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Highlights

Highlights of GAO-08-956, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

As part of its most recent estimate of the tax gap, for tax year 2001, the Internal Revenue Service (IRS) estimated that individuals underreported taxes related to their rental real estate activities by as much as $13 billion. Given the magnitude of underreporting, even small improvements in taxpayer compliance could result in substantial revenue.

GAO was asked to provide information on rental real estate reporting compliance. This report (1) provides information on the extent and primary types of taxpayer misreporting of rental real estate activities and (2) identifies challenges IRS faces in ensuring compliance and assesses options for increasing compliance. For estimates of taxpayer misreporting, GAO analyzed a probability sample of examination cases for tax year 2001 from IRS's most recent National Research Program (NRP) study of individual taxpayer compliance.

What GAO Recommends

Congress should consider making all taxpayers reporting rental real estate activity subject to the same information reporting requirements as other taxpayers with a trade or business. GAO also recommends that IRS require the reporting of additional details on tax and information returns, provide taxpayers with additional guidance, and enhance its outreach efforts.

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

To view the full product, including the scope and methodology, click on GAO-08-956. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

TAX GAP

Actions That Could Improve Rental Real Estate Reporting Compliance

What GAO Found

At least an estimated 53 percent of individual taxpayers with rental real estate misreported their rental real estate activities for tax year 2001, resulting in an estimated $12.4 billion of net misreported income. This amount of misreporting is understated because IRS knows it does not detect all misreporting during its NRP examinations and adjusts the amount of misreporting it detects to estimate the tax gap. Also, the rate of misreporting of rental real estate activity was substantially higher than for some other sources of income, such as wages, a disparity that undermines the fairness of the tax system. Misreporting of rental real estate expenses was the most common type of rental real estate misreporting.

Estimated Frequency of Types of Individual Taxpayer Misreporting of Rental Real Estate Activities That IRS Detected through NRP Examinations, Tax Year 2001

Type of misreporting	Estimated percentage of taxpayers with rental real estate activity who misreported
Misreported rental real estate expenses	43
Misreported rent received	15
Reported activity on an incorrect part of the individual tax return	6
Misreported loss from rental real estate	2
Other types of misreporting	5
All types of misreporting	53

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

Notes: Some taxpayers misreported rental activity for more than one type of misreporting. As such, estimates for types of misreporting do not sum to the total percentage of taxpayers who misreported.

Limited third-party information reporting for rental real estate activity is among the challenges IRS faces in ensuring compliance for rental real estate reporting. While information reporting, such as financial institutions sending information to IRS about taxpayers' mortgage interest payments, improves compliance, it is not practical to implement and enforce broad, new information reporting requirements for rental real estate activities. However, improving existing information reporting requirements is one of various options that could improve compliance. For example, based on current law, whether rental real estate property owners must file information returns for certain expenses they incur depends on whether the owners' rental activities are considered a trade or business, but the law does not define how to make this determination. Another approach to improving compliance is to require taxpayers to report additional detail about their rental real estate activities on tax returns. For example, requiring taxpayers to report complete property address information, which GAO found that some taxpayers did not report, could help IRS address misreporting. Requiring additional detail on tax returns could also compel paid tax return preparers, used by about 80 percent of individual taxpayers who report rental real estate activity, to obtain more accurate information from taxpayers. Enhanced IRS guidance, such as on required recordkeeping, and additional IRS outreach to paid preparers and others about rental real estate misreporting could also improve compliance.