United States General Accounting Office

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Report to the Honorable Dick Armey, Majority Leader, House of Representatives

April 2001

TAX DEDUCTIONS

Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing

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United States General Accounting Office
Washington, DC 20548

April 12, 2001

The Honorable Dick Armey
Majority Leader
House of Representatives

Dear Mr. Armey:

When computing their federal taxes, taxpayers either claim a standard deduction or itemize deductions. These deductions are subtracted from adjusted gross income in determining taxable income. Taxpayers in general claim the type of deduction that is larger because that minimizes their taxable income. In recent years, approximately 70 percent of taxpayers have claimed the standard deduction, while the remaining 30 percent have itemized.

This report is our initial response to your request for an estimate of the number of taxpayers who may have overpaid their taxes by claiming the standard deduction instead of itemizing their deductions, as well as the amount of taxes they may have overpaid. For this report, we estimated the number of returns where taxpayers who claimed the standard deduction may have had deductible mortgage interest expense in excess of their standard deduction. We developed our estimate by matching data from different Internal Revenue Service (IRS) databases.

We limited our estimate to itemizable mortgage interest because that was the only type of itemizable expense for which data were readily available. Not all mortgage interest payments can be claimed as itemized deductions. When the data allowed, we excluded certain categories of mortgage interest payments, such as interest on business mortgages, that may have been nonitemizable. Because of data limitations, we had to exclude some mortgage payments that likely were itemizable—to that extent our estimates are understated. We attempted to identify and exclude the most common nonitemizable mortgage interest payments. However, we could not exclude all cases of nonitemizable mortgage interest—to that extent our estimates are overstated. In a future report, we plan to do further estimates regarding the number of taxpayers who had a broader range of itemizable expenses, not just mortgage interest.[1] This will increase the size of our estimate.

As agreed with your office, we did not attempt to determine the reasons why taxpayers claimed the standard deduction when they might have paid less tax had they itemized deductions.

Results in Brief

We estimate that on about 510,000 tax year 1998 individual tax returns, taxpayers did not itemize their deductions yet had mortgage interest payments that exceeded the standard deduction amount for their tax filing status.[2] We estimate these taxpayers may have overpaid their taxes by about $311 million. The average overpayment amount was $610 and about 35 percent of the taxpayers[3] had overpaid their taxes by more than $500. In oral comments on this report, IRS officials stated that our methodology for developing our estimates was reasonable.

Background

The tax code allows taxpayers to subtract from gross income either a standard deduction or certain itemized deductions. The standard deduction is the sum of two components, the basic standard deduction and the additional standard deduction for taxpayers that are age 65 or over and/or blind. Both the basic and additional standard deductions vary in amount, depending on filing status. Basic and additional standard deduction amounts are set by Congress and are adjusted annually for inflation.

Itemized deductions are specified personal and other expenses that Congress has chosen to allow as deductions in arriving at taxable income. Deductible personal expenses include certain of the taxpayer's interest payments, such as mortgage interest and points, which are charges paid, or treated as paid, by a borrower to obtain a home mortgage; certain

[1]For example, other key itemizable deductions include state and local taxes, property taxes and charitable contributions.

[2]The five filing statuses are single, married filing jointly, qualified widow(er) with dependent child, head of household, and married filing separately. The standard deduction amounts vary by filing status. For tax year 1998, the basic standard deduction was $4,250 for filing single, $7,100 for married filing jointly or as a qualified widow(er), $6,250 for head of household, and $3,550 for married filing separately.

[3]95-percent confidence level: 30 to 40 percent.

nonfederal taxes, such as state and local income taxes, real estate taxes, and personal property taxes; gifts to charity; medical and dental expenses; and casualty and theft losses. Other deductible expenses include certain payments related to the production or collection of income and expenses related to the management of property held for the production of income.

Generally, a taxpayer is allowed to deduct the greater of itemized deductions or the standard deduction. To minimize their tax liability, taxpayers could compare their total standard deduction (the sum of their basic standard deduction and any additional standard deductions) to their total itemized deductions. If itemized deductions are less than their standard deduction, taxpayers would compute taxable income using the standard deduction. If their itemized deductions exceed the standard deduction, taxpayers would compute taxable income by itemizing.

Scope and Methodology

To estimate the number of taxpayers who potentially overpaid their taxes by claiming the standard deduction instead of itemizing and the amount of taxes they may have overpaid, we used IRS' Statistics of Income (SOI) data for tax year 1998 (the most recent year for which data were available). The SOI data consist of a random sample of about 164,000 individual returns filed in 1999, which is statistically representative of the 124.8 million tax year 1998 individual returns filed. To the sampled returns, we matched data from IRS' Information Returns Master File, which contains data from the various information returns, such as form 1098 for mortgage interest and form W-2 for wages. We used this matched file to obtain mortgage interest payment amounts for taxpayers in the sample who did not itemize their deductions.

We first identified the returns of all taxpayers in the SOI sample that did not itemize their deductions but whose mortgage interest exceeded the standard deduction available to them. We included only those taxpayers whose mortgage interest alone exceeded their standard deduction because the Information Returns Master File did not contain any data on taxpayers' itemizable deductions other than mortgage interest payments. Thus, we could not incorporate any of the other itemizable deductions—such as state and local income taxes, real estate and personal property taxes, and gifts to charities—in our estimates. Other taxpayers may also have overpaid their taxes because their total deductible expenses may have exceeded their standard deductions, but the data on expenses other than mortgage interest were unavailable.

We attempted to identify and exclude from our sample the most common situations in which mortgage interest could not be claimed as an itemized deduction. We excluded:

- *Returns with no tax liability*. Because these filers had no tax liability, there was no potential gain to them from itemizing deductions.

- *Returns where the filing status was "married, filing separately."* Taxpayers in this filing status are required to use the same type of deductions as their spouse (i.e., if one spouse claimed the standard deduction, the other must also). Some of these taxpayers may have been required to claim the standard deduction because their spouse did so. We did not have data on the filing status of their spouse, so we excluded these taxpayers from our analysis.

- *Returns where taxpayers reported mortgage interest on either their Schedule C: Profit or Loss From Business, Schedule E: Supplemental Income and Loss, or Schedule F: Profit or Loss From Farming*. We assumed that all the mortgage interest payments shown on these taxpayers' forms 1098 were for business purposes and not for personal expenses. Thus our estimates of the number of taxpayers who may have overpaid their taxes may be understated to the extent that the mortgage interest payments were actually personal expenses.

- *Returns of taxpayers that were in the phase-out range for itemizing deductions and who would not have lowered their taxes by itemizing*. Certain itemized deductions are subject to being phased out beginning at certain levels of adjusted gross income. The income levels are $124,500 for filing single; married, filing jointly; qualified widow(er) with dependent child; and head of household; and $62,250 for married, filing separately, for tax year 1998. The itemized deductions subject to phase-out are home mortgage interest, including points; state and local income taxes; real estate and personal property taxes; gifts to charities; unreimbursed employee expenses; and some other itemizable expenses.

- *Returns that later were amended by taxpayers*. Because these taxpayers may have itemized their deductions when they filed their amended return and we did not have data to indicate which taxpayers did later itemize deductions, we eliminated all returns that later were amended. Thus our estimates of the number of taxpayers who may have overpaid their taxes may be understated to the extent that taxpayers who filed amended returns did not later itemize their deductions.

In certain cases we were unable to exclude mortgage interest that may not have been itemizable. To the extent that these cases included nonitemizable mortgage interest payments, our estimates are overstated. Home mortgage interest payments that we identified as not being fully itemizable, but could not exclude from our estimates are:

- *Interest payments on mortgage balances over $1 million, where the mortgage(s) were used to acquire (that is, buy, build, or improve) the residence(s)*. Although we could not exclude them, it is unlikely that our sample included many such large mortgages. Less than one percent of the returns that we projected to have overpaid taxes had associated mortgage interest payments of $50,000 or more, which would be the interest payment on a $1 million mortgage at an interest rate of 5 percent.

- *Interest payments on home equity debt, where the mortgage totaled over the lesser of $100,000 or the fair market value of the home, reduced by acquisition indebtedness*. The amount of such interest could be limited by lending institutions.

- *Interest payments on a third home*. Taxpayers who meet this nondeductible category generally would have to have three non-income-producing homes. If any of the three homes were used for business purposes, including rental property, the mortgage interest payments would have been reported on the taxpayers' Schedules C, E, or F. If so, they were already excluded from our sample.

Our estimates may be affected by the accuracy of the form 1098 data we used. We assumed that the data were accurate for both the amount of the mortgage interest payments and the taxpayer that made the interest payments. If there are any errors in the data, our estimates are overstated to the extent that the mortgage interest amounts were overstated. Conversely, our estimates are understated to the extent that the mortgage interest amounts are understated. Also, if there are any taxpayers whose names and Social Security numbers appear on the forms 1098 who were not the persons legally entitled to claim a mortgage interest deduction, our estimates may be overstated.

All sample results in this report have been weighted to reflect the entire population and are subject to sampling error. Unless otherwise indicated, all estimates are surrounded by a 95-percent confidence interval. The confidence interval ranges are shown in tables 1 and 2. We did our work in March and April of 2001 in accordance with generally accepted government auditing standards.

We requested and received oral comments from the Director of SOI and other SOI staff on a draft of this report. They stated that the methodology we used for developing our estimates was reasonable.

Mortgage Interest Payments Exceeded the Standard Deduction for Some Taxpayers Who Did Not Itemize

For tax year 1998, taxpayers filed over 124 million tax returns. On almost 86 million, or about 70 percent of these returns, taxpayers claimed the standard deduction. On the remaining 38 million, or about 30 percent, they itemized their deductions. Of the 86 million returns claiming the standard deduction, we estimate that on about 510,000 returns, taxpayers may have reduced their taxes if they had itemized deductions, as shown in table 1.

Table 1: Estimated Number of Returns Where Taxpayers May Have Overpaid Their Taxes Because Their Mortgage Interest Payments Exceeded the Standard Deduction, Tax Year 1998

	Returns		
Return category	**Estimated number**	**Percent of total**	**95-percent confidence interval**
Total returns	124,770,662	100.0	
Returns where taxpayer claimed the standard deduction (i.e., did not itemize)	85,576,463	68.6	85,257,168 to 85,895,758
Returns claiming standard deduction and mortgage interest exceeded the standard deduction	1,533,346	1.2	1,467,546 to 1,601,308
excluding returns without a positive tax liability	1,153,643	1.0	1,096,581 to 1,212,883
excluding returns with filing status "married, filing separately"	1,009,963	0.9	956,590 to 1,065,519
excluding returns where taxpayers reported mortgage interest on their Schedule C, E, or F	543,416	0.5	504,387 to 584,653
excluding returns where taxpayers in the phase-out range for itemizing deductions could not have lowered their taxes by itemizing	529,526	0.4	491,000 to 570,262
excluding returns later amended by the taxpayer equals estimated number of returns where taxpayers may have overpaid their taxes	510,072	0.4	472,274 to 550,081

Source: GAO analysis of SOI and other IRS data.

We estimated that these taxpayers may have overpaid their 1998 taxes by about $311 million. The average overpaid tax amount is $610. On about 35 percent of returns, taxpayers may have overpaid their taxes by more than $500, as shown in table 2.

Table 2: Distribution of Returns Where Taxpayers May Have Overpaid Their Taxes Because Their Mortgage Interest Payments Exceeded the Standard Deduction, Tax Year 1998

	Returns		
Distribution of overpaid tax	**Estimated number**	**Percent of total**	**95-percent confidence interval**
$1 to $100	97,986	19.2	80,791 to 117,065
$101 to $250	113,149	22.2	94,904 to 133,065
$251 to $500	120,385	23.6	101,691 to 140,676
$501 to $1,000	109,535	21.5	91,523 to 129,248
$1,001 to $5,000	63,083	12.4	49,002 to 79,513
Over $5,000	5,934	1.2	2,059 to 13,106
Total	**510,072**	**100.0**	**472,274 to 550,081**

Note: Totals may not sum because of rounding.
Source: GAO analysis of SOI and other IRS data.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to Representative William Thomas, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; Senator Charles E. Grassley, Chairman, and Senator Max Baucus, Ranking Member, Senate Finance Committee; Representative Amo Houghton, Chairman, and Representative William J. Coyne, Ranking Minority Member, Subcommittee on Oversight, House Committee on Ways and Means; and the Honorable Charles O. Rossotti, Commissioner of Internal Revenue. We will also make copies available to others upon request.

If you have any questions regarding this report, please contact me at (202) 512-9110 or Ralph Block at (415) 904-2150. The major contributors to this report were John Mingus and Anne Stevens.

Sincerely yours,

James R. White
Director, Tax Issues

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