various Challenges Limit the Impact IRS Programs Have on Reducing the Individual Capital Gains Tax Gap for Securities

IRS's enforcement and taxpayer service programs face limitations in reducing the individual capital gains tax gap for securities. In addition to resource constraints that limit how many cases of potential noncompliance are pursued, table 6 summarizes the main limitations each program faces.

³⁰IRS performs some examinations through correspondence and others through face-to-face meetings with taxpayers.

³¹IRS publications related to capital gains or losses from securities include Publication 544, *Sales and Other Dispositions of Assets*, Publication 550, *Investment Income and Expenses*; Publication 551, *Basis of Assets*, and Publication 564, *Mutual Fund Distributions*.

Table 6: IRS Enforcement and Taxpayer Service Programs and Their Principle Limitations on Reducing the Individual Capital Gains Tax Gap for Securities

IRS program	Principle limitations
Math Error	Not intended to verify if taxpayers have accurately reported their capital gains tax liabilities for securities
AUR	Lack of basis information from brokers prevents AUR from verifying the accuracy of reported capital gains or losses from securities sales
ASFR	Lack of basis information from brokers prevents ASFR from accurately determining how much of taxpayers' gross proceeds from securities sales is taxable
Examination	Capital gains are too complex and time consuming to examine through correspondence Face-to-face examinations are resource intensive and cover a small percentage of taxpayers with capital gains
Taxpayer services	Taxpayers may not use the services Taxpayers may not understand information IRS provides

Source: IRS.

As table 6 shows, IRS cannot use its automated programs to fully verify the reported capital gains or losses from securities sales because it does not receive basis information from brokers. Also, according to IRS officials, a lack of basis information reduces productivity because IRS spends resources contacting taxpayers for whom it ultimately does not assess additional taxes. For example, for tax year 2002, the latest year for which IRS has complete data, IRS did not assess additional taxes for around 46 percent of the taxpayers it contacted through AUR to address potentially misreported securities sales.³² By comparison, this “no tax change” percentage was around 20 percent for AUR contacts for all other types of income for 2002.³³ For ASFR, IRS officials said that the lack of basis

³²For some taxpayers, IRS did not assess additional taxes when it identified underreported income from securities sales because the changes to reported income only reduced taxpayers' capital loss carryovers.

³³Through AUR, IRS contacted around 190,000 taxpayers who potentially misreported securities sales out of a total of over 2.3 million taxpayers it contacted for all types of misreported income for tax year 2002. IRS does not collect information on the number of taxpayers it contacts through Math Error and ASFR programs who potentially misreported capital gains.

information hampers IRS's ability to determine which taxpayers with gross proceeds from securities sales should have filed tax returns and to productively pursue those taxpayers who did not file.

Given that IRS does not receive basis information from brokers, it can only verify the accuracy of the basis and gains and losses that taxpayers report for their securities sales by examining these individuals' tax returns. IRS does not examine these taxpayers' returns through correspondence because it believes the returns are too difficult and would take too much time to examine. IRS can only verify the accuracy of the reported basis and gains and losses from securities sales through face-to-face examinations. However, these examinations are resource intensive and only cover a small percentage of individual taxpayers. For example, in fiscal year 2004, IRS conducted approximately 200,000 face-to-face examinations³⁴ for the 130 million individual taxpayers that filed tax returns in 2003, including the estimated 22.7 million taxpayers that filed a Schedule D with their tax returns.³⁵ Even when IRS selects individual taxpayers to examine face-to-face, IRS often places a greater focus on issues it believes are more productive than securities sales, such as business income or the sale of personal or business real property, according to an IRS official responsible for examination planning.

In providing taxpayer services, IRS faces challenges in communicating information to taxpayers on complying with capital gains reporting requirements. Taxpayers may not use the services IRS offers or may not understand the information that IRS provides. For example, IRS recently changed the instructions for filing Schedule D to include language that specifies taxpayers must include the details of all their capital gains transactions when filing their tax returns. Although IRS included this language to clarify an existing reporting requirement, some taxpayers and tax practitioners perceived that the instructions required taxpayers to report each capital asset transaction on Schedule D itself and not on attached brokerage statements, as otherwise allowed. This misconception required IRS to clarify on its Web site that taxpayers could continue to

³⁴By comparison, IRS examined through correspondence approximately 800,000 individual tax returns in fiscal year 2004. Approximate examination figures are given because, according to IRS, in general, examination activity may be associated with returns filed in the previous calendar year.

³⁵We are 95 percent confident that the number of taxpayers who reported capital gains or losses was from 22.4 million to 22.9 million.

report the details of their transactions on attached statements as long as all transactions were included and they reported aggregate information on Schedule D.

The Extent to Which IRS Enforcement Programs Have Reduced the 2001 Capital Gains Tax Gap for Securities Is Not Known

Through its enforcement programs, IRS assessed additional taxes for taxpayers who misreported their securities gains and losses for tax year 2001; however, neither IRS nor we know the extent to which these assessments reduced the securities tax gap for that year. IRS has not estimated the portion of the capital gains tax gap attributed to securities for tax year 2001, and we were not able to estimate this portion of the tax gap from our review of NRP case files. Likewise, IRS does not have complete information on the amount of additional taxes it assessed for taxpayers who underreported their income from securities sales for 2001.

Through AUR for tax year 2001, IRS assessed around \$190 million in additional taxes for securities sales and around another \$5 million for capital gain distributions, and refunded over \$8 million to taxpayers who overreported securities income.³⁶ For tax year 2001 examinations, IRS does not have complete data for the amount of taxes it assessed for misreported capital gains or losses. IRS maintains a database that tracks examination results by the type of issue examined, such as capital gains or losses. However, prior to October 2004, the database only captured examination results for around 60 percent of individual examinations, according to IRS officials.³⁷ As such, the database does not include all capital gains noncompliance that IRS identified in tax year 2001 examinations. Even when it includes such noncompliance, the database does not distinguish between misreported capital gains income from securities versus other capital assets. Likewise, the database does not specify the portion of additional tax assessments that is attributable to misreported capital gains

³⁶For tax year 2002, IRS increased the number of taxpayers contacted for potentially misreported securities sales to around 190,000, assessing over \$550 million in additional taxes.

³⁷As previously reported, IRS had not been entering all examination cases into this database, and started implementing improvements in October 2004 to case processing and data capture. See GAO, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, [GAO-05-753](#) (Washington, D.C.: July 18, 2005).

income versus other types of noncompliance.³⁸ Finally, IRS does not maintain data on additional taxes assessed and collected because of capital gains noncompliance through the Math Error or ASFR programs.

Reporting of Cost Basis Could Reduce the Individual Capital Gains Tax Gap for Securities, but Implementation Challenges Would Need to Be Addressed

Expanded reporting of cost basis information has the potential to reduce the individual capital gains tax gap for securities. Making administrative changes to IRS's compliance programs that address capital gains also has some potential to reduce the tax gap, but enforcement programs can be resource intensive and taxpayers do not always use IRS's taxpayer service programs. With such limitations, these changes likely would not significantly boost taxpayers' voluntary compliance involving securities sales. Information reporting of adjusted cost basis to taxpayers and IRS would likely help reduce the tax gap from securities sales by improving taxpayers' voluntary compliance and IRS's ability to cost effectively address noncompliant taxpayers. Consistent reporting of basis information would involve challenges that would need to be, and to some extent can be, mitigated.

Increasing Examinations of Taxpayers with Securities Sales Could Reduce That Portion of the Tax Gap but at the Expense of Not Covering Other Areas of Noncompliance

IRS could seek to reduce the capital gains tax gap for securities by increasing examination coverage of taxpayers with gains or losses from securities, either by considering them when selecting taxpayers to examine through correspondence or by increasing face-to-face examinations of these taxpayers. Conducting more of each type of examination could increase the amount of taxes assessed for misreporting securities income. However, absent an increase in resources or access to basis information, which would help IRS better target its resources toward truly noncompliant taxpayers, focusing on taxpayers with securities gains or losses would divert IRS's examination resources away from other productive areas of noncompliance, according to IRS officials. An increased focus on securities sales could reduce the capital gains tax gap, but a diversion of resources could result in greater noncompliance for other types of income. Moreover, although increasing examination coverage could induce taxpayers who are misreporting willfully to voluntarily comply, expanded coverage would not significantly affect voluntary compliance for taxpayers who make mistakes while trying to

³⁸If the data were complete, according to IRS it would be possible to estimate the portion of additional taxes IRS assessed that could be attributed to capital gains.

comply, such as taxpayers who made errors calculating basis, according to an IRS research official who has studied the impact of enforcement on taxpayer compliance.

Enhanced Taxpayer Services Might Improve Taxpayers' Voluntary Compliance, but the Impact of Any Changes Would Be Hard to Gauge

Addressing capital gains tax noncompliance for securities sales by enhancing IRS's taxpayer service efforts might improve taxpayers' voluntary compliance by helping them to better understand and fulfill their capital gains tax obligations for securities. However, the effects of any additional guidance that IRS might develop, for example on reporting losses or on resources for determining basis, would be tempered by challenges similar to those previously discussed, such as taxpayers not using or understanding information IRS provides. Although IRS attempts to generally ensure tax compliance through its service efforts, IRS researchers have found it difficult to determine the extent to which taxpayer services improve compliance among taxpayers who want to comply. As such, it is hard to know if these improvements to IRS's service efforts would have a substantial impact on taxpayer's reporting compliance for securities sales.

Regardless, IRS's instructions for reporting capital gains and losses and related guidance do not contain some information related to the causes for taxpayers misreporting the basis of securities they sold or failing to report sales at all—the leading types of noncompliance when taxpayers erred in reporting capital gains and losses. In many cases, we could not determine and IRS did not know exactly why taxpayers made these errors. However, some taxpayers did not know they had to report gains or losses and others did not understand how to determine basis. One counterintuitive situation existed among the cases we reviewed, that is some taxpayers did not report losses, which generally help them by lowering their tax liabilities. IRS's instructions for filing Schedule D direct taxpayers to report their capital gains or losses but the instructions do not clarify the appropriate use of capital losses to offset capital gains or other income. Further, although IRS provides guidance on how to calculate basis for a variety of securities transactions, the instructions to Schedule D do not contain guidance on resources available to taxpayers and tax practitioners to determine basis for securities. Some examples of resources taxpayers might use to determine the basis of their securities holdings include brokers, tax preparers, or Web sites for companies that issue stocks or other information. Providing taxpayers more information on the benefits of reporting losses and resources available to them on calculating basis would be consistent with IRS's responsibility to ensure that taxpayers pay the

right amount of tax. Further, compared to other steps such as enforcement actions, providing additional guidance to taxpayers would be a low cost option to potentially increase their capital gains reporting compliance. Finally, any improvement in taxpayers' compliance due to better guidance would reduce IRS's enforcement expenses related to capital gains.

Information Reporting of Adjusted Basis Could Reduce the Capital Gains Tax Gap for Securities

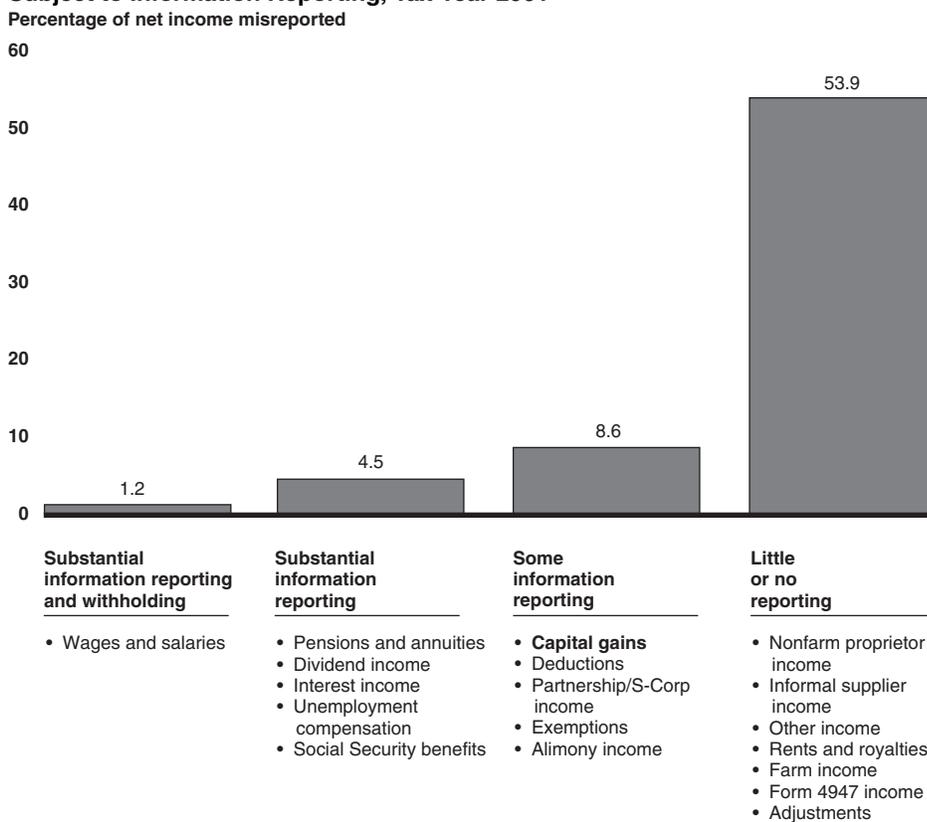
According to IRS officials and some representatives related to the securities industry, taxpayers would likely report their gains or losses from securities sales more accurately and at a reduced burden if brokers consistently provided them with the adjusted basis of the securities they sold. Likewise, basis reporting would allow IRS to verify taxpayers' securities gains and losses through its automated enforcement programs and take more efficient enforcement actions to address noncompliant taxpayers, according to IRS compliance officials. The likely increase in taxpayers' voluntary compliance and in the productivity of IRS enforcement actions resulting from basis reporting would likely substantially reduce the capital gains tax gap for securities.

Taxpayers would benefit from basis reporting because, in many cases, they would not have to track and compute the adjusted basis of the securities they sold. Therefore, basis reporting would likely reduce the chance that taxpayers who had not been tracking their adjusted basis would misreport it for securities they sold. Also, if taxpayers received basis information from their brokers for the securities they sold, they would enjoy a reduced burden in filing Schedule D with their tax returns because, in many cases, they would not need to make basis calculations on their own.

For taxpayers, the greater accuracy and reduced burden of reporting basis that would result from basis reporting would likely improve their voluntary compliance. As shown in figure 2, taxpayers tend to accurately report income that third parties report on information returns because the income is transparent to taxpayers as well as to IRS. For example, individual taxpayers misreport nearly twice the percentage of their income from sources subject only to some information reporting, which is the case with income from securities sales now, compared to income subject to substantial information reporting, such as income from dividends and interest, and which would be close to the case for securities sales if basis were consistently reported, according to an IRS research official. Also, as discussed previously, based on our file review, taxpayers were much less likely to misreport capital gain distributions (13 percent), which are similar to dividends and are subject to substantial information reporting,

compared to income from securities sales (36 percent), for which information reporting only covers gross proceeds but not cost basis. The smallest percentage of misreporting is for wage and salary income, for which substantial information reporting exists and taxes are withheld by taxpayers' employers.

Figure 2: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Information Reporting, Tax Year 2001



Source: IRS.

Cost basis reporting would also benefit IRS, to the extent the reporting was complete and accurate. IRS could use basis information to verify securities gains and losses through its automated enforcement programs and could more effectively allocate its enforcement resources to focus on the most noncompliant taxpayers. For AUR and ASFR, IRS officials told us that basis information would allow it to more precisely determine taxpayers' income for securities sales and would allow it to identify which taxpayers who

misreported securities income have the greatest potential for additional tax assessments. IRS's examination program could similarly benefit. Specifically, IRS officials told us that receiving cost basis information might enable IRS to examine noncompliant taxpayers through correspondence because it could productively select tax returns to examine. Also, having cost basis information could help IRS identify the best cases to examine face-to-face, making the examinations more productive while simultaneously reducing the burden imposed on compliant taxpayers who otherwise would be selected for examination. As a result of all these benefits, basis reporting would allow IRS to better allocate its resources that focus on securities misreporting across its enforcement programs.

IRS has endorsed the concept of matching information returns to tax returns for the purpose of identifying unreported income since the 1960s and Congress has created a number of statutes requiring information reporting for various types of income or taxpayer information.³⁹ The related GAO products section at the end of this report provides references to selected GAO reports related to information reporting.

We previously discussed the notion of basis reporting to help reduce capital gains tax noncompliance in our May 1994 report on the tax gap.⁴⁰ Also, based on discussions we had with officials from IRS's Taxpayer Advocate Service when we initiated our review, the National Taxpayer Advocate recommended that brokers be required to track and report cost basis for stocks and mutual funds in her *2005 Annual Report to Congress*.⁴¹ In March 2006 a bill was introduced in the U.S. Senate and in April and May 2006 bills were introduced in the House of Representatives that would require brokers to report taxpayers' basis for their securities transactions.⁴²

³⁹For a list of major legislation affecting IRS's information returns program, see [GAO-03-378](#).

⁴⁰GAO, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, [GAO/GGD-94-123](#) (Washington, D.C.: May 11, 1994).

⁴¹Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2005 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2005).

⁴²S. 2414, 109th Cong. §2 (2006), H.R. 5176, 109th Cong. §206 (2006), and H.R. 5367, 109th Cong. §2 (2006).

Expanding Basis Reporting Involves Implementation Challenges That Would Need to Be Addressed

Expanding information reporting on securities sales to include basis information would involve challenges for brokers and IRS. There are various ways to mitigate each challenge. Tables 7 and 8 list some major challenges for brokers and IRS, respectively, as well as some ways to start mitigating the challenges. Discussion after the tables covers some issues to consider when evaluating these mitigation strategies.

Table 7: Challenges to Brokers Associated with Basis Reporting and How the Challenges Could Be Mitigated

Challenges to brokers	Ways to mitigate challenges
Implementing systems to track and report basis involves monetary costs	<ul style="list-style-type: none"> Although the following do not directly mitigate costs for all brokers, Many brokers and mutual funds already track and report basis to many taxpayers, which could help form a foundation for expanded basis reporting Brokers could leverage existing systems that track and report gross proceeds to taxpayers and IRS Congress or IRS could provide an appropriate effective date that would allow brokers that lack such systems to develop them
Brokers may not be able to determine basis for some securities transactions because of complex tax laws	<ul style="list-style-type: none"> Brokers could report on those securities transactions not affected by complex tax laws Tax laws on selling securities could be simplified^a Absent tax law changes, IRS could develop consistent reporting rules in concert with those who report
Brokers may not know basis for securities purchased through another broker	<ul style="list-style-type: none"> Brokers could use an existing system that allows them to transfer basis information when taxpayers move their securities holdings from one broker to another
Brokers may not know basis for securities purchased through companies that directly issue stock (e.g., employee stock purchase plans)	<ul style="list-style-type: none"> Companies that directly issue stock could track and report basis and use the basis transfer system
Brokers may not know basis for older securities	<ul style="list-style-type: none"> Brokers could track and report basis prospectively (i.e., only for securities purchased after a particular date)
Brokers that do not know the basis may rely on taxpayers to provide basis without any verification (e.g., for stocks received as gifts)	<ul style="list-style-type: none"> Prospective reporting would likely produce fewer cases in which the broker does not know the basis Brokers could indicate on the information return if the basis information came from taxpayers

(Continued From Previous Page)

Challenges to brokers	Ways to mitigate challenges
Brokers cannot always obtain timely adjusted basis information from companies that issue stock and engage in corporate events (e.g., mergers, acquisitions)	<ul style="list-style-type: none"> • These companies and the securities industry in concert with IRS could develop a system to timely make such information available on corporate events that affect basis

Source: GAO.

^aTax code simplification is a method through which some believe tax compliance could be enhanced. See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, [GAO-05-1009SP](#) (Washington, D.C.: September 2005).

Table 8: Challenges to IRS Associated with Basis Reporting and How the Challenges Could Be Mitigated

Challenges to IRS	Ways to mitigate challenges
Expanding IRS's computer system capacity to store and use additional data on basis involves monetary costs	<ul style="list-style-type: none"> • Cost to implement system would be outweighed by increased tax revenue resulting from higher voluntary reporting compliance (although such funds would not be IRS's to directly use) • Funds could be budgeted to cover these costs
IRS systems may not be able to process and match basis for each securities sale reported on information returns and on Schedule D of the Form 1040 (including any attachments on the securities sold)	<ul style="list-style-type: none"> • Brokers could report aggregate adjusted basis for all securities sold for a taxpayer on the information return while reporting adjusted basis for all sales on annual statements provided to taxpayers
IRS may still encounter taxpayers that misclassify the holding period for their securities sales	<ul style="list-style-type: none"> • Brokers could report aggregate basis and gross proceeds for short-term and long-term transactions separately on the information return
Taxpayers may improperly report basis when they sell portions of their holdings in a security that they purchased on multiple occasions	<ul style="list-style-type: none"> • Allow taxpayers to use the average costs of their securities holdings to determine basis for securities beyond mutual funds • Taxpayers could indicate the method they will use to determine basis when their security is sold and brokers then would report the method selected and the related basis amount on the information return

Source: GAO.

Although not all inclusive, the strategies discussed above could help mitigate many of the challenges facing brokers and IRS if information reporting were expanded to include cost basis. However, the strategies also involve a number of trade-offs that would need to be considered in terms of the costs and burdens associated with basis reporting for taxpayers, IRS,

and brokers, and the impact on reducing the capital gains tax gap for securities.

Representatives from the securities industry we interviewed said that brokers would incur additional costs to develop and maintain systems to track and report basis, although they did not provide precise costs. However, we were also told that almost all of the largest brokers directly provide basis information to a significant portion of their clients, and many smaller brokers provide basis to a significant portion of their clients through outsourcing. Also, representatives of the mutual fund industry estimated that 80 to 90 percent of mutual funds provide average cost basis information to their shareholders. Likewise, from a societal perspective, the cost that brokers would incur in reporting basis information would be offset to some extent by the reduced costs to taxpayers in researching, calculating, and reporting basis, or paying a return preparer to perform such services. However, some brokers may pass on the costs of reporting basis information to their customers. Further, decisions about the scope and details of basis reporting, as further discussed below, could constrain how much brokers' costs would increase.⁴³

Also, representatives from the securities industry told us that their ability to provide taxpayers and IRS with accurate basis information would be challenged when taxpayers move their securities holdings from one broker to another. Some brokers use a system to transfer basis among one another, but the system is not used by all brokers. In addition, brokers do not always track and transfer basis in a consistent manner; that is, some track original cost basis while others track adjusted cost basis. Without a system through which all brokers transfer standardized basis information, the effectiveness of basis reporting would be limited.

Additionally, brokers do not always know or may be challenged in determining the basis of taxpayers' holdings. For example, some taxpayers may hold securities that they purchased long ago or received as a gift, for which neither they nor their brokers know the original purchase dates. In these cases, brokers cannot know the basis of the securities. However, this challenge could be mitigated to a large extent if brokers were to track and

⁴³Although IRS has not estimated the costs to taxpayers of filing Schedule D, taxpayers spend billions of dollars every year in complying with their tax obligations. See GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, [GAO-05-878](#) (Washington, D.C.: Aug. 26, 2005).

report basis prospectively, that is, only for securities purchased after a specified future date. The trade-off to prospective basis reporting, however, is that it would not help some taxpayers report basis for securities they owned before brokers began to report basis, which for a period of time would limit the impact basis reporting would have on reducing the tax gap. Also, prospective reporting would be complicated in cases where a taxpayer held a security prior to the specified date and then purchased additional shares of the same security after the specified date. Brokers would likely incur some additional costs to separately account for shares of stock purchased before and after the specified date for prospective reporting on information returns.

Likewise, it is difficult for brokers to determine basis for some complicated securities transactions, according to representatives of the securities industry. For example, when taxpayers sell stock for a loss and then buy shares of the same stock within 30 days, they are prohibited from claiming a loss on the original sale. For these sales, known as wash sales, basis is difficult for the broker to determine because the taxpayer is required to add the disallowed loss from the wash sale to the basis of the subsequently purchased stock. The difficulty in determining basis for wash sales is compounded when taxpayers sell a stock at a loss through one broker and then buy the same stock within 30 days from another broker. In this case, the second broker would not know of the wash sale the taxpayer executed through the first broker and would not know to adjust the taxpayer's basis accordingly. We only found two cases through our file review where taxpayers had misreported basis because of wash sales. Regardless, transactions such as wash sales may be too complex for brokers to feasibly report basis. Excluding these transactions from basis reporting, however, would further reduce the impact of basis reporting on closing the securities tax gap.

For IRS, having basis information, along with gross proceeds information, for each of a taxpayer's securities sales would best enable the agency to check whether taxpayers properly reported their capital gains and losses. However, storing and making use of such information would be challenging because of the costs and difficulty involved in storing and computer matching the large volume of information that transactional reporting would entail. However, if brokers were to report only aggregate basis amounts to IRS for all of a taxpayer's transactions, the costs and difficulties of storing and using the information for matching would be reduced. Aggregate reporting would also reduce the costs to brokers of reporting

basis to IRS, although they could still report basis for all transactions to taxpayers.

Another complication for IRS and brokers is that taxpayers can choose among various methods for reporting basis in cases where they sell some of their shares of a security they purchased on multiple occasions. Taxpayers may choose to report basis in a different way than brokers would otherwise choose because taxpayers can (1) specifically identify which shares they sell among many they hold and report basis for those shares; (2) use the basis of the first shares they bought; or (3) in the case of mutual funds, use the average cost of the shares they own.⁴⁴ Taxpayers could indicate the method they chose to determine basis when they sell their securities, and brokers then could report the method selected and the related basis amount on information returns. However, this additional layer of tracking would likely add to costs to taxpayers, brokers, and IRS. Although this challenge could be alleviated if taxpayers were required to report basis in a consistent manner, this requirement would end taxpayers' ability to determine basis in the most advantageous manner for their particular tax situations.

Given the number of decisions that would need to be made in conjunction with basis reporting, IRS may not be able to require such reporting given its current authority. Although IRS has long had the authority to require information reporting related to securities, an official from IRS's Office of Chief Counsel told us that IRS may not have the authority to require all of the actions that would be needed to implement cost basis information reporting, such as regulating a system through which brokers transfer standardized basis information. Therefore, it may be difficult for IRS to implement cost basis information reporting without further statutory authority.

Representatives from the securities industry told us that in order to implement basis reporting, a set of rules would need to be developed to clearly establish, for example, what types of securities transactions would be covered by any requirement and how a system to transfer basis would

⁴⁴Taxpayers who own mutual funds face similar choices through reinvested dividends. However, tracking and computing cost basis for dividend reinvestments may not be as challenging to track because mutual funds shareholders can use the average costs of their holdings to determine basis, a method that cannot be used for stocks or other securities.

be standardized. These representatives thought their input could be helpful in designing any set of rules.

Conclusion

Although neither IRS nor we know the size of the tax gap related to securities sales, tens of millions of taxpayers hold securities outside of their retirement accounts and, according to our analysis of IRS data, an estimated 36 percent of taxpayers who sold securities in 2001 erred in reporting their gains and losses (an estimated 7.3 million out of an estimated 20.3 million taxpayers). Of those erring, an estimated 64 percent underreported their income and 33 percent overreported income. Also, an estimated 9 percent of individual taxpayers who sold securities misclassified their holding periods, either reporting short-term holdings as long-term, or vice versa. Enhancing IRS's current enforcement and service efforts is an option for addressing these compliance problems, but the most effective tool for improving taxpayers' compliance levels has long been information reporting and tax withholding. Individual taxpayers misreport nearly twice the percentage of their income from sources subject only to some information reporting—which is the case for securities income now—compared to income subject to substantial information reporting. Also, given that the tax consequences associated with the holding period of securities are significant, broker reporting on this specific issue, whether as part of basis reporting or separately, would help taxpayers apply the proper tax rules to their gains or losses and help IRS in identifying compliance problems.

Extending information reporting for securities sales to include basis information is not a simple and straightforward proposition. The manner in which basis reporting is designed would affect how the costs of basis reporting are distributed among taxpayers, brokers, and IRS, and the extent to which basis reporting would close the securities-related tax gap. In addition, although IRS has the general authority to require basis reporting, IRS officials were not certain the agency had sufficient authority to regulate how such reporting is implemented, such as regulating a system through which brokers transfer standardized basis information.

In the event that brokers were required to report basis for securities purchased as of a specific future date, some taxpayers may continue to misreport their gains and losses from the securities holdings they currently hold. For these taxpayers, additional guidance on reporting basis and gains or losses for securities sales could be a low cost way to help them voluntarily comply with their tax obligations. For example, an estimated 28

percent of taxpayers who failed to report their securities sales had losses. Clarification of IRS's instructions for Schedule D on the appropriate use of capital losses to offset capital gains or other income could be a means to help ensure that taxpayers do not disadvantage themselves when they experience losses from their investments. Also, given the complexity involved in determining some securities' basis because of events such as stock splits, guidance on the resources available to taxpayers on determining basis, such as utilizing brokers, or services offered by companies that issue stocks or other information available on Web sites, could help improve taxpayers' ability to determine their securities' basis.

Matters for Congressional Consideration

In order to reduce the capital gains tax gap for securities, Congress may want to consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell and ensuring that IRS has sufficient regulatory authority to implement the requirement. Either in connection with requiring basis reporting or separately, Congress could also require brokers to report to taxpayers and IRS whether the securities sold were short-term or long-term holdings. Additionally, Congress could direct IRS to work with brokers and related parties to develop rules that seek to mitigate some of the challenges associated with requiring basis reporting.

Recommendations for Executive Action

To assist taxpayers in accurately reporting their capital gains and losses from securities, in the instructions to Schedule D the Commissioner of Internal Revenue should (1) clarify the appropriate use of capital losses to offset capital gains or other income and (2) provide guidance on resources available to taxpayers to determine their basis.

Agency Comments and Our Evaluation

In written comments on a draft of this report, which are reprinted in appendix II, the Commissioner of Internal Revenue agreed with our recommendations. He also concurred that for some securities, basis reporting involves unique challenges and noted that IRS is committed to working with industry stakeholders to develop cost effective methods to mitigate such reporting challenges. IRS also provided comments on several technical issues, which we incorporated in this report where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its

issue date. At that time, we will send copies to the Chairman and Ranking Minority Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. Copies will be made available to others upon request. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Scope and Methodology

To provide information on the extent of and primary types of noncompliance that cause individual taxpayers to misreport capital gains from securities, we performed a number of activities that relied on data from IRS's National Research Program (NRP). Through NRP, IRS selected and reviewed a stratified random sample of 45,925 individual income tax returns from tax year 2001. The NRP sample is divided across 30 strata by the type of individual tax return filed and income levels. IRS accepted as filed some of the NRP returns, accepted others with minor adjustments, and examined the remainder of returns either through correspondence or face-to-face meetings with taxpayers. If IRS examiners determined that taxpayers misreported income for any aspect of the selected tax returns, they adjusted the taxpayers' income accordingly and assessed additional taxes.

IRS captured data from taxpayer returns and examination results in the NRP database, including capital gains income. However, the data on capital gains do not indicate the type of capital asset for which taxpayers reported gains or losses or for which examiners made income adjustments. Therefore, to obtain information on the extent and primary types of capital gains tax noncompliance specific to securities, we selected a statistical sample of NRP examination files to review.

The sample we selected contained 1,017 cases spread across 90 substrata, defined by replicating each of the 30 NRP strata across 3 GAO substrata. The first GAO substratum consisted of examination cases for which the adjustments to capital gain income the examiners made had the largest impact on the total amount of these adjustments for all taxpayers when weighted for the entire population of individual taxpayers. We focused on cases with the largest adjustments, in weighted terms, because including these cases would improve the level of confidence of any estimates of the total amount of capital gains income adjustments for securities. Because our sample is a subsample of the NRP sample and is subject to sampling error, we added cases, when applicable, to ensure that each of the 30 NRP strata in this GAO substratum contained a minimum of 5 cases. In total, we selected 290 cases for the first GAO substratum, and these cases accounted for around 75 percent of the total capital gains adjustments in NRP when weighted for the population of individual taxpayers.

The second substratum consisted of 187 cases for which IRS did not identify misreported capital gains income when it reviewed or examined the tax returns. We included these returns as part of our sample to verify that the NRP examinations had correctly recorded when taxpayers were

compliant with respect to reporting capital gains and losses. We selected these cases at random and in proportion to the NRP sample through an iterative process, ensuring that a minimum of 5 cases and a maximum of 15 cases was included in each of the 30 NRP strata.

The remaining 540 cases that constitute the third GAO substratum were selected from cases for which IRS examined taxpayers' capital gain income. We selected these cases at random and in proportion to the number of NRP returns for which IRS examined capital gains income, ensuring that we selected a minimum of 5 cases for each NRP stratum. For one stratum, we only included 2 cases because they were the only cases in the corresponding NRP stratum.

Of the 1,017 cases we selected for our sample, we reviewed 849 cases. We did not review the remaining 168 cases because either IRS did not provide the files in time to include in our review (164 cases) or the files did not contain examination workpapers essential to determining if examiners made adjustments to taxpayers income from securities (4 cases).¹ Based on an analysis of the response rates by the 90 GAO substrata, we concluded that the missing cases did not bias our analyses. We requested the cases at two points, in late-December 2005 and late-January 2006, and periodically checked on the status of our requests with IRS. We were only able to review cases that arrived by April 21, 2006 in order to meet our agreed upon issue date for the report.

We reviewed each selected case file to determine if the taxpayers reported securities transactions on their returns or if examiners discovered any misreported securities transactions. For returns where examiners discovered misreported income from securities transactions, we determined, when possible, the related security type, holding period, adjustment amount, and reason for the adjustment, along with other information. We recorded all determinations on a data collection instrument (DCI) that we developed.

To ensure that our data collection efforts conformed to GAO's data quality standards, each DCI that a GAO analyst completed was reviewed by another GAO analyst. The reviewers compared the data recorded on the DCI to the data in the corresponding case file to determine whether they

¹IRS could not provide one of these cases that was not yet closed because it was with IRS's Appeals function.

concluded with how the data were recorded. When the analysts differed on how the data were recorded, they met to reconcile any differences.

We input the data we recorded on the DCIs into a computer data collection program. To ensure the accuracy of the transcribed data, each electronic DCI entry was compared to its corresponding paper DCI by analysts other than those that electronically entered the data. If the reviewers found any errors, changes were made to the electronic entries, and the entries were reviewed again to ensure that all data were transcribed accurately.

The estimates we included in this report were based on the NRP database and the data we collected through our file review and were generated using statistical software. All computer programming for the resulting statistical analyses were checked by a second, independent analyst. Our final sample size was large enough to generalize the results of our review or had margins of error small enough to produce meaningful estimates in terms of percentages of taxpayers who were noncompliant in reporting capital gains from securities transactions. However, we could not produce meaningful estimates of the total amount of net misreported capital gain income from securities or determine the securities tax gap, in part because (1) in selecting our sample, we could not distinguish which cases included misreported securities transactions as opposed to misreported transactions for other types of capital assets, (2) some cases with large amounts of misreported capital gains or losses were due to noncompliance for assets other than securities, (3) 53 of the cases we requested from IRS from our first substratum, which represented a large percentage of the total amounts of misreported capital gains or losses, were not provided in time to include in our review, and (4) taxpayers misreported a wide range of dollar amounts from the transactions.² We discussed our estimates with IRS officials to obtain their perspectives on the results of our analysis.

Because we followed a probability procedure based on random selection, our sample is only one of a large number of samples that we might have selected. Since each sample could have resulted in different estimates, we express our confidence in the precision of our particular sample's results as a 95 percent confidence interval, plus or minus the margin of error indicated along with each estimate in the report. This interval would

²IRS could not provide one of these cases that was not yet closed because it was with IRS's Appeals function.

contain the actual population value for 95 percent of the samples we could have selected.

We assessed whether the examination results and data contained in the NRP database were sufficiently reliable for the purposes of our review. For this assessment, we interviewed IRS officials about the data, collected and reviewed documentation about the data and the system used to capture the data, and performed electronic testing of relevant data fields for obvious errors in accuracy and completeness. We compared the information we collected through our case file review to corresponding information in the NRP database to identify inconsistencies. Based on our assessment, we determined that the NRP database was sufficiently reliable for the purposes of our review.

We also used IRS's Statistics of Income (SOI) file for individual taxpayers, which relies on a stratified probability sample of individual income tax returns, to develop estimates for categories of individual taxpayers on adjusted gross income, the percentage of individual taxpayers that used paid tax preparers, and the number of taxpayers that filed a Schedule D with their tax returns for tax year 2003. We compared our analyses against published IRS data to determine that the SOI database was sufficiently reliable for the purposes of our review.

To provide information on actions IRS takes in attempting to reduce the individual capital gains tax gap for securities and on challenges that IRS faces with these actions, we reviewed documents from IRS compliance programs as they related to capital gains and interviewed IRS officials knowledgeable about the subject. We reviewed documentation for IRS's enforcement programs that address capital gains and reviewed IRS publications and other documents that provided information on how to accurately report capital gains and losses. To provide additional information on IRS's compliance programs and identify challenges IRS faces in using these programs to reduce the individual capital gains tax gap for securities, we interviewed IRS officials from various areas of the agency, including the enforcement, taxpayer service, and research functions.

To identify options with the potential to improve taxpayers' voluntary compliance for reporting securities gains and losses and IRS's ability to find noncompliance related to the individual capital gains tax gap for securities, we reviewed prior GAO reports and other documents on capital gains reporting and compliance such as those from IRS compliance programs

and industry reports on securities holdings and information reporting. We also spoke with IRS officials and numerous representatives from, and related to, the securities industry. At IRS, we spoke with officials from various areas of the agency, including the enforcement, taxpayer service, and research functions. Additionally, we spoke with officials from the Taxpayer Advocate Service and members of IRS's Information Return Program Advisory Committee (IRPAC).³ We also spoke with representatives of the Securities Industry Association; Investment Company Institute, which represents the mutual fund industry; Bond Market Association; American Banking Association Securities Association; American Institute of Certified Public Accountants; and the American Bar Association to get their perspectives on capital gains tax noncompliance, ways to reduce noncompliance, and any challenges related to reducing noncompliance and how those challenges could be mitigated.

³IRPAC advises IRS on information reporting issues of mutual concern to the private sector and federal government. It is composed of 17 members who represent various private and public sector organizations with an interest in, or responsibility for, information reporting.

Comments from the Internal Revenue Service



COMMISSIONER

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

June 5, 2006

Mr. Michael Brostek
Director, Tax Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Brostek:

I have reviewed the draft Government Accountability Office (GAO) report titled "Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed" (GAO-06-603). We agree with the recommendation contained in the report and would like to offer several comments.

Accurate reporting of capital gains and losses related to securities is an important component of the tax gap. Determining cost calculations for stocks or mutual funds is complex especially when purchased over a long time span, and where dividends and other distributions are automatically reinvested. Calculations may also be complicated by the taxpayer's choice of accounting methods, stock splits, mergers and corporate reorganizations.

This report suggests that Congress consider requiring brokers to report the adjusted basis of securities sold and identify whether gains and losses are short or long-term. IRS research shows that taxpayer's reporting compliance is strongly related to the extent of third party reporting, however, basis reporting would raise unique challenges in the area of burden on brokers and taxpayers when reporting unique situations such as wash sales and options. The report discusses that a solution would be to exclude wash sale transactions from basis reporting. To exclude these transactions from basis reporting, a broker must be able to distinguish them from non-wash sale transactions. Because of the way wash sale transactions are defined under current law, however, in many cases brokers would not be able to identify the transactions by the time reporting would be required, so excluding them may not be possible in all situations.

In the short term, the IRS will continue to clarify guidance related to the accurate reporting of capital gains and losses. We will revise the instructions for Schedule D, "Capital Gains and Losses," to clarify the appropriate use of capital losses and provide guidance on resources available to taxpayers to determine their basis. A previous example of our efforts is the 2005 revision of instructions for Schedule D. The revision provides taxpayers with references to IRS publications and applicable Internal Revenue Code sections, and reminds taxpayers to report information critical to evaluating the accuracy of the capital gain or loss claimed.

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I am pleased to inform you that the IRS Office of Taxpayer Burden Reduction is leading an effort to address the capital gains tax gap and related tax burden. We are committed to working with industry stakeholders to develop cost effective methods to mitigate reporting challenges that impact taxpayers, tax practitioners, financial institutions and tax software vendors.

I appreciate your continued support and the valuable assistance and guidance from your staff. Our response to your recommendation is enclosed. If you have any questions please contact Floyd Williams, Director, Legislative Affairs, at (202) 622-4725.

Sincerely,



Mark W. Everson

Enclosure

Enclosure

GAO Draft Report – Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed (GAO-06-603)

GAO Recommendation: To assist taxpayers in accurately reporting their capital gains and losses from securities, in the instructions to Schedule D the Commissioner of Internal Revenue should (1) clarify the appropriate use of capital losses to offset capital gains and (2) provide guidance on resources available to taxpayers to determine their basis.

IRS Response: We agree with the recommendation and will revise the instructions for Schedule D to clarify the appropriate use of capital losses and provide guidance on resources available to taxpayers to determine their basis.

GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Wes Phillips and Tom Short, Assistant Directors; Jeff Arkin; Susan Baker; Candace Carpenter; Keira Dembowski; Fred Jimenez; Matthew Keeler; Donna Miller; John Mingus; Franklin Ng; Karen O’Conor; Cheryl Peterson; Sam Scrutchins; Jay Smale; and Jennifer Li Wong made key contributions to this report.

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