

Testimony of Jay A. Soled
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Before the
Committee on Homeland Security and Governmental Affairs
September 26, 2006

CLOSING THE CAPITAL GAINS TAX GAP

Mr. Chairman and Distinguished Members of the Committee:

My name is Jay Soled. I am a professor of taxation at Rutgers University and I have written several papers on the issue of the capital gains tax gap. Thank you for inviting me to testify on how the government can close the capital gains tax gap and, in particular, in favor of the Simplification Through Additional Reporting Tax (“START”) Act of 2006. This legislation, which was endorsed by the National Taxpayer Advocate, was introduced several months ago by your colleague, Senator Bayh, and co-sponsored by this Committee’s Co-Chair, Senator Carper, would require mutual fund companies and brokerage firms to track and report an investment’s tax basis to both taxpayers and the IRS.

Before detailing the importance of the START Act, however, I think it’s incumbent upon me to highlight several salient points that were (and were not) made by the General Accountability Office (“GAO”) in a report it issued earlier this year entitled the “Capital Gains Tax Gap.”

- First, what the GAO report stated is that for tax year 2001, an estimated 38 percent of individual taxpayers who had securities transactions failed to accurately report their capital gains or losses from these transactions.
 - What the GAO report did not say is that if security ownership continues to expand and is left unchecked, almost four out of every ten taxpayers will submit income tax returns that are incorrect.
- Second, the GAO report stated that these mistakes cost the government over \$11 billion annually.
 - What the GAO report did not emphasize, however, is that this \$11 billion figure relates to individual income tax returns in 2001. As such, it probably grossly understates the magnitude of the problem. If the GAO were to have expanded the scope of its investigation to include corporate and other taxpayers such as trusts and estates, the estimated revenue loss to the government could easily exceed \$25 billion annually.

- Third, the GAO report stated that the IRS is virtually powerless to close the capital gains tax gap.
 - Without trying to paint too bleak of a picture, what the GAO report was really saying is that even if the IRS could audit every single taxpayer's return, the capital gains tax gap would, unfortunately, remain largely intact. This is because most taxpayers lack accurate records and the ability to track the tax basis they have in their investments.

Why is the size of the capital gains tax gap so large? Let me offer five reasons.

Reason #1: Taxpayers are notoriously lax record keepers. When it comes to record keeping, few taxpayers would deserve Oscars for their efforts. Record keeping relating to tax basis information is particularly nettlesome insofar as these records must commonly be maintained for years or even decades.

Reason #2: Computation of an investment's tax basis can be extraordinarily complex. The starting point for basis computation seems simple enough: tax basis is equal to cost. But this is where the simplicity ends. For a moment, consider that when it comes to gifts, a recipient takes a carryover basis (unless, of course, any gift tax is paid); when it comes to death, a recipient takes a basis equal to fair market value (unless, of course, the estate's executor had elected the alternative valuation date); when it comes to stock splits, a shareholder must reduce his stock tax basis in half (unless, of course, the stock split constitutes a taxable event). The bottom line is this: an asset's tax basis is fluid, and the fluidity of tax basis can sometimes overwhelm even the most civic-minded taxpayer.

Reason #3: When it comes to third-party information returns, there is no tax basis reporting to the IRS. Think otherwise? Check out the face of a Form 1099, which reports the amount realized from a transaction but not the sold asset's tax basis. Past studies universally indicate that in the absence of information returns, taxpayer compliance plummets. (In comparison, when information returns are in place, compliance usually hovers around the 99% mark.) Indeed, the Commissioner of the IRS, Mark Everson, has previously stated that compliance is highest when there is third-party information reporting. There is simply no reason to assume that when it comes to tax basis reporting, in the absence of third-party information returns, halos magically appear above taxpayers' heads.

Reason #4: The IRS has a disincentive to pursue tax basis issues. One of the fundamental myths that pervade this area of the law is that in the absence of substantiating evidence, an asset's tax basis is deemed to be zero (i.e., all sale proceeds are treated as taxable income). Instead, the truth is that the so-called Cohan rule applies. This rule allows the taxpayers to estimate an investment's tax basis. In tax controversies, the Cohan rule often gives taxpayers the upper hand against the IRS.

Reason #5: The penalty for misreporting an asset's tax basis is so negligible that it is likely to be ignored. The Code's penalty structure serves as a strong deterrent against taxpayer noncompliance in income tax reporting. However, this is not so when it comes to tax basis

misreporting: the penalty for such misreporting is ordinarily 20 percent of the tax due; multiplying this rate against the highest capital gains rate of 15 percent only produces a tiny 3 percent toll charge, with respect to tax basis misidentifications.

The START Act offers hope to taxpayers and the government that tax basis misidentifications will be a problem of the past and that the capital gains tax gap will narrow. Due to technological changes, the time to implement this legislation is now. Never before have the financial markets been this poised to institute reforms of the nature suggested.

Kindly allow me to highlight the salient features of the START Act. They are as follows:

- The Act would require that mutual fund companies and brokerage firms track the tax basis of their clients' investments.
- Upon the triggering of a reporting event (such as a sale or other disposition), the mutual fund company or brokerage firm would, in addition to reporting the amount realized, also report the investment's tax basis.
- The Act would function prospectively, effective for transactions commencing after 2007.
- The Secretary of the Treasury would be delegated the duty of drafting regulations and detailing the specifics of how this reporting requirement would be implemented.

Passage of the START Act and broader tax basis legislation to close the capital gains tax gap would be a boon to taxpayers, the government, and even mutual fund companies and brokerage firms.

The benefits to taxpayers would be as follows:

- Taxpayers would have easy access to critical tax basis information and save them tremendous amounts of time preparing their tax returns. Put slightly differently, every April 15 there would likely be far fewer shoeboxes that taxpayers would have to dust off and bring to their accountants.
- Next, in having their tax returns professionally prepared, taxpayers would not have to spend additional money to have their accountants compute the tax basis of their investments.
- Finally, receipt of these third-party information returns would instill taxpayer confidence in the integrity of the tax system and in the belief that, in general, everyone is shouldering his fair share of the nation's tax burden.

The benefits to the government would be as follows:

- The most identifiable benefit is that the government could, over a ten-year scoring period, collect up to an additional quarter of a trillion dollars of revenue.
- Furthermore, having put the brakes on tax basis misreporting, the IRS could redirect its scarce resources to other areas where taxpayer compliance is lagging.

The benefits to the mutual fund companies and brokerage firms would be as follows:

- There are a fair number of taxpayers who invest on their own without the use of a mutual fund company or brokerage firm to assist them. Implementation of the START Act legislation could attract these “independent” taxpayers to retain the expertise of the financial service industry to relieve them of the burdensome chore of tax basis identification.
- Moreover, around tax season, no longer would individuals who staff the telephones and offices at mutual fund companies and brokerage firms be beleaguered by clients who call or stop by and make tax basis inquiries.
- Mutual fund companies and brokerage firms often already provide tax reporting services for their higher net worth clients. By mandating tax basis reporting for all their clients, the financial service sector could have a universal practice.

My biggest complaint with the START Act is that it doesn’t go far enough. More comprehensive legislation is probably required to narrow the capital gains tax gap even further. Such comprehensive legislation might include the following features:

- First, third-party tax basis reporting requirements should include closely held business interests in S corporations, partnerships, and limited liabilities. Currently, the face of a Form K-1 (which is issued annually to the owners in these closely held business enterprises) suffers from the same deficiency as the face of a Form 1099-B: neither contains critical tax basis information.
- Second, taxpayer obligations to properly identify the tax basis they have in their investments should be strengthened. Just as the Internal Revenue Code requires substantiation of travel and entertainment expenses, taxpayers should be required to substantiate, rather than estimate, the tax basis they have in their investments.
- Third, legal changes should be instituted that simplify tax basis identifications. These changes might include several minor tweaks such as eliminating Code § 1015(d)(6), which upwardly adjusts the tax basis of gifted assets by a portion of the gift tax paid on the receipt of appreciated property. Other changes might include more fundamental reforms, such as moving to a mark-to-market tax system that requires annual recognition of all gains and losses.

So, from my perspective, the START Act is just that—a starting point that should immediately be put into place. With its passage, however, Senators, please do not consider your work done. Knowledge of an asset's basis is fundamental to our income tax system where gains and losses are computed upon the difference between the amount realized and an asset's tax basis. Proper tax basis identification is thus the key to the continued success of the income tax. Therefore, any compliance mechanisms that you can put into place should be gladly welcomed by taxpayers and politicians alike who care about our nation's fiscal solvency and the integrity and equity of the Internal Revenue Code.

In closing, Senators, before you ask me any questions, please let me take this opportunity to pose a question to each of you: Do you know the tax basis you have in each of your investments? Assuming you don't, then you should recognize the importance of the START Act and the need for its immediate passage.