INFLATED TAX BASIS AND THE QUARTER-TRILLION-DOLLAR REVENUE QUESTION

By Joseph M. Dodge and Jay A. Soled

Joseph M. Dodge is the Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor at Florida State University College of Law. Jay A. Soled is a professor at Rutgers University.

In this article, Dodge and Soled explain why inflated tax basis reporting is pervasive, estimating that this problem will cost the federal government $250 billion over the next 10 years and that the real figure could easily be much higher. And, unlike corporate tax shelters, this type of tax fraud is available to all taxpayers who engage in property transactions.

Furthermore, they assert, the underlying problem of tax basis identifications will be dramatically exacerbated if the new Congress moves quickly (as seems likely) to permanently repeal the estate tax, in which case a carryover tax basis regime of section 1022 will supplant the current basis-equals-fair-market-value-at-death rule. The authors question, however, how estate fiduciaries could possibly calculate the tax basis that decedents had in their investments, if the taxpayers themselves, while alive, did not know that basis. A carryover basis regime failed so badly in 1976 that it was retroactively repealed, according to Dodge and Soled. In light of this failure, there is no reason to suspect that the carryover basis regime scheduled to take effect in 2010 will fare any better, unless Congress and the IRS institute safeguards along the lines that the authors propose.

In a conversation with Mikhail Gorbachev, Ronald Reagan once said, “Trust, but verify.” In making that remark, Reagan made an important observation about how perhaps we should conduct diplomacy and, the authors suspect, our affairs in general. They think that tax basis identifications require the same vigilance on the part of Congress and the IRS.

Table of Contents

I. Introduction ....................... 453
II. Crisis in Compliance ............... 454
   A. Sources of Noncompliance .......... 454
   B. Lack of IRS Oversight ............... 457
III. Cost of Noncompliance ............. 459
IV. Practical Reforms ................. 460
V. Conclusion ......................... 461

I. Introduction

An unpublicized problem of crisis proportions is plaguing the administration of the Internal Revenue Code, and it is costing the nation billions of dollars annually. The problem is neither hypertechnical nor hard to discern: On the sale of investments, taxpayers inflate their tax basis and do so with impunity, which results in the underreporting of gains and the overstatement of losses. How is that possible? This article seeks to answer that question, quantify the associated revenue loss, and suggest practical reforms.

References herein to the term investments include the following: (1) intangible financial assets purchasable on an exchange (referred to as marketable financial assets), (2) intangible financial assets not purchasable on an exchange (referred to as nonmarketable financial assets), (3) tangible assets purchasable on an exchange or through brokers and auction houses (referred to as brokered tangible assets), and (4) all other tangible assets (referred to as nonbrokered tangible assets).

The category of marketable financial assets includes, besides marketable securities, mutual fund investments and other financial products, commodities futures dealt with on a commodities exchange, and over-the-counter stocks. Nonmarketable financial assets include interests in closely held businesses, such as investments in partnerships, limited liability companies, and S corporations. Brokered tangible assets include most investment real estate plus artworks and collectibles purchased at auction houses. Artwork and collectibles purchased from dealers or private parties either directly or over the Internet are treated as nonbrokered tangible assets.

We exclude from investments personal-use assets (such as automobiles and refrigerators), because taxpayers ordinarily dispose of those assets at a nondeductible loss. Section 165(c). Furthermore, we also exclude from investments inventory and business-use assets (other than real estate) because taxpayers usually hold those assets short-term or annually depreciate them so that in either event recordkeeping is not a major issue. (It appears that the most common basis issue for business-use assets is the straightforward one of failing to reduce basis to reflect depreciation, as mandated by section 1016(a)(2).)

Section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.
Aside from the obvious tax savings associated with this practice, there are several other reasons why taxpayers inflate the basis they have in their investments. First, because the tax basis rules themselves are often arcane, complex, and opaque, only the most civic-minded taxpayers will take the time or incur the expense to establish the tax basis of investments sold or otherwise disposed of. Second, basis depends on historical records, and keeping adequate records requires an awareness of the need to keep basis records, effort, a sound filing system, and an efficient retrieval system. Third, there is effectively no sanctionable duty for taxpayers to maintain their basis records. Therefore, when a sale occurs years, sometimes decades, after an investment’s initial acquisition, taxpayers often must estimate their tax basis. Fourth, there are no meaningful third-party obligations to report basis information to taxpayers or the IRS. Fifth, tax return preparers are not subject to a duty to inquire into facts that would bear on a taxpayer’s basis assertions. This is because the professional standards established by the American Bar Association and the American Institute of Certified Public Accountants implicitly discourage tax basis inquiries. Finally, there is no tax return preparer penalty under the code for failing to seek this information.

The likely cumulative effect of those factors strongly suggests that the inflation of tax basis is pervasive. Despite the ubiquity of inflated basis, the IRS has both practical reasons (for example, relating to the cost and effort required to make basis inquiries) and substantive reasons (for example, relating to a relatively small or nonexistent immediate payoff) to avoid pursuing tax basis identifications.

One of the strangest aspects of the inflated tax basis problem is that, despite its severity, there are several practical solutions readily at hand to address it: (1) establish a sanctionable duty for taxpayers to keep more accurate tax basis records; (2) impose meaningful third-party basis reporting requirements; (3) require tax return preparers to obtain the records referred to in (1) and (2); and (4) simplify the code’s tax basis rules, including the modification of the code’s current realization requirement by moving to a partial or full mark-to-market tax system. The adoption of some or more of those reform measures would energize one of the code’s cornerstones, namely section 1001, which requires gain or loss realization on the difference between an asset’s amount realized and its adjusted tax basis.

Having revealed this income tax compliance void, political will is now required to fix it. In contrast to other legislative revenue-raising initiatives, reform in this area would not be a politically thankless task because it would promote tax simplification, improve tax compliance (and, with that, a perception that the system is fair), and raise billions of dollars, all in one package and without “raising taxes” (as that pejorative phrase is used in political discourse). And the costs of not responding to the problem are steep: Inaction would likely cause the federal government to forfeit more than $250 billion of revenue over a 10-year scoring period.

II. Crisis in Compliance

Apart from all of the facts, figures, and statistics presented in the remainder of this article, our chances of ultimately convincing you, the reader, that there is a tax compliance crisis attributable to inflated basis reporting will probably depend on your visceral responses to the following two questions:

(1) Do you know the tax basis you have in each of your investments? (Don’t worry. You’re not answering under oath.)

(2) What percentage of taxpayers do you suppose actually knows and accurately reports the tax basis held in each of their investments?

Those who are involved in the tax field (which would include most readers of this article) probably have a fairly good handle on the tax basis of their investments. However, we suspect this handle is imperfect. We further suspect that the vast majority of you recognize and would readily acknowledge that most non-tax-savvy taxpayers generally do not have a good command of the tax basis they have in their investments. Moreover, we suspect that you would agree that if the opportunity presented itself, many taxpayers would inflate the tax basis they hold in their investments to minimize their tax burdens and that subterfuge of that sort would likely go undetected. Finally, given the remote likelihood of detection (and the virtual nonexistence of meaningful sanctions), we suspect that a pervasive environment of noncompliance exists.

The next two sections of this analysis strive to verify that those suspicions are grounded in reality by pinpointing the sources of widespread inflated tax basis reporting and painting a picture of IRS indifference to accurate basis reporting.

A. Sources of Noncompliance

Noncompliance has three root causes: fact and rule complexity, the absence of a substantiation requirement, and the lack of compliance incentives.

1. Complexity. In theory, proper tax basis identification involves nothing more than determining one’s investment in an asset. Fostering that impression, for example, is Schedule D of Form 1040. On that schedule, individual taxpayers are instructed to report their gains and losses from their investments. Schedule D itself, however, devotes only one column to the identification of tax basis, tersely instructing taxpayers to reflect “cost or other basis” for each security sold.10

10In some cases, fulfillment of this terse instruction is not a difficult task. Suppose X purchases 100 Company Y shares for $10 each and later sells 50 shares for $20 each. Who could possibly believe that a taxpayer would not actually know how much each of those 50 shares cost? (Footnote continued on next page.)
Tax basis rules, however, are far more complex than those scanty instructions belie. The complexity contributes (along with shoddy recordkeeping, addressed below) to pervasive overstatements of basis. Because (inaccurately) filling in the basis space on a return is much less likely to attract IRS attention than leaving the space blank, taxpayers are essentially forced to make estimates based on inadequate awareness of the facts and the law. When those estimates dictate how much or how little tax taxpayers owe, there is little doubt that those estimates will favor the taxpayer (that is, be on the high side). But our emphasis on the complexity of tax basis rules may be counterintuitive, because most taxpayers are aware of the core rule that basis equals cost. Consider, however, the plethora of tax basis rules relating to investment acquisitions, retentions, and dispositions. Each of those events can implicate little-known or poorly understood tax basis rules.

Investment acquisitions can be divided into two categories: those in which taxpayers have made a direct investment (for example, purchases and in-kind payments for services rendered) and those they have not (for example, gifts, bequests, and interspousal transfers). For direct investments, the taxpayer’s initial tax basis must be adjusted for sales commissions and other capitalized costs. Taxpayers are not always familiar with those rules or how they apply. For investment acquisitions that do not involve a taxpayer’s direct investment, several even more intricate rules apply. Gifts require knowledge of the donor’s basis and adjustments must be made for gift and generation-skipping transfer taxes, if any. Bequests (under current law) require knowledge of date-of-death values and whether an alternate valuation election was made. (In 2010 a carryover basis rule is scheduled to apply that will require the decedent’s personal representative to know the decedent’s basis in the decedent’s investments.) Finally, interspousal transfers require knowledge of the spouse’s or ex-spouse’s basis in the investments transferred. Even those taxpayers who wish to be compliant with those rules may find the relevant information difficult or impossible to locate.

$1,000. X’s tax basis in Company Y shares would be $1,000, or $10 per share ($1,000 divided by 100).

To illustrate how these tax basis rules generally apply, suppose X purchases 100 shares of stock in Corporation Y for $1,000 (or $10 per share) and the 100 shares appreciate in value to $10,000 (or $100 per share). If X gifts the shares to her daughter, X’s daughter will hold the Corporation B shares with a $1,000 tax basis. Section 1015(a). If X dies and bequeaths the shares to her daughter, X’s daughter will hold the Corporation B shares with a $10,000 tax basis. Section 1014(a). If, under a divorce settlement, X transfers the shares to her former spouse, X’s former spouse will also hold the Corporation B shares with a $1,000 tax basis. Section 1041(b).

Taxpayers will also have a difficult time knowing their tax basis in investments at the time of disposition. To illustrate, if marketable securities are purchased in a series of transactions, it is necessary to “identify” the basis of those securities when they are later sold (assuming that all of the taxpayer’s securities are not sold in the same tax year). When the specific identification method

TAX NOTES, January 24, 2005 455

COMMENTARY / SPECIAL REPORT

Tax basis rules do not remain fixed during the period of investment ownership. To the contrary, tax basis remains entirely fluid. The tax basis of S corporation shares and of interests in entities classified as partnerships for federal income tax purposes are subject to constant upward and downward adjustments. The capital changes corporations may undergo can have a major rippling effect on the tax basis shareholders have in their shares. Most taxpayers, however, lack the ability, time, or resources necessary to track their tax basis resulting from those events.

Taxpayers will also have a difficult time knowing their tax basis in investments at the time of disposition. To illustrate, if marketable securities are purchased in a series of transactions, it is necessary to “identify” the basis of those securities when they are later sold (assuming that all of the taxpayer’s securities are not sold in the same tax year). When the specific identification method

(footnote continued in next column.)
cannot be followed, the default rule is first-in, first-out (FIFO),
which (being a technical accounting convention) the typical individual investor may not either be able or willing to grasp. To complicate matters further, mutual fund shares can, under an election, be subject to an "average cost" basis rule if the shares are held in street name.22

2. Absence of substantiation requirement. Aside from the complexity that tax basis rules bring, several other factors contribute to taxpayers' failure to know their tax basis and to taxpayers' proclivities to inflate their tax basis. Consider the fact that taxpayers are notorious for keeping poor books and records,23 which (in the absence of any carrots or sticks) is understandable, considering that recordkeeping alone entails significant transaction costs without current or foreseeable future benefit. The notion of a benefit can take the form of avoiding a penalty. However, there is no requirement (akin to that found under section 274(d), which requires all travel and entertainment expenses to be substantiated) that basis be "substantiated" by records or other documents.24

The instructions to Form 1040, under the heading "General Information," has a short section entitled "How Long Should Records Be Kept?" where it is stated that "tax returns, worksheets, and forms should be kept for three years; but records relating to property should be kept longer insofar as they are relevant for determining basis." The operative word here is should, not must. Another publication, IRS Publication 552 (as revised October 1999), Recordkeeping for Individuals, is similarly nonassertive. Page two of Pub. 552 states that "everybody should keep" basis records for their homes,25 but it says nothing about other property.26 Under "How Long to Keep Records," the same IRS publication states that basis records should be kept until the period of limitations expires for the year in which the property is disposed. In none of those IRS publications or forms is it stated that basis records must be kept.

3. Lack of compliance incentives. A final reason taxpayers inflate their tax basis is the virtual absence of compliance incentives. Studies indicate that when third-party information returns are issued, tax compliance is relatively high; absent the issuance of information returns, the same studies indicate that compliance drops precipitously.27 Although many investment transactions involve the issuance of information returns, those information returns completely neglect tax basis information.28

One might yet presume that tax return preparers and tax professionals would steer taxpayers towards tax compliance and accurate tax basis identifications. However, because of their flat free arrangements for tax return preparation work, there is an economic disincentive to pursue basis inquiries, and professional ethical standards support this "don't ask, we don't want to know" attitude.29 That problem is compounded by the fact that the provision dealing with tax return preparer penalties, section 6694, adopts the same posture.30 Thus, Treas. reg. section 1.6694-1(e)(1) states:

(footnote continued in next column.)

(task. Stock of the same class in the same corporation acquired and disposed of at various times poses the same problem as inventory accounting; but, contrary to logic, the general rule is one of actual identification of the shares sold. Actual identification is illogical, because same-class shares of stock of the same corporation are wholly fungible.31

Treas. reg. section 1.1012-1(c)(1).32 See Treas. reg. section 1.1012-1(e).

Exacerbating this problem of poor recordkeeping is the fact that taxpayers are supposed to keep those books and records for the duration of their investment ownership, and then be able to locate them. That ownership can extend for years and decades — long enough for even the most fastidious of taxpayers to lose or misplace their books and records. Taxpayers often have a difficult time producing records they are supposed to maintain on an annual basis (for example, deductions relating to charitable contributions). Why do we assume that taxpayers would adequately cope with the task of maintaining investment records that they must retain for much longer periods? Moreover, a taxpayer may rationally avoid keeping basis information on the assumption that the asset will be held until death and acquire a FMV-at-death under section 1014.

Another recordkeeping problem stems from the popularity of automatic dividend reinvestment plans (DRIPs). DRIPs allow taxpayers to use the dividends earned by the investments they own to make new investments. Most taxpayers, however, never record their monthly and quarterly acquisitions, lessening the prospects of future accurate tax basis identifications.

The reference to the basis of homes is odd because the gains on most sales of principal residences are permanently exempt from tax. See section 121 (excluding the first $250,000 of gain ($500,000, in the case of married taxpayers filing joint tax returns) from income taxation on the sale or exchange of property that the taxpayer has owned and used as the taxpayer's principal residence for periods of two years or more during the five-year period ending on the date of the sale or exchange).33

Treas. reg. section 1.1015(g)(1), however, states that donors and donees "should" keep such records as are relevant to figuring the donee's basis. But most of the relevant information (if accurate) is on Form 709 (the gift tax return), which is not available to the donee as a matter of right. Curiously, the corresponding duty regarding section 1041 (transfers to spouse or to ex-spouse in a divorce) is couched in mandatory terms. See Treas. reg. section 1.1041-1T (Q&A 14).

See, e.g., Joel Slemrod and Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Debate Over Taxes 178 (3rd ed. 2004) (one study showed a 99.1 percent compliance rate for wages and salaries and a 18.6 percent compliance rate for informal suppliers (eg, sidewalk vendors and housepainters).34

Section 6045 appears to be the most relevant information-reporting submission section. It imposes an obligation on a broker (or dealer) to file an information return "with such details regarding gross proceeds and other information as the Secretary by forms and regulations may require." Nonetheless, however, is the reporting of tax basis required.

Neither the ABA nor the AICPA professional standards require that tax professionals confirm or substantiate the accuracy of an asset's tax basis alleged by clients; essentially, whatever figure clients claim, tax professionals use for reporting purposes.

35 The main tax return preparer penalty provision is section 6694(a). It applies when the following threefold conjunctive test is met: (1) a taxpayer's tax liability stems from a nonmeritorious position (2) that was known to the tax return preparer, and (3) such position was not disclosed or was frivolous. The term position seems to refer to a legal position, such as the scope of a code provision or the import of a court case. A position is (footnote continued on next page.)
The preparer generally may rely in good faith without verification upon information furnished by the taxpayer. Thus, the preparer is not required to audit, examine, review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer’s information.

The regulation goes on to say that the preparer cannot ignore the implications of information actually known by the preparer or neglect to provide substantiation required by a code section or regulation as a condition for claiming a deduction, but those exceptions would rarely require any kind of basis inquiry.31 In sum, tax return preparers can rely on taxpayer statements of basis that the taxpayer knows (or, with reasonable diligence, should know) to be incorrect.

Finally, the paucity of tax audits (and, in particular, those that involve tax basis issues) is emblematic to many taxpayers that the IRS is not particularly concerned about tax basis.32 The foregoing factors signify that taxpayers have both the motivation to inflate their tax basis (in the form of augmented tax savings) and the unbridled opportunity to do so (because of the complexity of the law, lax recordkeeping requirements, and lack of compliance incentives). Admittedly, social norms and individual personality traits may dissuade some taxpayers not to shortchange the government,33 but several factors (for example, globalization and financial innovations) present challenges to those traditional safeguards.34 Thus left unchecked, tax savings and opportunity are generally a dangerous combination insofar as potential damage to the fisc is concerned. The next section illustrates that despite that danger, the IRS has paid little attention to monitoring accurate tax basis reporting.

B. Lack of IRS Oversight

Usually, when the IRS knows that there is an abuse being perpetrated on the tax system, it gathers its energies and resources and directs attacks at the source of the problem. Take, for example, the cases of individual tax shelters and corporate tax shelters. For the last several decades, the IRS has devoted considerable attention to attacking those shelters and imposing penalties on those taxpayers (and their advisers) committing the abuses.35 Furthermore, in 1986 and again in 2004, the IRS successfully lobbied Congress to pass legislation in the form of passive activity loss limitation and disclosure rules that would give the agency the upper hand in helping to eliminate tax shelter shenanigans.36

Why, then, hasn’t the agency been as proactive in devoting its resources to eliminating the abuse of inflated tax basis? There are two reasons. The first is procedural in nature. Although commentators and others may think a tax basis in an investment is $0 unless a taxpayer offers substantive proof to the contrary, a different rule actually applies.37 That rule, derived from Cohan v. Commis-

sufficiently meritorious if it has at least a one-in-three possibility of being upheld on the merits (that is, disregarding the chances of being audited). See Treas. reg. section 1.6694-2(b)(3) (all nine examples referring to legal issues). The amount of this penalty is $250. Section 6694(a). A larger tax return preparer penalty ($1,000) applies when the tax return preparer willfully attempts to understatement a taxpayer’s tax liability or exhibits reckless or intentional disregard of rules or regulations. Section 6694(b). The “reckless or willful” conduct penalty is described in terms of applying law to taxpayer-supplied data. Treas. reg. section 1.6694-3(c).

Rev. Proc. 80-40, 1980-2 C.B. 774, explicitly states that a return preparer has no duty to verify facts but does have a duty to inquire into facts if the taxpayer-supplied information is incomplete or appears on its face to be incorrect. In Brockhaus v. United States, 749 F.2d 1248 (7th Cir. 1984), for example, the Seventh Circuit upheld the imposition of a tax return preparer penalty on the basis of the accountant’s failure to inquire about the import of a known fact, relying on the then-version of section 6694 that encompassed “negligent disregard of rules and regulations.” Curiously, the facts of Brockhaus are virtually identical to those of Rev. Rul. 80-265, 1980-2 C.B. 378, in which the IRS held that section 6694 was not applicable. In Rev. Rul. 80-266, 1980-2 C.B. 378, the IRS distinguished between (1) the situation in which an accountant asked if the taxpayer could substantiate entertainment expense deductions and the taxpayer (falsely) said that he could do so (no penalty) and (2) one in which the accountant failed to ask the taxpayer if such substantiation existed (penalty imposed). However, this ruling can be distinguished from the Brockhaus decision on the ground that substantiation is a legal prerequisite for claiming entertainment expense deductions. See section 274(d).


37This supposed rule is derived from a misreading of Raytheon v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied 323 U.S. 779 (1944). Raytheon involved the income tax treatment of the receipt of civil antitrust damages for injury to goodwill. The First Circuit opinion notes that the record was devoid of evidence as to the amount of the taxpayer’s basis in the goodwill and, that being the case, quoted the Tax Court in determining that “in the absence of evidence of the basis of the business and good will of [the taxpayer], the amount of any nontaxable capital recovery cannot be ascertained.” Id. at 114. However, the suggestion that Raytheon thus stands for the proposition that basis is equal to $0 absent proof to the contrary is incorrect for two reasons. First, the taxpayer in Raytheon had a zero basis as a matter of law because outlays relating to self-created goodwill are deducted as expenses (or possibly are charged to the basis of identifiable assets other than goodwill). Second, the taxpayer in
sion, 28 states that, in the absence of clear substantiation, taxpayers can offer estimates of the tax basis they hold in their investments. 29 If an audit is triggered by basis claims, the IRS may find the litigation route particularly frustrating, especially since there is no sanctionable duty on taxpayers to keep basis records. To some extent, the Cohan rule levels the playing ground between taxpayers and the IRS.

To further compound the problem, the IRS lacks the resources to monitor compliance. Because of an anemic budget and greatly expanded taxpayer service responsibilities, the number of compliance audits the IRS conducts has suffered a precipitous decline. 40 When IRS agents do conduct individual income tax audits, they appear far more interested in examining Schedule A and C deductions than in challenging tax basis identifications. 41 When it comes to tax basis identification litigation, court dockets are virtually devoid of cases in which the IRS challenges taxpayers’ averred tax basis in their investments. 42

Anecdotal evidence offers chilling affirmation that tax basis identifications have run amok. Behind closed doors, accountants and members of tax preparation firms offer stunning revelations regarding the fact that many of their clients don’t have any idea of their tax basis in the investments they own. 43 Also, few of those tax professionals or their clients harbor fears that IRS agents will challenge the tax basis identifications they proffer. Even the press suggests that when it comes to tax basis identifications, the use of guesstimations will suffice for IRS purposes. 44

Aside from procedural reasons, there are also substantive reasons why the IRS does not pursue basis issues. For one, even if the IRS succeeds in lowering basis, its success may produce minimal immediate benefits. First, a large (and possibly suspicious-looking) net capital loss may save the taxpayer very few current tax dollars because of the capital loss limitation rules. 45 In other words, reducing a large net capital loss may bear fruit for the IRS only in reduced deductions in future years. Second, when net capital gain may be understated, the government stands to gain — on a taxpayer-by-taxpayer basis — modest tax dollars (currently, 15 percent) for each dollar of basis overstatement. 46

In sum, despite the problem of taxpayers inflating the tax basis they have in their investments, the IRS will not often use its powers to curtail that abuse. Measured on a taxpayer-by-taxpayer basis, the meager upside benefits do not justify the costs and downside risks.

42 Over two decades ago, in debating the merits of a carry-over tax basis rule, Congress got a stark glimpse into the dismal state of affairs of tax basis identifications at that time. Carryover Basis Provisions: Hearing Before the House Comm. On Ways and Means, 96th Cong., 1st Sess. 13 (1979) (‘‘that cost basis information for marketable securities was impossible to locate in 22 percent of estates, required time and research in 44 percent, and was readily available in 34 percent’’). Despite such a dire assessment, Congress blithely chose then to ignore the tax basis identification problem. That benighted ignorance continues today.

43 In a Wall Street Journal investment advice column, a taxpayer stated that he lost his records for a particular security and wanted to know the consequences. The columnist’s reply was as follows:

Technically, if you can’t show proof of the purchase price, the IRS can make you pay capital gains tax on the entire sale. But the tax cops often will accept a reasonable estimate. For instance, if you’re fairly certain you bought the stock in 1982 or 1983, an average of the high and low price for that two-year period would probably do.


45 Noncorporate taxpayers can use up to $3,000 of capital losses against ordinary income; in contrast, corporate taxpayers cannot deduct any excess capital losses. See section 1211. Excess capital losses are carried forward indefinitely to future tax years, except in the case of corporations, which can carry them back up to three years and carry them forward up to five years. Section 1212(a).

46 Generally, capital losses taken against capital gains in arriving at net capital gain for the year produce a tax benefit equal to the maximum marginal rate applicable to net capital gains (currently, 15 percent). Thus, the stakes are lower if the overstated basis inheres in a capital gain or loss transaction than in an ordinary gain or loss transaction, in which each incremental dollar of basis saves taxes equal to such loss times the maximum marginal rate of the taxpayer (currently, up to 35 percent).
III. Cost of Noncompliance

When it comes to underreporting and misreporting of income, quantification is not easy, because attempts to hide income and overstate deductions are purposely designed to elude detection. Inflated basis reporting is no exception. Quantification is, nevertheless, a worthwhile endeavor because its absence makes it virtually impossible to pinpoint the amount of attention a particular problem warrants.

Given the vast number of annual transactions involving marketable securities (several hundred billion), the potential for abusive basis reporting is virtually unlimited. A particular area of concern is publicly traded stock that results from stock splits and stock dividends, for which it is easy for taxpayers to erroneously treat the per share basis as being the same as the per share basis when the stock was originally acquired. Another area replete with abuse potential is investment real estate, for which tax-free, like-kind exchanges are increasingly common; in that economic sector, it is particularly tempting to ignore the substituted basis rule and instead to treat the basis of the asset received as being equal to the FMV on the date of acquisition. Inflated basis reporting may also be common with appreciated collectibles (now readily salable online) because cost records may be missing and third-party records unobtainable or not sought after. The bottom line is that whenever there is an acquisition or a sale of an investment, the opportunity for inflated basis reporting is virtually open-ended.

The Department of the Treasury’s most recently prepared compliance report, the 1996 Compliance Report, provides a numeric estimate of the problem’s severity. In that report, Treasury investigated those sources of unreported income that contributed to the tax gap — the difference between what taxpayers should have paid and what they actually paid. The 1996 Compliance Report (for tax year 1992) found that individual taxpayers had annually underreported their capital gains income to the tune of approximately $9.25 billion, resulting in an annual revenue loss of $2.45 billion. Insofar as individual income tax returns are concerned, that capital gains represented an $11.25 billion portion of the $127 billion individual and corporation tax gap for 1992.

Since the issuance of the 1996 Compliance Report and the GAO Report, neither Treasury nor the IRS has conducted additional comprehensive studies of the tax gap. Nevertheless, the most recent estimate of the tax gap (based largely on extrapolating information from those earlier studies) for all taxpayers reports the annual tax gap for 2001 to be $311 billion. Of that, approximately $228 billion is related to the individual and corporation income taxes.

That most recent estimate does not, however, break down the tax gap on a category-by-category basis. Therefore, there is no way to identify what portion of the 2001 tax gap is attributable to taxpayers inflating their tax basis. Nevertheless, consider that the individual and corporate income tax gap has risen approximately 80 percent since 1992. If compliance rates are thus held consistent, it makes sense to claim that the tax gap associated with the underreporting of capital gains is likely to be $21 billion annually ($11.5 billion (1992 tax gap attributable to capital gains understatements) times 1.8, rounded up).

According to a General Accounting Office report issued in 1994 (the GAO Report), the “compliance problem [of underreported capital gains] comes from taxpayers overstating their ‘basis’ in [assets].” By analyzing all income tax returns (including those of corporate taxpayers), the more expansive GAO Report (prepared two years earlier than the 1996 Compliance Report, yet still concerning the 1992 tax year) presents a much bleaker numeric picture: “[T]he IRS’ TCMP data show that individuals and small corporations significantly under-reported their capital gains income by $25 billion. In addition, capital gains represented an $11.5 billion portion of the $127 billion individual and corporation tax gap for 1992.”

Since the issuance of the 1996 Compliance Report and the GAO Report, neither Treasury nor the IRS has conducted additional comprehensive studies of the tax gap. Nevertheless, the most recent estimate of the tax gap (based largely on extrapolating information from those earlier studies) for all taxpayers reports the annual tax gap for 2001 to be $311 billion. Of that, approximately $228 billion is related to the individual and corporation income taxes.

That most recent estimate does not, however, break down the tax gap on a category-by-category basis. Therefore, there is no way to identify what portion of the 2001 tax gap is attributable to taxpayers inflating their tax basis. Nevertheless, consider that the individual and corporate income tax gap has risen approximately 80 percent since 1992. If compliance rates are thus held consistent, it makes sense to claim that the tax gap associated with the underreporting of capital gains is likely to be $21 billion annually ($11.5 billion (1992 tax gap attributable to capital gains understatements) times 1.8, rounded up).

---

50Id. See also “IRS Report on ‘Tax Gap’ Estimates (Publication 7285),’ 88 TNT 61-35 (1988) (presenting a chart for 1987 indicating that close to 10 percent of the tax gap was attributable to the misreporting of capital gains income).
51GAO Report, supra note 48 at 48. Obviously, inflated tax basis may not be the sole source of taxpayers underreporting their capital gain income. Other sources would likely include taxpayers’ underreporting of the amount realized and not reporting a transaction at all. We suspect, however, that because of information return issuance (at least in the case of brokered transactions), there would likely be fewer occasions when those practices give rise to compliance problems.
52Id.
53See supra note 32 at 21 (Table 1.2.1).
54Id.
55There are reasons why this estimate may be too low or too high. Estimate too low: Another way to estimate the scope of the problem might be to consider the increase in marketable security activity. Using market security activity as a gauge, it could be argued that the government currently stands to lose approximately $112 billion annually. That estimate is based on the approximate annual revenue loss of $11.25 billion (under the more expansive GAO Report) times 10, which is roughly the increase in stock market volume since the relevant tax year (1992) examined in the GAO Report. See supra note 48. We concede that this estimate, like the one offered in the text, is rough. In the absence of more recent data, however, there is some logic to correlating the severity of the basis problem with the number of market transactions today versus 1992, the year (Footnote continued on next page.)
That is no small leakage in the income tax system. Were the Joint Committee on Taxation to score that annual loss of $21 billion per year over a 10-year span, more than $210 billion of revenue, conservatively, would be in jeopardy of being lost over the course of the coming decade. Even for politicians who can be relatively numb to 10- and 11-digit figures, 12-digit figures can still usually get their attention.

IV. Practical Reforms

Given the severity of the revenue loss associated with taxpayers inflating tax basis in their investments, the question is what ameliorative measures are in order. In this section, we outline several reforms that we group under the moniker Three S’s. The Three S’s stand for strengthen, stretch, and simplify. In this section we amplify the meaning of each S.

First, Congress should seek to strengthen recordkeeping requirements. Right now, they are woefully inadequate, and taxpayers know it. That lax congressional attitude toward recordkeeping enables taxpayers to avoid accurate tax basis reporting. Congress could correct the problem by imposing a sanctionable duty on taxpayers to keep accurate books and records documenting their tax basis in their investments. As with section 274(b), those records should be contemporaneous with the transactions or events that affect basis, such as acquisitions, improvements, and capital changes. Taxpayers who fail to adhere to this standard would be penalized: Any investment for which adequate proof of tax basis could not be offered would have a deemed-zero tax basis. Akin to unsubstantiated travel and entertainment expenses, taxpayers would no longer be at liberty to invoke the use of the Cohan rule and estimate the tax basis they have in their investments. Moreover, a substantiation requirement imposed on taxpayers would “transfer” to tax return preparers under Treas. reg. section 1.6694-1(e)(1).

Second, we recommend that Congress stretch the current third-party reporting requirements to include tax basis. It’s a known fact that taxpayers are the most compliant when they are cajoled into that role, namely, when third-party reporting is commonplace. There is thus no reason not to expand on that success. We therefore offer a twofold recommendation. First, when taxpayers purchase investments using a broker, the broker should issue information returns to the taxpayer and to the IRS reporting the amount of the purchase price. Taxpayers would then have to report their acquisitions on a schedule attached to their tax returns. Congress could extend that reporting requirement to taxpayers who engage in nonbrokered investment acquisitions in excess of, say, $100,000, and require that those acquisitions be reported by taxpayers on a separate schedule attached to their income tax returns.

For the second leg of third-party reporting, brokers who retain legal title (that is, hold marketable securities in street name) would have a sanctionable duty to track taxpayers’ basis through capital changes and report the basis when taxpayers dispose of their investments.

56See infra notes 30-31 and accompanying text. If the proposal were adopted, the Treasury Department would need to amend this regulation to specifically refer to the kind of proof that tax preparers would require to substantiate taxpayers’ tax basis in their investments.

57See supra notes 48 and 49 at 43 (“Taxpayers are more prone to report income that is also reported on information returns to IRS.”); Michael C. Durst, “Report of the Second Invitational Conference on Income Tax Compliance,” 42 Tax Law. 705, 707 (1989) (“Computer-based enforcement techniques, relying largely on information returns filed by payers of wages, interest, dividends, and other items, have provided valuable benefits by virtually eliminating noncompliance with respect to important categories of income.”); Gene Steuerle, “The Heyday of the Comprehensive Individual Audit Is Over,” Tax Notes, Nov. 18, 1991, p. 859 at 860 (advocating further expansion of third-party information reporting).

58To illustrate, suppose X purchases 100 Company Y shares for $1,000 and X uses a brokerage firm to hold her Company Y shares. Suppose further that five years later, X sells her Company Y shares for $10,000. Under the proposal, X’s brokerage firm would have to issue a Form 1099-B that not only delineated (Footnote continued on next page.)
This duty to track basis during the duration of investment ownership could also extend to taxpayers who made investments in S corporations, closely held C corporations, limited liability companies, and partnerships. That is, the person(s) responsible for signing the entity’s tax return could have a concomitant obligation to track basis on behalf of the entity’s shareholders, members, and partners.64

The third (but most indirect) element of possible reform would be for Congress to Simplify the code. That mode of reform could be carried out along several dimensions. The first, and most painless, would pertain to one or more of the basis rules that perennially perplex taxpayers and whose complexity is not justified (for example, in lieu of the identification and FIFO accounting methods for marketable security dispositions, mandate the use of a blended basis).65 The second would involve substantive tax rules that bear tangentially on issues of tax basis (for example, repealing section 1031 and expanding the section 121 exclusion of personal residence gains).66 The third would be along the lines of fundamental reform that would buoy the overall strength of the income tax and, by doing so, invigorate tax basis reporting practices (for example, requiring the use of an annual mark-to-market system for marketable securities).67

Adoption68 of one or more of the Three S’s should go quite far to eliminate taxpayer basis overstatements.69

V. Conclusion

In the classroom, when academics stress the importance of tax basis and its pivotal role in the income tax system, they usually ignore taxpayer compliance issues.


67See generally Joseph M. Dodge, “A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal,” 50 Tax L. Rev. 265 (1995). In a mark-to-market system, basis is adjusted annually to the investment’s FMV at the close of the previous year.

68We recognize that the adoption of many of these reform measures would require the adoption of transition rules. The discussion of those transition rules, however, is beyond the scope of this analysis.

69Aside from the obvious benefits adoption of this proposal offers, there are some other less obvious, serendipitous benefits as well. Undoubtedly, those state governments that have instituted an income tax would derive a piggyback benefit from the implementation of this proposal. Also, consider that high-income taxpayers own a disproportionately large share of the nation’s marketable securities; this proposal thus curbs taxpayer noncompliance primarily concentrated in the ranks of high-income taxpayers, offering the opportunity for a more equitable tax system. Next, adoption of this proposal will help alleviate the lock-in effect. More specifically, some taxpayers who don’t know their tax basis in their marketable securities hold onto those securities until death because, under current law, the code requires that the tax basis of a decedent’s assets be adjusted to equal FMV at death. Once there is an information return submission requirement in place, taxpayers who previously did not monitor the tax basis of their marketable securities will not be placed in the awkward predicament of holding their investments until death to avoid having to make basis guesstimations. Finally, adoption of this proposal will also offer the first concrete opportunity to ensure that the carryover tax basis rules passed into law under the Economic Growth and Tax Relief Reconciliation Act of 2001 become an administrative reality.

Compute the gain or loss that results from capital changes on the subsequent sale of securities. It includes the latest transactions collected for all publicly traded companies. Most transactions are reported within one to two days of the announcement of stock distributions, dividends, splits, and effectiveness of mergers and acquisitions. See http://www.cap.cch.com/.

Conspicuously absent from the face of the current version of Form K-1 is the basis taxpayers have in their ownership interest as a shareholder, member, or partner. Yet every year, a taxpayer’s basis is virtually certain to change because of income, losses, and distributions, and, in the cases of limited liability companies and partnerships, liabilities incurred by the entity itself. See supra note 17 and section 755.

See supra notes 20-22 and accompanying text. Another simplification rule would be to eliminate the complexities of section 1015 when the donor’s basis exceeds the FMV of the property on the date of gift.

Despite having charted the numerous advantages offered by adoption of this proposal, there surely will be critics that question its merits. Critics will argue that to require taxpayers to record and brokers to track an investment’s tax basis places an undue administrative burden on each. Similar arguments were probably made decades ago when Congress instituted other information-reporting requirements, such as the issuance of Forms W-2. However, one of the fundamental keys to income tax compliance has been the issuance of those returns. If tax compliance trends have taught us anything, Congress should look for ways to expand information-reporting requirements whenever it can. Our proposals offer such an opportunity.
Instead, they implicitly convey the message that taxpayers will keep accurate books and records, spend hours reading and mastering the tax basis rules (or be willing to pay a tax professional to do so), and practice honest basis reporting. The analysis here suggests that such an imagined scenario is based on truly heroic assumptions. In truth, the more probable scenario is one in which taxpayers (when left to their own devices) fail miserably to keep and retrieve their records; avoid the effort and expense to learn arcane, complex, and opaque rules (and are unwilling to pay others to do so on their behalf); and are less than forthright in their tax reporting practices, particularly in the complete absence of compliance incentives.

Given this woeful state of affairs, legislative action is required. Reform requires a combination of strengthened recordkeeping requirements, enhanced third-party reporting, and simplified rules. On balance, although reforms of that nature will entail small additional administrative burdens, the vast majority of taxpayers will find tax compliance much easier because they will have at their fingertips information that will readily enable them to complete their tax returns insofar as their investments are concerned.

Aside from taxpayers, another benefactor of this reform will be the government. The elimination of a large source of taxpayer noncompliance will result in the collection of billions of dollars of additional tax revenue. As a practical matter, the IRS is understaffed to police tax basis identifications, and given the significant number of investment transactions, it will never be in a logistic position to provide sufficient oversight. Instituting these reporting requirements will liberate the IRS from that impossible policing task, enabling it to devote its limited resources to monitoring other areas of noncompliance, particularly as tax basis identification problems gradually wane.

Ultimately, this piece’s message is aimed at the Treasury Department and at congressional taxwriting members and staff. It is no secret that the current agenda is to cut taxes (or at least preserve existing tax cuts scheduled to expire), but that agenda is potentially blocked (or at least compromised) by the need to stem the torrent of red ink. The agenda includes elimination of the federal estate tax, but the trade-off for that, the carryover basis regime of section 1022, may not be viable. By instituting the reforms we suggest, those legislative agendas can be advanced, knowing that $250 billion would likely be at the disposal of Congress and that a carryover basis rule would be much more practical. And, apart from possible changes in taxpayer-friendly substantive tax rules (such as section 1031), all of this can be attained without having to “raise taxes.”

### Tax Notes Wants You!

*Tax Notes* has a voracious appetite when it comes to high-quality analysis, commentary, and practice articles. We publish more and better articles than anyone else, and we are always looking for more.

Do you have some thoughts on the American Jobs Creation Act? Fundamental tax reform? Tax shelters? Federal budget woes? Recent IRS guidance? Important court decisions? Maybe you’ve read a revenue ruling that has flown under the radar screen but is full of traps for the unwary.

If you think what you have to say about any federal tax matter might be of interest to the nation’s tax policymakers, academics, and leading practitioners, please send your pieces to us at taxnotes@tax.org.

Remember, people pay attention to what appears in *Tax Notes.*