

June 2008

# TAX EXPENDITURES

## Available Data Are Insufficient to Determine the Use and Impact of Indian Reservation Depreciation





Highlights of [GAO-08-731](#), a report to the Committee on Finance, U.S. Senate

## Why GAO Did This Study

Indians lag behind other Americans on many key economic indicators, such as median household income. To improve such conditions, Congress in 1993 created Indian reservation depreciation (IRD), a tax expenditure offering accelerated depreciation for property invested on Indian reservations.

GAO was asked to (1) describe which taxpayers claimed IRD, (2) analyze the effect of IRD on the economic development of reservations, and (3) describe the tax benefits offered by IRD. GAO used the Internal Revenue Service's (IRS) Statistics of Income data to try to identify IRD users and measure IRD's effects; however, the data were unreliable for those purposes. GAO also calculated examples of potential IRD tax benefits for different property classes.

## What GAO Recommends

Congress should consider requiring IRS to compile in a database information identifying which taxpayers use IRD and require taxpayers to report the reservation and/or address where they have placed the property into service. Additionally, GAO recommends that the Commissioner of Internal Revenue clarify instructions and revise forms, if needed, to ensure taxpayers separately report IRD from other kinds of depreciation. IRS generally agreed with the report and said that it would look at its instructions and publications on depreciation to determine where additional information on IRD might be beneficial.

To view the full product, including the scope and methodology, click on [GAO-08-731](#). For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

## TAX EXPENDITURES

### Available Data Are Insufficient to Determine the Use and Impact of Indian Reservation Depreciation

#### What GAO Found

Available data are insufficient to identify users of the Indian reservation depreciation (IRD) provision. Although IRD is to be calculated using unique recovery periods, this and other information that taxpayers report are not sufficient to infer from the tax returns which taxpayers are using IRD, in part because taxpayers appear to have reported IRD in combination with other depreciation on their tax forms. In some instances, taxpayers also appear to have made mistakes filling out Form 4562, listing recovery periods inconsistent with IRD when the deduction and basis amounts they reported suggest IRD was in fact used.

Data are also insufficient to determine whether IRD increases economic development on Indian reservations. Taxpayers are not required to identify the reservation on which the depreciated property is located. This location data is critical for determining the effects of IRD on the economic development of reservations. Such a determination requires linking IRD investment to economic indicators on specific reservations and controlling for the influence of other economic trends, such as the growth of gaming facilities on these reservations. The lack of data on IRD also may affect how well the Internal Revenue Service (IRS) enforces IRD compliance with the tax law. IRS does not track compliance issues related to IRD and could fail to detect taxpayers who claim IRD deductions but do not in fact have property on a reservation. IRS officials said getting additional information could be costly to obtain, but auditors told us it would be useful. In fact, IRS collects data on some other tax expenditures that allow closer examination of compliance and use. For example, the low-income housing tax credit requires taxpayers to list the address for the property they are claiming, and New Markets Tax Credits users report identifying information for the Department of the Treasury.

Tax benefits can accrue to taxpayers who use the IRD schedule because they can achieve higher depreciation deductions, in present value terms, than a taxpayer who claims a depreciation deduction under the usual schedule for the same type of property over the entire life of the property. For example, on a \$50,000 property, the savings range from about 1 percent savings over the normal schedule to 22 percent savings, depending on the type of property depreciated. The greatest potential tax savings come from IRD claimed for property with the longest recovery periods. Additional bonus depreciation, when available, however, may decrease the incentive to use IRD.

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## Abbreviations

ADS	Alternative Depreciation System
BIA	Bureau of Indian Affairs
GDS	General Depreciation System
IRD	Indian reservation depreciation
IRS	Internal Revenue Service
MACRS	Modified Accelerated Cost Recovery System
NRP	National Research Program
PV	present value
SOI	IRS Statistics of Income Division

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United States Government Accountability Office  
Washington, DC 20548

June 26, 2008

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

Indians continue to experience economic distress and lag behind other groups in the United States on key economic indicators, such as employment and median household income, as they have for years in the past.<sup>1</sup> For example, according to the 2006 U.S. Census information, American Indians' median household income was about \$15,000 less than the median of all households in the United States. American Indians also had the highest poverty rate of all Census ethnic categories, at 26.6 percent.

Among the programs that the federal government has initiated to assist Indians and Indian reservations, Congress in 1993 adopted a special depreciation deduction schedule for certain property used by businesses on Indian reservations.<sup>2</sup> This provision permits taxpayers to accelerate their depreciation, i.e., to take a larger deduction for depreciation from their business income earlier than they otherwise would be allowed, and is featured in marketing materials by some tax preparers and Indian business associations. Indian reservation depreciation (IRD) is considered a tax expenditure,<sup>3</sup> and as we reported in the past, many tax expenditures are not regularly reviewed and may overlap other programs.<sup>4</sup> With the nation's

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<sup>1</sup>The term Indian refers to individuals who self-report to the U.S. Census as American Indian and Alaska Native.

<sup>2</sup>26 U.S.C. § 168(j).

<sup>3</sup>Tax expenditures are revenue losses—the amount of revenue that the government forgoes—resulting from federal tax provisions that grant special tax relief for certain kinds of behavior by taxpayers or for taxpayers in special circumstances. These provisions may be viewed as spending programs channeled through the tax system and are classified in the U.S. budget by the same functional categories as other spending, such as energy and health.

<sup>4</sup>GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

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fiscal imbalance projected to grow as the 21st century progresses, programs such as tax expenditures, including IRD, need to be periodically reexamined to ensure they are achieving intended results.

Because of the continued economic challenges on some Indian reservations, you asked us to study the effects IRD has had on reservations' economic development. The objectives of this report were to describe (1) who uses the IRD and for what types of properties; (2) the effect of this provision on the economic well being of Indian tribal members; and (3) the tax benefits resulting from use of the accelerated depreciation.

In attempting to describe the taxpayers who use IRD, we analyzed the Internal Revenue Service's (IRS) Statistics of Income Division (SOI) data on depreciation for individuals, partnerships, and corporations. We tried to identify IRD claimants and the amounts they claimed using this data. To attempt to assess the economic effects of IRD, we had planned to use the data from the first objective. Additionally, we reviewed the literature on depreciation and economic development and interviewed officials from IRS and the Department of the Interior's Bureau of Indian Affairs (BIA). However, we found that available data were not reliable for completing these analyses. To describe the tax benefits afforded by IRD, we used IRS instructions on depreciation under the Modified Accelerated Cost Recovery System (MACRS) to determine what tax benefits, if any, taxpayers might gain for claiming IRD compared to the standard depreciation method. A more detailed description of our methodology appears in appendix I.

We conducted this performance audit from March 2007 through June 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Results in Brief

Available data were not sufficient to determine who claims IRD, how much IRD is claimed, or how IRD investment affects Indian well being by promoting economic development on reservations. It is difficult to determine who is claiming IRD from IRS data, in part, because available information is insufficient to infer who uses IRD and because instructions for filling out the form on which taxpayers report depreciation allow

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taxpayers to consolidate property on a single line of the form, obscuring the amount of IRD a taxpayer may have claimed. Further, in some instances, taxpayers appear to have made mistakes filling out Form 4562, listing recovery periods inconsistent with IRD when the deduction and basis amounts they reported suggest IRD was in fact used.

Data limitations also exist for determining the effectiveness of the IRD provision. Without data specifying where property is placed in service,<sup>5</sup> we could not assess the effect of the depreciation provision on economic development. Such an assessment requires linking IRD investment to economic indicators on specific reservations and controlling for the effects of other broad economic trends on reservations, such as the growth of Indian gaming facilities. IRS officials said that they do not need location data or additional data identifying IRD claimants because such data was not needed to process returns or to ensure compliance with tax laws and that changing the form on depreciation could be costly. Identifying IRD users and IRD property locations would require a change in IRS forms and form-processing procedures, but precedents exist for IRS collecting location information, such as the reporting requirements for the low income housing tax credit. Furthermore, lack of data identifying IRD users may affect how well IRS enforces IRD compliance, as current IRD enforcement methods rely on an ability to identify users of different tax provisions. IRS officials said that more accurate data on how taxpayers computed their depreciation deduction would help compliance efforts.

A taxpayer who uses the IRD schedule has the potential for higher tax savings than a taxpayer who claims a depreciation deduction under the IRS's standard schedule for the same type of property. The extent of the savings depends on how much more quickly the IRD property is depreciated relative to property using regular depreciation and how much more valuable to the taxpayer current deductions are relative to future deductions. In general, the tax savings for IRD users are largest for property being depreciated with the longest recovery periods. For example, a taxpayer who purchased a tractor for \$50,000 can deduct, on a present value (PV) basis, about \$600 more under IRD than the regular depreciation schedule, and a taxpayer with \$50,000 in nonresidential real estate property can deduct about \$6,800 more with IRD than the regular

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<sup>5</sup>“Placed in service” is the act of making property ready and available for a specific use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. For other definitions of depreciation terms, see the Glossary at the back of this report.

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method. However, an additional first-year depreciation deduction—bonus depreciation—was available for certain qualified property, including applicable IRD property, during the years we reviewed that allowed taxpayers to deduct the costs of the property (up to a limit) in the year it was purchased, narrowing the advantage provided by IRD and possibly reducing its incentive.

Given the insufficient information to study the use of IRD or its effects on reservations, Congress should consider enacting additional requirements for IRD reporting, such as requiring taxpayers to identify whether they are claiming IRD and the reservation where that property is placed into service. In deliberating additional requirements, Congress should weigh the need for more IRD information with IRS's other priorities because such requirements likely would increase, to some degree, the administrative costs for IRS and the compliance burden on taxpayers. To help taxpayers more accurately report IRD, which would assist current compliance efforts and future evaluation research, we recommend that the Commissioner of Internal Revenue change the instructions on the directions for Form 4562 to clarify that taxpayers depreciating IRD property should use different recovery periods. The directions also should include an example of how to fill out Form 4562 properly. IRS generally agreed with the report's findings and said that it would review instructions and publications to determine where additional information on IRD would be beneficial. IRS also said that making changes to collect additional information on IRD would add considerable administrative costs for IRS and administrative burdens on taxpayers.

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## Background

According to the U.S. Census, 4.5 million people, or 2 percent of the total U.S. population, reported that they were at least part Indian in 2007. During the 2000 Census, about 36 percent of Indians lived on reservations.<sup>6</sup> The largest federal Indian reservation covers roughly 15 million acres and the smallest reservation covers slightly more than 0.9 of an acre. Indian tribes are sovereign governments that generally are exempt from federal income taxation, but individual Indians are not exempt from income taxes.

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<sup>6</sup>For Census information, the term "Indian reservation" refers to the following areas: American Indian reservations and/or off-reservation trust lands (federal), Oklahoma tribal statistical areas, Tribal designated statistical areas, American Indian reservations (state), and state designated American Indian statistical areas, and Alaska Native Village Statistical areas.



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Indians are among the most economically distressed groups in the United States. The Census estimated in 2006 that 32 percent of American Indians and Alaska Natives were unemployed. The Census also reported that the median household income of American Indians and Alaska Natives was \$33,762, nearly \$15,000 less than the median of all households in the United States, and had the highest poverty rate of all Census ethnic categories at 26.6 percent.

The federal government has more than 100 programs that can assist Indians. Indian tribes also have used various strategies to stimulate economic development on reservations, but our previous work has shown that the prospects for economic growth may be limited.<sup>7</sup> Tribes own enterprises on reservations in a number of sectors, including gaming, tourism, manufacturing, natural resources, and agriculture, and some tribes may encourage private companies owned by nonmembers to locate on their reservations. Still, many tribes lack some of the factors, including accessibility to population centers and adequate physical infrastructure, shown to be important for economic growth.<sup>8</sup> Reservations located in rural or remote locations have limited access to markets and may lack physical infrastructure, such as roads, electricity, water, and suitable land for building, making it difficult for many businesses to operate.

In 1993, Congress passed legislation enacting IRD, which acts as an incentive for investing on Indian reservations.<sup>9</sup> Depreciation is an annual deduction from income that allows taxpayers to recover the cost or other basis of certain property<sup>10</sup> used in a business or other income-producing

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<sup>7</sup>GAO, *Welfare Reform: Tribal TANF Allows Flexibility to Tailor Programs, but Conditions on Reservations Make It Difficult to Move Recipients into Jobs*, [GAO-02-768](#) (Washington, D.C: July 5, 2002), and GAO, *Telecommunications: Challenges to Assessing and Improving Telecommunications for Native Americans on Tribal Lands*, [GAO-06-189](#) (Washington, D.C: Jan. 11, 2006).

<sup>8</sup>[GAO-02-768](#).

<sup>9</sup>That year, Congress also created another Indian-directed tax program called the Indian employment credit, a tax benefit for employers of Indians (26 U.S.C. § 45A). The credit is based on wages and health insurance for employees who are enrolled members of an Indian tribe or the tribal member's spouse, who perform services substantially within an Indian reservation, and who live on or near the reservation in which the services are performed.

<sup>10</sup>Property must meet four requirements to be depreciated: it must be owned by the taxpayer; it must be used for business or income-producing activity; it must have a determinable useful life; and it must be expected to last more than 1 year.

activity over the useful life of the property.<sup>11</sup> The deduction is calculated on IRS Form 4562. According to IRS, MACRS is used to recover the basis of most property placed in service after 1986. The General Depreciation System (GDS) is one of the recovery systems permitted by MACRS.<sup>12</sup> GDS allows taxpayers to depreciate their property using specified amounts of time—called recovery periods—which differ in length according to the category—called a property class—that the property belongs. For example, tractors and race horses are categorized as 3-year property.<sup>13</sup>

Under IRD, taxpayers use shorter recovery periods than are otherwise permitted under GDS.<sup>14</sup> Table 1 shows the GDS schedule for property class recovery periods and the corresponding IRD schedule.

**Table 1: Recovery Periods for General Depreciation System Property and Indian Reservation Depreciation Property by Property Class**

Property class	Recovery periods for general depreciation system	Recovery periods for Indian reservation depreciation
3-year property	3 years	2 years
5-year property	5 years	3 years
7-year property	7 years	4 years
10-year property	10 years	6 years
15-year property	15 years	9 years
20-year property	20 years	12 years
25-year property	25 years	Not applicable
Residential real property	27.5 years	Not applicable
Nonresidential real property	39 years	22 years

Source: IRS Publication 946.

<sup>11</sup>Useful life is an estimate of how long an item of property can be expected to be usable in trade or business or to produce income.

<sup>12</sup>The other system permitted under MACRS is the alternative depreciation recovery system (ADS), but IRD is available only for taxpayers who would otherwise qualify and elect to use GDS.

<sup>13</sup>For more examples of property in different class designations, see appendix II.

<sup>14</sup>For purposes of claiming IRD, laws define “Indian reservation” to include lands such as existing Indian reservations, public domain Indian allotments, and former Indian reservations in Oklahoma as restricted by the Taxpayer Relief Act of 1997.

Table 2 shows an example of the effects that IRD has on taxpayers' depreciation deduction. According to the rules, the same method and convention<sup>15</sup> should be used when calculating the deduction for IRD and GDS. To compare the difference in deduction between IRD and GDS most simply, the example uses the straight line method and the half-year convention to depreciate a property with a basis of \$30,000 and falls in the 3-year property class. Under the rules for straight line depreciation, taxpayers deduct the same amount in each year except for the year in which the property was placed in service and the final year it was depreciated. With the half-year convention, the portion of the year during which the property is to be depreciated determines the amount deducted. With the half-year convention, as shown in table 2, one-half of the amount invested (called the basis) divided by the recovery period is deducted in the first and final years.<sup>16</sup>

**Table 2: Depreciation Deductions for a \$30,000, 3-Year Property**

Year of depreciation	Deduction amount under GDS, non-IRD property	Deduction amount IRD property
First	\$5,000	\$7,500
Second	\$10,000	\$15,000
Third	\$10,000	\$7,500
Fourth	\$5,000	\$0
<b>Total (basis)</b>	<b>\$30,000</b>	<b>\$30,000</b>

Source: GAO analysis of Publication 946.

IRD provides an incentive by permitting taxpayers to deduct a greater proportion of the cost of the property earlier within the property's depreciable life. This deduction can reduce taxpayers' tax liability, if any. Reducing tax liability earlier acts as an incentive because of the time value of money—having a lower tax payment today is worth more to the taxpayer than having the lower payment in the future. IRD was designed to reduce the after-tax cost of capital by exploiting this timing difference in deductions and thereby make more funds available to the taxpayer for additional investment on Indian reservations.

<sup>15</sup> A convention is a method established under MACRS to determine the portion of the year to depreciate property both in the year the property is placed in service and in the year of disposition.

<sup>16</sup> For GDS, the first and final years would equal  $1/3$  times  $1/2$ , or  $1/6$  of the basis, while for IRD, the first and final years would equal  $1/2$  times  $1/2$ , or  $1/4$  of the basis.

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To qualify for IRD, property must be used predominately in the conduct of an active trade or business on an Indian reservation.<sup>17</sup> Some property, however, does not qualify for IRD even if it is located or used on a reservation, such as residential rental property, 25-year property, property acquired from a related person, and property placed in service for conducting or housing certain gaming facilities.

An additional first-year bonus depreciation deduction was allowed for certain property—including MACRS property and any applicable IRD property—placed in service after September 10, 2001, and before January 1, 2005.<sup>18</sup> The bonus depreciation deduction was available for property being depreciated using the IRD and GDS systems. For property acquired after September 10, 2001, and before May 6, 2003, and placed in service before January 1, 2005, a 30 percent rate applied. For property acquired after May 5, 2003, and placed in service before January 1, 2005, a 50 percent rate applied.<sup>19</sup> Essentially, bonus depreciation allowed taxpayers a greater deduction in the first year in which property was placed in service. For example, under 50 percent bonus depreciation in 2004, the initial basis of a \$50,000 property would have been reduced to \$25,000, which the taxpayer then would have continued to depreciate under IRS's guidelines for GDS or IRD.

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<sup>17</sup>Certain qualified infrastructure property located outside an Indian reservation may also qualify.

<sup>18</sup>26 U.S.C. § 168(k). Bonus depreciation was included in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, but our study focuses on tax years 1998 through 2004, for which data on depreciation claims were available.

<sup>19</sup>The placed-in-service deadline was extended for one year to January 1, 2006, for certain property.

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## Amount of IRD Use and Its Effect on Reservation Economic Development Cannot Be Determined with Available Data

In 2005, we reported that information on tax expenditures, such as IRD, was needed to evaluate their effectiveness as a means of accomplishing federal objectives and to ensure that they are achieving their intended purpose.<sup>20</sup> A wide variety of data could be useful for determining whether IRD is stimulating economic development on Indian reservations, but three essential pieces of information include which taxpayers claim IRD, how much they invest in IRD properties, and on which reservations they have placed IRD properties. The taxpayers' identities and investment amounts are needed for several reasons, including for analyses determining whether and how much the IRD incentive is leading taxpayers to change their investment behavior consistent with the provision's purpose. The IRD tax incentive, like other kinds of accelerated depreciation, could boost economic development, in the first place, by affecting business' decisions about how much and where to invest. The identity of IRD investors and the amounts they invest could be used to determine whether the tax incentive increases the total amount of taxpayers' investment or induces IRD investors to shift investment onto reservations from other locations, a shift that would be consistent with IRD's purpose. The identity of IRD claimants also could be used to determine whether IRD overlaps other programs designed to assist Indians in a way that affects the incentive to invest on Indian reservations. The location of the IRD properties being placed into service is needed to assess whether those investments are affecting the economic development of the specific reservations on which the properties are placed.

However, available data cannot be used to identify IRD claimants because of limitations in the manner in which IRS instructs taxpayers to report depreciation and limitations on how IRS compiles tax return information. Although IRD properties have unique recovery periods compared to other depreciation recovery periods and Form 4562 does provide space for taxpayers to report the recovery period, depreciation deduction, and basis by property class, this information is insufficient to determine whether the depreciation is IRD in all cases. Figure 1 shows how a taxpayer would report the depreciation of a \$30,000, 3-year property to IRS. The taxpayer would report the basis, recovery period, method, convention, and depreciation amount on Part III of the form.

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<sup>20</sup> [GAO-05-690](#).

**Figure 1: How a Taxpayer Would Report a \$30,000, 3-Year, IRD Property on Part III of Form 4562**

Form <b>4562</b> Department of the Treasury Internal Revenue Service	<b>Depreciation and Amortization</b> <b>(Including Information on Listed Property)</b> ▶ See separate instructions. ▶ Attach to your tax return.	OMB No. 1545-0172 <b>2007</b> Attachment Sequence No. 67				
Name(s) shown on return		Identifying number				
<b>Part I Election To Expense Certain Property Under Section 179</b> Note: If you have any listed property, complete Part V before you complete Part I.						
1	Maximum amount. See the instructions for a higher limit for certain businesses . . . . .	1 \$125,000				
2	Total cost of section 179 property placed in service (see instructions) . . . . .	2				
3	Threshold cost of section 179 property before reduction in limitation . . . . .	3 \$500,000				
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	4				
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separate					
<b>Part III MACRS Depreciation (Do not include listed property.) (See instructions.)</b> Section A						
6	17 MACRS deductions for assets placed in service in tax years beginning before 2007 . . . . .	17				
7	18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here . . . . .	<input type="checkbox"/>				
<b>Section B—Assets Placed in Service During 2007 Tax Year Using the General Depreciation System</b>						
(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
<b>19a</b> 3-year property		<b>\$30,000</b>	<b>2</b>	<b>HY</b>	<b>S/L</b>	<b>\$7,500</b>
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Source: GAO analysis of IRS Publication 946 and Form 4562 instructions.

The currently required information on Form 4562 is insufficient to identify accurately all claimants of IRD or the amounts they invest in IRD property in part because taxpayers are allowed to group properties on Form 4562. Form 4562 on line 18 permits taxpayers to combine properties in the same property class. If the properties within any given property class (lines 19a to 19i in figure 1) are both IRD and GDS properties, however, IRD claimants cannot be identified unless taxpayers indicate an IRD recovery period on the form. The instructions provide no guidance for how taxpayers should record recovery IRD periods if they are reporting both IRD and GDS property. IRD users can be identified from Form 4562 when they claim depreciation only for IRD property within any given property class and enter the recovery period correctly on Form 4562. However,

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even in this case, it is difficult to identify all users because IRS does not transcribe recovery period data from paper-filed Forms 4562 and electronically compile recovery periods into a database. Our data analysis also shows reported depreciation deductions that could be explained by taxpayers grouping IRD with non-IRD property.

Given these limitations, we attempted to use the basis and depreciation amounts from Form 4562 (columns c and g in figure 1), which IRS does compile and maintain in its SOI database, to infer the recovery period. However, we found that the amount of depreciation and basis did not uniquely determine which recovery period was used by the taxpayer and thus did not identify all claimants of IRD. The reported depreciation and basis were consistent with both the IRD and the GDS depreciation recovery period for certain property classes when different methods and conventions were used. Accordingly, although we could identify reliably a portion of those who claimed IRD and the amounts they invested, we could not do so for a possibly significant portion of those who claimed IRD.

When we reviewed a non-representative sample<sup>21</sup> of corporate SOI returns to verify the reliability of our inference methodology, we also found that taxpayers may not fill out the form correctly. For example, we saw several instances where all other information on the Form 4562 pointed to the taxpayer having used IRD, yet the taxpayer recorded a recovery period on the Form 4562 that was not consistent with IRD. For example, the taxpayer may have indicated that the property had a 3-year recovery period and yet the depreciation amount claimed could have resulted from the taxpayer depreciating the property over the 2-year recovery period allowed by IRD. These taxpayers may have recorded that the property with a 3-year recovery period simply because the name of the property class is “3-year property.”

IRS does not collect the other essential information to assess the effectiveness of IRD in promoting economic development on reservations. IRD property location data—that is, which reservation the property has been placed into service—are necessary to evaluate the impact of IRD on economic development on Indian reservations. A common evaluation approach would be to compare development in communities that receive

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<sup>21</sup>We selected examples from each type of property class and examined those returns that were readily available on SOI's database.

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IRD investment to those that do not while controlling for other factors that affect development. However, IRS does not require taxpayers to list where property is placed in service. Not knowing which reservation the investment is occurring means that it is impossible to link the property invested through IRD to indicators of the reservation's economic performance. It also is impossible to distinguish between the effect on economic growth of IRD investment and other kinds of investment that may occur on reservations, such as the growth of gaming facilities.

IRS officials said that IRS did not compile information on the use of IRD or require the location of IRD property to be reported because the information was not needed for processing returns or for compliance purposes. Collecting additional data on IRD also could take resources from other priorities, such as combating tax avoidance schemes. IRS officials said that although redesigning Form 4562 for reporting IRD location information could be done, no system was in place to transcribe, collect, and analyze the information from paper returns, and they said that creating such a system could be costly. IRS officials said that IRS likely would not collect additional Indian reservation depreciation information unless doing so would result in enforcement actions that would be cost efficient. Although IRS may incur costs to acquire the appropriate data, these additional costs would be required to evaluate whether the provision is accomplishing its legislative intent.

Obtaining data that identifies IRD claimants and the IRD amounts claimed could be accomplished by requiring taxpayers to self-identify IRD use with a check box on Form 4562 and file separate forms listing IRD property. IRS would need to revise Form 4562 to include the check box, and space appears to be available to do so. Thus the change would not require redesigning forms. Segregating the IRD properties also appears unlikely to impose significant additional costs on taxpayers since they already need to separately identify the properties in their books and records to be able to calculate and claim the correct depreciation amount. IRS officials also said that large corporations often file spreadsheets as attachments to Form 4562 that show their depreciation calculations for individual properties. However, to compile data on the forms that identify IRD claimants, IRS officials told us that significant changes would need to be made in how Form 4562 was processed, such as putting validation checks in place and developing a system to segregate IRD Form 4562s from non-IRD Form 4562s, which would add considerable burden to forms processing. The officials said that the benefit given the cost would be questionable. Obtaining location data for IRD properties likely also would require some change to tax forms. Form 4562 does not have sufficient space to add an



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address field for each of the properties being depreciated using IRD. IRS managers and officials in submissions processing and media and publications did not provide a specific dollar amount on how much it would cost to make the changes, but IRS managers said a new form would be burdensome and involve substantial changes to the way IRS processes forms, including many of the issues of form redesign already discussed, plus changes to IRS's system for processing tax forms.

Other tax forms require taxpayers to provide information analogous to what is needed to assess the effectiveness of IRD. For example, Schedule E requires those renting properties to list the location of each rental property that they claim and the low income housing tax credit form (Form 8609) also requires taxpayers to list the address of each claimed property. A form also exists for claiming the Indian employment tax credit (Form 8845), which the Joint Committee on Taxation (JCT) estimated had less than \$50 million in revenue loss for fiscal year 2008, far less than the \$300 million revenue loss estimate on IRD for the same year. An IRS official said that information gathered on forms varies by the program for such reasons as legislative requirements, IRS policy, compliance-enforcement needs, or the scope of the IRD provision's use.

Some economic development programs that we have studied also have more data for monitoring performance than IRD. For example, we were able to analyze the New Markets Tax Credit (NMTC)<sup>22</sup> partly because its overseeing agency, the Community Development Financial Institutions Fund, collected data on NMTC investors and on the location, type and size of the investment.<sup>23</sup> JCT's most recent tax expenditure estimates for fiscal year 2008 estimated revenue loss for NMTC to be about \$900 million, \$600 million more than the IRD estimate. In our 2004 report on the Economic Development Administration (EDA) grants to Indian tribes, we were able to analyze the results of grants because we had information on who the recipients were and where the grants were being used from grant applications.<sup>24</sup> The grants to Indian tribes were much smaller than the

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<sup>22</sup>NMTC provides investors (individuals, financial institutions, other corporations, etc.) with a tax credit for investing in communities that are economically distressed or consist of low-income populations.

<sup>23</sup>GAO, *Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, [GAO-07-296](#) (Washington, D.C.: Jan. 21, 2007).

<sup>24</sup>[GAO-04-847](#).

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revenue losses estimated for IRD, totaling about \$112 million from 1993 to 2002, or an average of about \$11.2 million per year. But IRD is similar to other programs we have studied in lacking adequate data for evaluation of its effectiveness. For example, we said in our 2007 report that the Empowerment Zone (EZ) and Enterprise Communities (EC) program, which provides grants and tax benefits for certain impoverished urban communities, lacks complete data on program tax benefits and the data it has cannot be linked to individual communities.<sup>25</sup> The JCT revenue loss estimate for fiscal year 2008 for the EZ/EC provisions was \$600 million.

Although having information on which taxpayers claimed IRD, how much they invested, and where those investments were located would help in assessing whether the IRD is leading to economic development on Indian reservations, gauging the effect of economic development programs is very complex. Often analyses of such programs cannot definitively show how much a program has contributed to economic development. Nevertheless, without these data on taxpayers' use of IRD no valid assessment can be made on the effect of the IRD provision.

The absence of data on IRD users could affect IRS's ability to determine IRD compliance. To enforce IRD, IRS officials said that IRS uses a computer scoring model and other audit selection programs, such as special projects where auditors focus on identifying and analyzing specific audit issues. The model may be able to identify taxpayers who likely are noncompliant overall in claiming depreciation deductions, but it could not do so for IRD itself, because, as we found, it is impossible to accurately identify each taxpayer who uses IRD with existing data. Also, even if auditors were to detect a pattern of IRD noncompliance, a special compliance project would have difficulty targeting returns with IRD for review because taxpayers do not directly report its use on their tax returns. IRS officials also told us that despite the limitations on information reported on Form 4562, if a tax return was selected for audit, experienced auditors should still be able to recognize use of IRD from the property class, basis, and deduction amount reported on Form 4562. Based on our analysis, auditors should be able to infer the use of IRD in some cases, but not all. Of course, if the auditor reviews all of the support for

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<sup>25</sup>GAO, *Empowerment Zone and Enterprise Community Program: Improvements Occurred in Communities, but the Effect of the Program Is Unclear*, GAO-06-727 (Washington, D.C.: Sept. 22, 2006).

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claimed depreciation expenses, the taxpayer should be able to provide evidence from books and records supporting the proper claim of IRD.

Although an IRS manager said that IRS would not collect data when the available data are sufficient to enforce IRD, some other IRS officials involved with audits said that additional, more accurate information on items taxpayers use to calculate their deductions would be helpful. In particular, the officials said that an automated system that taxpayers could use to calculate their depreciation deductions based on the property class and basis would be helpful. The officials pointed to the spreadsheets that some large taxpayers attach to their returns as an example of a format that would provide more useful information.

In addition to the possible tax enforcement challenges caused by being unable to identify IRD users, data specifically on IRD compliance problems found during audits do not exist. For example, examination databases that track audit issues do not single out information specifically on IRD. Thus, there is no readily available way to determine patterns of noncompliance, if any, by IRD claimants from IRS examination records. We know from our previous work, however, that depreciation is a prominent audit issue, at least for individuals.<sup>26</sup> According to figures from IRS's National Research Program (NRP), depreciation was one of the four most misreported items by individuals filing business tax returns in 2001, with 42 percent of those returns containing a depreciation error. NRP did not systematically compile information on how often those errors involved IRD.

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<sup>26</sup>GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, [GAO-07-1014](#) (Washington, D.C.: July 13, 2007).

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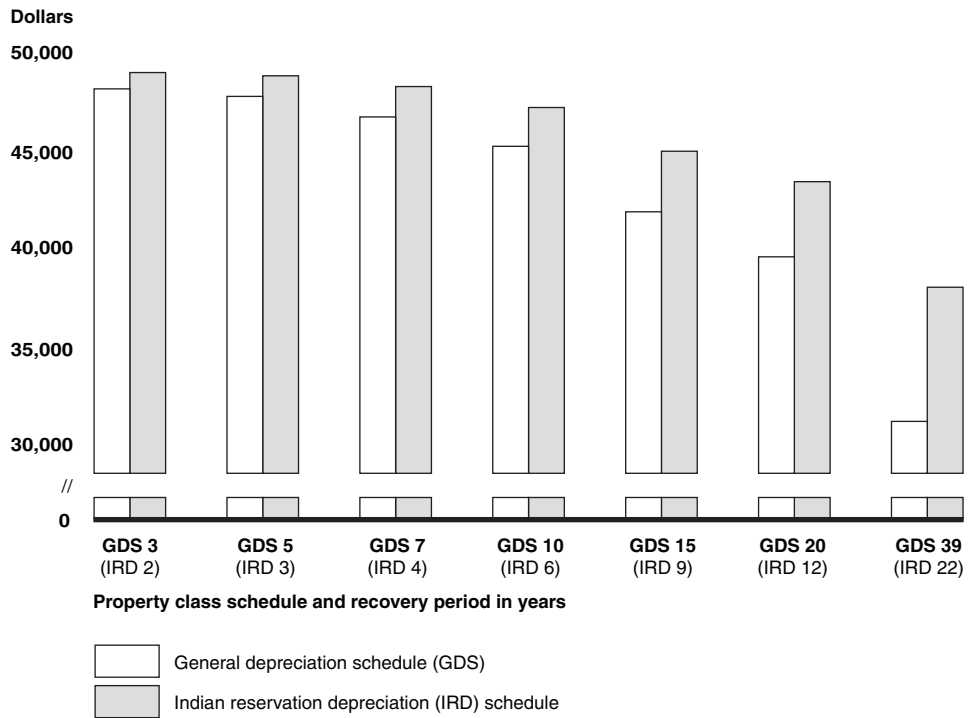
## IRD Offers Greater Potential for Tax Savings Than Regular Depreciation, Especially for Long-Term Investments

A taxpayer who depreciates property under the IRD schedule will be able to make larger deductions in the near term than under the GDS schedule for the same property, and the advantage of using IRD grows as property-class recovery periods become longer. For example, figure 2 shows that for a hypothetical \$50,000 property in the 3-year property class, the present value (PV) of the cumulative deduction under IRD is \$577—or 1.2 percent—more than the deduction permitted under the GDS schedule.<sup>27</sup> In contrast, the PV-adjusted deduction for a 39-year property (nonresidential real property class) is \$6,786—or 21.7 percent—higher for IRD than the same property under GDS.

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<sup>27</sup>Dollar values in this section are discounted to take into account the time value of money. Future payments with a dollar value equal to current payments are worth less in present value. Likewise, tax savings received in the future have less value to the taxpayer than if received today. For information on the discount rates used to make these calculations, see app. I.

**Figure 2: Cumulative Deduction Amounts for a \$50,000 Property under IRD and GDS**



Source: GAO analysis.

Note: Dollars are listed in present value amounts. For details on how these calculations were made, see app. I.

The extent of the tax savings depends on how much more quickly the IRD property is depreciated relative to GDS recovery periods and how much more valuable to the taxpayer current deductions are relative to future deductions. The incentive to use the IRD schedule for shorter-life property classes is relatively small compared to longer-life property classes because the PV of the depreciation deduction does not increase as much for shorter property classes as it does for property classes with longer recovery periods. Additionally, the incentive to use IRD will vary by the discount rate, which is the interest rate used to determine the PV of a future stream of receipts or outlays. The larger the discount rate, the greater the difference in cumulative deduction amounts for each property class and the greater incentive there would be to use IRD.

The availability of bonus depreciation, which narrowed the difference between cumulative IRD and GDS tax deductions, also could have reduced

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the incentive to use IRD. For example, a \$50,000, 20-year property under bonus depreciation had a cumulative tax deduction value that was \$1,901 higher in present-value terms under IRD than GDS. In comparison, the difference between the two methods *without* bonus depreciation for the same property was \$3,802, or double the amount *with* bonus depreciation. Although IRD still retained a relative advantage in cumulative tax deduction PV, the smaller differences could have led more taxpayers to invest outside reservations, given that other factors besides tax savings influence decisions on where to invest.

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## Conclusions

We found no way to determine reliably from available data which taxpayers use IRD, how much IRD investment is made, or whether the provision is having a positive effect on Indians. The analytical and oversight problems stemming from the lack of IRD data echo concerns we have expressed about tax expenditures in recent years. As we have said previously, information on tax expenditures is needed to evaluate their effectiveness, but inadequate or missing data can impede effectiveness studies of tax expenditures. IRD is a case in point. Without additional data, it is impossible to know whether IRD is succeeding in having its intended impact. Furthermore, with more than 100 programs on Indian economic development, the potential exists for IRD overlap with these programs. As we found with the bonus depreciation provision described in this report, overlap from other tax expenditures could interfere with IRD as an incentive.

Gathering and analyzing data that identifies IRD users and the location of IRD property likely would increase administrative costs—perhaps substantially, according to IRS—for IRS, as additional forms and processing procedures would be needed. However, precedents exist for IRS collecting this kind of information on other tax provisions, such as depreciation of rental property and the low-income housing tax credit. In cases where the right data exist, economic analysis is possible, although still challenging.

Our review also raises questions about IRS's ability to ensure compliance with the IRD provision, a potentially key shortcoming given that depreciation is one of the most misreported items by individuals with businesses. Without the ability for auditors to identify IRD users from tax forms, noncompliant taxpayers could more easily go undetected. Improved information and instructions on the recovery periods taxpayers use to calculate their depreciation deductions on Form 4562—a concern given the mistakes listing recovery periods we observed on taxpayers'

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returns—could help IRS auditors better ensure compliance not only of IRD but also of all depreciation deductions.

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## Matter for Congressional Consideration

Given the lack of information on IRD users and where property claimed under IRD is placed in service, Congress should consider requiring IRS to collect information identifying which taxpayers use IRD and the reservation and/or address where they have placed the property into service. In deliberating additional requirements, Congress should weigh the need for more IRD information with the associated costs of collecting and analyzing the information as well as the effects on IRS's other priorities.

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## Recommendation for Executive Action

We recommend that the Commissioner of Internal Revenue change the instructions on the directions for Form 4562 so that it is clear that taxpayers depreciating IRD property should use different recovery periods. The updated directions also should include an example of how to fill out Form 4562 properly.

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## Agency Comments and Our Evaluation

We requested written comments from the Commission of Internal Revenue and received a letter from the IRS on June 16, 2008 (see app. III). The IRS generally agreed with our findings. Its letter emphasized that compiling data on IRD would add burden to IRS administration of its processing functions and increase taxpayer burden. IRS also said it would review its publications and instructions on depreciation and determine where additional information about IRD would be beneficial.

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As agreed with your offices, unless you publicly release the contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies to interested congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. The report will also be available at no charge on the GAO Web site at <http://www.gao.gov>.

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If you or your staff have any questions about this report, 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. GAO staff who made major contributions to this report are listed in appendix IV.



Michael Brostek  
Director, Tax Issues  
Strategic Issues



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# Appendix I: Scope and Methodology

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In attempting to identify and describe Indian reservation depreciation users, we analyzed data from IRS's Statistics of Income (SOI) database on the corporate tax return (Form 1120), individual return (Form 1040), partnership return (Form 1065), and the depreciation form (Form 4562) for tax years 1998 through 2004. IRD has a unique recovery period schedule and Form 4562 provides space for taxpayers to report the recovery period. However, IRS does not compile this recovery period information electronically. Therefore, we used information on depreciation deduction and basis by property class from Form 4562 to construct an algorithm for identifying IRD claimants by comparing the depreciation they are required to claim on Form 4562 to the amount that they claimed using all available methods and conventions. To limit error from false positives to an acceptable level, we intended to identify taxpayers as claiming IRD if the calculated amount was within 1 percent of the actual amount that they claimed on the form. Our goal was to produce estimates that represented a reasonable lower bound on the size of the program.

After repeated sensitivity tests and refinements of the algorithm, we concluded that the information reported on Form 4562 is insufficient to determine which taxpayers are claiming IRD. Our analysis of the IRS data showed that, in many cases, the amount of basis and depreciation did not uniquely determine which recovery period was used by the taxpayer. The reported depreciation and basis were consistent with both the IRD and the regular General Depreciation System (GDS) depreciation recovery period for the property class even when different methods and conventions were used. Therefore, the number of claimants and the amount invested with IRD cannot be determined accurately and completely from IRS data.

To analyze the effects of IRD, we reviewed previous GAO work on economic development,<sup>1</sup> and tax expenditures, including our 2005 report on tax expenditures in general,<sup>2</sup> as well as our work on individual tax

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<sup>1</sup>For example, GAO, *Indian Economic Development: Relationship to EDA Grants and Self-determination Contracting Is Mixed*, [GAO-04-847](#) (Washington, D.C.: Sept. 8, 2004) and *Highway and Transit Investments: Options for Improved Information on Projects' Benefits and Costs and Increasing Accountability for Results*, [GAO-05-172](#) (Washington, D.C.: Jan. 24, 2005).

<sup>2</sup>GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, [GAO-05-690](#) (Washington, D.C.: Sept. 23, 2005).

expenditures, such as the new markets tax credit<sup>3</sup> and the empowerment zone and community enterprise program.<sup>4</sup> We discussed our objectives with officials from IRS, which has data on depreciation and the U.S. Department of the Interior's Bureau of Indian Affairs to discuss business on reservations. We had planned to use the SOI data to conduct an analysis of IRD investment as an initial step in analyzing how IRD affects economic development on Indian reservations. However, we determined that available information was not sufficient for this purpose because we could not identify all claimants of IRD.

To show the potential tax advantages for taking accelerated Indian reservation depreciation, we calculated regular depreciation and accelerated depreciation for the following properties: 3-year, 5-year, 7-year, 10-year, 15-year, 20-year, and nonresidential real property. Further calculations included 30 percent bonus depreciation and 50 percent bonus depreciation for both regular depreciation and accelerated depreciation.<sup>5</sup> We chose a basis value of \$50,000 to determine the present value for all the types of depreciation. To determine the present value (PV) for all the types of depreciation, we chose the half-year convention. For 3-year, 5-year, 7-year, and 10-year property, we chose the double-declining balance method switching to straight line method in the optimal year.<sup>6</sup> For 15-year and 20-year property, we chose the 150 percent declining balance switching to straight line method in the optimal year. Nonresidential real property was depreciated with the straight line method and midmonth convention as required by IRS. The discount rate for each property class was derived from the Federal Reserve's report of (July 7, 2007) inflation-adjusted

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<sup>3</sup>GAO, *Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, [GAO-07-296](#) (Washington, D.C.: Jan. 31, 2007).

<sup>4</sup>GAO, *Empowerment Zone and Enterprise Community Program: Improvements Occurred in Communities, but the Effect of the Program Is Unclear*, [GAO-06-727](#) (Washington, D.C.: Sept. 22, 2006).

<sup>5</sup>IRS Publication 946 year 2004 pages 32-46, were used to determine the equations to calculate depreciation. Bonus depreciation was not applied to nonresidential property because bonus depreciation does not apply to this type of property.

<sup>6</sup>Optimal year to switch to straight line method is the first year for which it will give an equal or greater deduction.

interest rates for U.S. Treasury debt instruments of corresponding maturities.<sup>7</sup>

We conducted this performance audit from March 2007 through June 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>7</sup>The 15-year property discount rate was determined as the average for 10-year and 20-year rates.

# Appendix II: General Depreciation System Property Classes and Indian Reservation Depreciation Recovery Schedules

The following is a list of the nine General Depreciation System (GDS) property classes and the corresponding Indian reservation depreciation (IRD) recovery period schedule, along with examples of the types of property included in each class.

**Table 3: Examples of GDS Property Classes with Corresponding IRD Recovery Periods**

GDS property classes	IRD recovery periods	Examples of eligible property
3-year property	2 years	<ul style="list-style-type: none"> <li>Tractor units for use over the road</li> <li>Racehorse over 2 years old when placed in service</li> <li>Any other horse over 12 years old when placed in service</li> <li>Qualified rent-to-own property</li> </ul>
5-year property	3 years	<ul style="list-style-type: none"> <li>Automobiles, taxis, buses, and trucks</li> <li>Computers and peripheral equipment</li> <li>Office machinery (such as typewriters, calculators, and copiers)</li> <li>Any property used in research and experimentation</li> <li>Breeding cattle and dairy cattle</li> <li>Appliances, carpets, furniture, etc. used in a residential rental real estate activity</li> </ul>
7-year property	4 years	<ul style="list-style-type: none"> <li>Office furniture and fixtures such as desks, files, and safes</li> <li>Agricultural machinery and equipment</li> <li>Any property that does not have a class life and has not been designated by law as being in any other class</li> </ul>
10-year property	6 years	<ul style="list-style-type: none"> <li>Vessels, barges, tugs, and other water transportation equipment</li> <li>Single-purpose agricultural or horticultural structures</li> <li>Fruit-bearing or nut-bearing trees or vines</li> </ul>
15-year property	9 years	<ul style="list-style-type: none"> <li>Municipal wastewater treatment plants</li> <li>Certain improvements made directly to land or added to it</li> <li>Retail motor fuels outlet such as a convenience store</li> <li>Qualified restaurant property</li> </ul>
20-year property	12 years	<ul style="list-style-type: none"> <li>Farm buildings</li> <li>Municipal sewers not classified as 25-year property</li> </ul>
Nonresidential real property (39 years)	22 years	<ul style="list-style-type: none"> <li>Real property that is not:               <ul style="list-style-type: none"> <li>(1) residential rental property</li> <li>(2) property with a class life of less than 27.5 years</li> </ul> </li> <li>Includes:               <ul style="list-style-type: none"> <li>Warehouses</li> <li>Office buildings</li> <li>Stores</li> </ul> </li> </ul>

Source: IRS Publication 946.

# Appendix III: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

June 16, 2008

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

Dear Mr. Brostek:

I am writing in response to the draft Government Accountability Office (GAO) audit report entitled *TAX EXPENDITURES: Available Data Are Insufficient to Determine the Use and Impact of Indian Reservation Depreciation* (GAO-08-731). I reviewed the report and generally agree with its findings. The report accurately reflects the difficulty in trying to determine which taxpayers claimed the Indian Reservation Depreciation (IRD), the amount invested in IRD properties, and the location of the properties.

As part of its mission, the IRS continually seeks to balance additional administrative costs and additional burden on taxpayers with the need to enhance compliance with the tax laws. We routinely review and revise our tax forms and publications to ensure that they are understandable for taxpayers to comply with the tax laws. In this case, instructions to Form 4562, *Depreciation and Amortization*, refer to a number of IRS publications, including Publication 946, *How to Depreciate Property*. We will review the instructions and publications to determine where additional information about IRD would be beneficial.

As noted in your report, to compile data identifying IRD claimants would require significant changes in how Form 4562 is processed, such as putting validation checks in place and developing a system to segregate IRD Forms 4562 from non-IRD Forms 4562, which would add considerable burden to our processing function. I appreciate your acknowledging that a decision to collect additional data on IRD should be weighed against IRS's other priorities and that collecting additional data would increase both IRS's administrative costs and the compliance burden on taxpayers.

If you have any questions, or would like to discuss this response in more detail, please contact Denise Fayne, Director, Media and Publications, at (202) 622-9375.

Sincerely,

A handwritten signature in black ink that reads "Linda E. Stiff".

Linda E. Stiff

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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

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

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## Acknowledgments

In addition to the contact named above, Kevin Daly, Assistant Director; Eric Gorman; Tami Gurley; Cheryl Peterson; Jennifer Neer; and Anne Stevens made key contributions to this report.

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# Glossary

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Basis	A measure of an individual's investment in property for tax purposes.
Convention	A method established under MACRS to determine the portion of the year to depreciate property both in the year the property is placed in service and in the year of disposition.
Depreciation	The annual deduction allowed to recover the cost of business or investment property having a useful life substantially beyond the tax year.
Placed in service	A term that means property is ready and available for a specific use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.
Present value (PV)	The discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.
Property class	A category for property under MACRS that generally determines the depreciation method, recovery period, and convention.
Recovery period	The number of years over which the basis of an item of property is recovered.
Straight line method	A way to figure depreciation for property that ratably deducts the same amount for each year in the recovery period. The rate (in percentage terms) is determined by dividing 1 by the number of years in the recovery period.
Useful life	An estimate of how long an item of property can be expected to be usable in trade or business or to produce income.

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