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Highlights

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

June 2006

CAPITAL GAINS TAX GAP

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

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.

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.