

**GAO**

Report to the Committee on Finance,  
U.S. Senate

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August 2008

# TAX GAP

## Actions That Could Improve Rental Real Estate Reporting Compliance





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](mailto: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.

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
<b>All types of misreporting</b>	<b>53</b>

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.

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United States Government Accountability Office  
Washington, DC 20548

August 28, 2008

The Honorable Max Baucus  
Chairman  
The Honorable Charles Grassley  
Ranking Member  
Committee on Finance  
United States Senate

The Internal Revenue Service (IRS) estimated that individual owners of rental real estate underreported their taxes by as much as \$13 billion for tax year 2001.<sup>1</sup> By misreporting their rental real estate activities, these taxpayers contribute to the gross tax gap, most recently estimated at around \$345 billion for tax year 2001. The tax gap is the difference between the taxes that taxpayers pay voluntarily and on time and the amounts they should pay under the law.

We have noted in past reports and testimonies that the tax gap has multiple causes, spans five types of taxes, and is spread over individuals and different business types. For these reasons, addressing the tax gap requires understanding the characteristics of specific types of misreporting, such as for rental real estate, in order to develop potential solutions for closing the gap. Given the magnitude of the estimated tax gap from rental real estate misreporting, even small improvements in taxpayer compliance could result in substantial revenue. Increasing compliance could also improve the fairness of the tax system, as misreporting taxpayers increase the burden of funding the nation's commitments for those taxpayers who voluntarily pay their taxes.

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<sup>1</sup>This \$13 billion portion of the tax gap includes misreported net income from royalties—such as from oil, gas, or mineral properties; copyrights; and patents—because individual taxpayers are required to report net income from rental real estate and royalties on the same part of the individual tax return (Part I of Schedule E). The estimate does not distinguish what part of the \$13 billion is attributed to rental real estate misreporting. We do not evaluate royalties in this report. Likewise, net income or loss from rental real estate held through a partnership, S corporation, estate, or trust or for farm rentals is to be reported elsewhere on Schedule E, and IRS includes misreporting from these activities in a separate portion of the tax gap estimate. Accordingly, our analyses in this report only cover rental real estate activities that were, or should have been, reported on Part I of Schedule E.

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Given your long-standing concern about the tax gap, you asked us to provide information on individual taxpayer compliance in reporting rental real estate activity. In response, this report (1) provides information on the extent and primary types of individual taxpayer misreporting of rental real estate activities and (2) identifies challenges IRS faces in ensuring compliance with rental real estate reporting and assesses options for increasing compliance.

To provide information on the extent and primary types of individual taxpayer misreporting of rental real estate activities, we selected a probability sample of case files from a larger sample of individual tax returns IRS examined through its National Research Program (NRP). We reviewed case files for 1,000 returns that included rental real estate or royalty activity<sup>2</sup> and used the results of our case file review along with data from IRS's examinations of the tax returns from NRP to make estimates for the entire population of individual taxpayers with rental real estate activity. Since our estimates are based on a sample, we express our confidence in the estimates as a 95 percent confidence interval, plus or minus a margin of error. These intervals would contain the actual population value for 95 percent of the samples we could have selected. Unless otherwise noted, all percentage estimates have a margin of error of less than 5 percentage points; value estimates have a margin of error of less than 8 percent. To identify challenges IRS faces in ensuring rental real estate reporting compliance and assess options for increasing compliance, we reviewed IRS forms, publications, and other taxpayer guidance related to reporting rental real estate activity and reviewed documents and data from IRS's enforcement programs. In addition, we interviewed officials from IRS's Small Business/Self-Employed; Wage and Investment; and Research, Analysis, and Statistics divisions who have knowledge of rental real estate compliance issues. We also interviewed representatives of the tax return preparation, property management, and mortgage banking industries. We conducted this performance audit from May 2007 through August 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe

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<sup>2</sup>We selected cases with royalty activity to estimate misreporting from royalties, which IRS combines with misreporting from rental real estate to estimate the tax gap for these two activities.

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that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Results in Brief

We estimate that at least 53 percent of individual taxpayers with rental real estate activity for tax year 2001 misreported their rental real estate activity, resulting in an estimated \$12.4 billion of net misreported income. This amount of misreporting understates the total amount of misreported income from rental real estate because IRS knows it does not detect all misreporting during its NRP examinations and uses various methodologies and other sources of data to adjust the amount of misreporting it detects to estimate the tax gap. Also, individual taxpayers misreported net income from rental real estate more frequently than some other types of income. For example, 10 percent of taxpayers misreported the amount of wages they earned. This disparity in compliance undermines the fairness of our tax system. Misreporting of rental real estate expenses was the most common type of misreporting of rental real estate activities we found that IRS identified through the NRP examinations. One problem was substantiating expenses—about one-quarter of taxpayers with rental real estate activity could not substantiate some expenses they reported on their tax returns. Other types of misreporting included misreporting of rents received, reporting activity on the wrong part of the individual tax return, and misreporting the amount of loss from rental real estate.

Limited information reporting for rental real estate activity, the complexity involved in reporting the activity, and the number of taxpayers misreporting their rental real estate activity are challenges IRS faces in ensuring compliance with rental real estate reporting. For example, IRS receives information returns from third parties—such as those that rental real estate management companies file reporting the rent taxpayers receive or that financial institutions file reporting the mortgage interest taxpayers pay—for only a small number of taxpayers who report rental real estate activity on their tax returns. As a result, it can be difficult for IRS to systematically identify taxpayers who may have misreported or failed to report their activities. While information reporting improves compliance, implementing broad, new third-party information reporting for rental real estate activities is not practical. For example, requiring all renters to report to IRS the amount of rent they pay would place a substantial burden on renters and would present enforcement challenges for IRS. However, other options exist to improve rental real estate reporting compliance. Existing third-party information reporting requirements could be improved. Currently, financial institutions do not have to provide mortgaged property addresses when reporting to IRS on

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taxpayers' mortgage interest payments. Also, under existing law, only taxpayers whose rental real estate activity is considered a trade or business are required to report expense payments on information returns, but the law for filing the returns does not clearly spell out how to determine whether taxpayers' rental real estate activity should be considered a trade or business. Another approach to improving taxpayer 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 we found that some taxpayers did not report, could help IRS address misreporting during examinations. Requiring additional detail on tax returns could have the added benefit of compelling paid tax return preparers, used by about 80 percent of individual taxpayers who report rental real estate activity, to obtain more accurate income and expense information from taxpayers. Also, IRS guidance in the instructions to the individual tax return could be improved for some aspects of rental real estate activity, such as required recordkeeping. Finally, IRS officials suggested additional IRS outreach to paid tax return preparers and others about common types of rental real estate misreporting.

This report suggests that Congress consider amending the Internal Revenue Code to make all taxpayers with rental real estate activity subject to the same information reporting requirements as other taxpayers operating a trade or business. We are also making several recommendations to IRS to help it identify and address misreporting and assist taxpayers, and their paid preparers, in accurately reporting rental real estate activities, such as requiring third parties to report mortgaged property addresses on mortgage interest statements, requiring taxpayers to report additional information on their tax returns for their rental real estate activities, providing taxpayers with additional guidance, and enhancing IRS's outreach efforts with regard to rental real estate activity. In commenting on a draft of the report, IRS agreed with seven of our nine recommendations. However, IRS agreed only to consider implementing our recommendation to require third parties to report mortgaged property addresses on the mortgage interest statement information return because the requirement would increase burden on third parties. Also, IRS disagreed with our recommendation to require taxpayers to report on the individual tax return the basis amount attributed to land versus structure when depreciating rental properties. However, IRS agreed to add information in its instructions about allocating basis to land. We believe that these two recommendations could improve compliance if implemented. Representatives of the mortgage banking industry told us that it would be feasible to report property address information on

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mortgage interest statements. Also, we believe that requiring taxpayers to report the land values on tax returns could prevent some taxpayers from including the value of their land when calculating depreciation for their rental properties. Although the instructions to the individual tax return state that land is not depreciable, we found that about 166,000 taxpayers included the value of land when depreciating their rental properties for tax year 2001.

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## Background

Individuals report their rental real estate activities on their tax returns, including for the rental of residential, vacation, and commercial properties. Individuals own and manage a large amount of residential properties in the United States. According to a study by the Department of Housing and Urban Development and the U.S. Census Bureau (Census), individuals owned an estimated 83 percent of the 15.7 million rental housing properties with fewer than 50 units in 2001 (with the remainder owned by partnerships or other entities). Individuals owned 13 percent of the estimated 71,000 rental properties with 50 units or more.<sup>3</sup>

Likewise, according to a Census study of rental property management characteristics for 1995, an estimated 67 percent of rental housing properties with fewer than 50 units were managed by their owners as opposed to management companies or another type of manager. Owners managed an estimated 5 percent of rental properties with 50 units or more.<sup>4</sup> According to IRS data, the estimated number of individual taxpayers who reported rental real estate activity for properties they owned directly was 8.7 million in 2001 and 9.1 million in 2005.<sup>5</sup>

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<sup>3</sup>Department of Housing and Urban Development and Department of Commerce, U.S. Census Bureau, *Residential Finance Survey: 2001* (Washington, D.C.: 2005). These estimates include rented and vacant single-family and multifamily houses, condominiums, mobile homes and complexes, and rental or cooperative apartment buildings. Certain properties, such as some publicly owned properties or properties with more than 50 percent of the floor space used for business, industrial, or nonresidential purposes, were not included in the estimate.

<sup>4</sup>U.S. Census Bureau, *1995 Property Owners and Managers Survey*, <http://www.census.gov/hhes/www/housing/poms/poms.html> (accessed Apr. 17, 2007). Certain properties, such as those owned by a public housing authority or properties used primarily as second or vacation homes, were not included in the estimate.

<sup>5</sup>Figures do not include taxpayers who reported activity from rental real estate held by a partnership or other entity. According to an IRS technical advisor, a large percentage of partnerships are engaged in rental real estate activity.

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Individual taxpayers generally must report as income any rent they receive from the use or occupation of real estate on Part I of Schedule E, which they attach to the individual tax return—Form 1040.<sup>6</sup> The amount of income taxpayers must report includes rent payments and other amounts, such as kept security deposits or the fair market value of services taxpayers receive from tenants in lieu of rent. Taxpayers ordinarily are allowed to deduct the expenses of renting property from their rental income on Part I of Schedule E.<sup>7</sup> However, the costs of property improvements that add to the value of a property or extend its useful life, such as a bathroom addition or new built-in appliances, must be depreciated, meaning that taxpayers must deduct such costs on their tax returns over multiple years. Likewise, taxpayers must depreciate the cost of acquiring a rental property. The amount of depreciation that a taxpayer can deduct for both property improvements and the cost of rental property depends on the taxpayer's basis in the property, among other factors. A taxpayer's basis in a rental property is generally the cost of the property when it was acquired, excluding the cost of land, which is not depreciable (in practice, taxpayers must determine what portion of the cost of their properties is attributed to land versus actual structures in order to determine their depreciable basis).

If individual taxpayers use their properties for both rental and personal purposes in a given tax year the expenses they can deduct may be limited.<sup>8</sup> Personal use of a property includes the use by the taxpayer or any other person who has an interest in the property or use of the property by a family member of either, even if the property is rented at a fair rental price.<sup>9</sup> Personal use also includes use by nonowners and non-family

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<sup>6</sup>Income from other types of rental activities, such as rentals where significant services (such as maid services) are provided, the rental of personal property or farm rentals, and rental properties held by a partnership or other entity, are reported elsewhere on the individual tax return.

<sup>7</sup>Deductible expenses include advertising, auto and travel, cleaning and maintenance, commissions, insurance, legal and professional fees, management fees, mortgage and other interest, repairs, supplies, taxes, utilities, and other miscellaneous expenses.

<sup>8</sup>The tax treatment of rental property that taxpayers also use for personal purposes depends on whether taxpayers use the property as a residence. For the purposes of this requirement, a property is considered to be used as a residence if the taxpayer uses it for personal purposes more than the greater of (1) 14 days or (2) 10 percent of the number of days the unit is rented at a fair rental price. 26 U.S.C. § 280A(d).

<sup>9</sup>Fair rental price for a given property is generally the amount of rent that a person not related to the property owner(s) would be willing to pay to rent the property.

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members if the rental is at less than a fair rental price. However, in general, renting property to a family member or another person is not considered to be personal use if the property is rented at a fair rental price and is used by the renter as his or her principal residence. Taxpayers who use their properties for both rental and personal purposes, but whose personal use is not enough for the property to be considered a residence, must allocate their expenses between rental and personal use based on the number of days used for each purpose.

To assist in filing their tax returns, individual taxpayers are expected, and in some cases required, to keep records, including those for rent received and expenses. Additionally, taxpayers must keep records to substantiate items on their tax returns in case IRS has questions about the items. Taxpayers who, upon IRS examination, cannot produce evidence to support items they reported on their tax returns may be subject to additional taxes and penalties. For example, taxpayers who cannot substantiate their rental real estate expenses with appropriate records may have their expenses disallowed, resulting in additional taxes owed.

Information reporting provides taxpayers, as well as IRS, with some records of rent received and expenses from rental real estate. For example, when an individual taxpayer receives rent of \$600 or more through a rental agent, such as a rental management company, the agent is required to report the amount of rent received to the taxpayer and IRS on a Form 1099-MISC. Payees of rent payments of \$600 or more made in the course of a trade or business, such as renting office space, are also required to report those payments on Form 1099-MISC.<sup>10</sup> Likewise, financial institutions are required to report to taxpayers and IRS on Form 1098 the amount of interest taxpayers paid on mortgages they held on their rental properties. A taxpayer whose rental real estate activity is a trade or business is required to report service payments of \$600 or more on Form 1099-MISC. However, according to IRS, whether a taxpayer's rental real estate activity is considered a trade or business is determined on a facts and circumstances basis. Generally, taxpayers currently do not have to file Form 1099-MISC for payments made to corporations.

IRS relies on both enforcement and taxpayer service programs to ensure compliance by taxpayers with rental real estate activity. Two enforcement

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<sup>10</sup>Direct payments of rent to rental agents and rent payments made to corporations are excluded from the Form 1099-MISC reporting requirement.

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programs IRS uses to ensure compliance are the Automated Underreporter program (AUR) and examinations. Through AUR, IRS matches information that taxpayers report on Schedule E for rent received and mortgage interest to amounts that third parties report for these items on Forms 1099-MISC and 1098, respectively. When mismatches arise between amounts on tax returns and Forms 1099-MISC and 1098, IRS may send notices asking taxpayers to explain the discrepancies or pay additional taxes. Examinations may address any type of misreporting and come in three forms. Correspondence examinations are conducted through the mail and usually cover a narrow issue or two. Office examinations are also limited in scope but involve taxpayers going to an IRS office. For field examinations, IRS sends a revenue agent to a taxpayer's home or business to examine the misreporting that IRS suspects it has identified. During examinations, IRS uses information from third parties, taxpayers, and external sources, such as public records.

Through its taxpayer service programs, IRS provides publications, forms, and instructions to help taxpayers understand and comply with their rental real estate reporting requirements.<sup>11</sup> IRS also disseminates relevant information to tax professionals, such as tax return preparer associations, and business organizations. For example, in July 2007, IRS released a fact sheet on the requirements for reporting rental real estate activity. In addition to publishing the fact sheet on its Web site, IRS disseminated the information to the media and a wide network of tax professional and small business organizations. IRS also provides assistance to taxpayers through its toll-free telephone service where taxpayers can call and speak directly with IRS staff about their tax issues.

IRS periodically measures taxpayer compliance and the tax gap that results from misreporting, including those for individual taxpayers with rental real estate activity. The portion of IRS's 2001 tax gap estimate caused by individual underreporting is based on NRP. Through NRP, IRS conducted a review and examination of a representative sample of about 46,000 individual tax returns from tax year 2001. IRS generalized from the NRP sample results to compute estimates of underreporting of income and taxes for all individual tax returns. Because even the detailed NRP reviews could not detect all misreporting, IRS adjusted the NRP results to account

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<sup>11</sup>In addition to Schedule E and its associated instructions, IRS produces publications that cover rental real estate issues, such as Publication 527, *Residential Rental Property*, and Publication 925, *Passive Activity and At-Risk Rules*.

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for undetected misreporting when estimating the tax gap, as will be discussed in the next section of this report.

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## About Half of Individual Taxpayers with Rental Real Estate Activities Misreported, Often Because of Overstated or Unsubstantiated Expenses

Based on the unadjusted NRP results, at least an estimated 53 percent of taxpayers with rental real estate activity (about 4.8 million out of 8.9 million taxpayers) misreported their rental real estate activities for tax year 2001. Individual taxpayers misreported their rental real estate activities more frequently than some other types of income for tax year 2001. For example, we previously reported that an estimated 10 percent, 17 percent, and 22 percent of individual taxpayers with wage and salary, dividend, and interest income, respectively, misreported their income from these sources.<sup>12</sup> This disparity in compliance undermines the fairness of the tax system, because when some taxpayers fail to pay the amount of taxes they should pay under the law, the burden of funding the nation's commitments falls more heavily on compliant taxpayers.

Individual taxpayers misreported an estimated \$12.4 billion of net income from rental real estate, before adjusting for tax gap purposes.<sup>13</sup> The unadjusted NRP results understate the amount of net misreported income from rental real estate, as they represent only what IRS detected through NRP examinations. IRS knows that it does not detect all misreporting during its examinations. As such, it uses various methodologies and other sources of data to adjust the aggregate NRP results for tax gap purposes to estimate net misreporting for categories of income or activities, such as rental real estate and royalties (total rental real estate income or loss is reported on the same line of Schedule E). After these adjustments, IRS estimated that the tax gap for rental real estate and royalty activities was \$13 billion for tax year 2001. Misreported rental real estate likely accounted for most of the \$13 billion because taxpayers misreported an estimated \$23.7 million of net income from royalties<sup>14</sup> compared to the \$12.4 billion of net income from rental real estate that taxpayers misreported.

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<sup>12</sup>GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

<sup>13</sup>Estimate has a margin of error of less than 21 percent.

<sup>14</sup>We are 95 percent confident that taxpayers who misreported their net income from royalties misreported from -\$15.5 million to \$63.0 million, meaning that these taxpayers may have reported more net income from royalties than they should have.

Of the 4.8 million taxpayers who misreported their rental real estate activities, an estimated 75 percent underreported their net income from rental real estate (by either understating rent received or overstating expenses or loss). For these taxpayers, a relatively small number underreported \$10,000 or more in net income from rental real estate, but these taxpayers accounted for a large amount of misreported net income, as shown in table 1. Conversely, nearly one-third of underreporting taxpayers (about 1.2 million out of about 3.6 million underreporting taxpayers) underreported less than \$1,000. By comparison, an estimated 25 percent of taxpayers who misreported rental real estate activities overreported their net income from rental real estate (by overstating rent received or understating expenses or loss), although the amounts they misreported were relatively small. For example, the estimated median amount of net income that misreporting taxpayers overreported was \$518,<sup>15</sup> about one-quarter of the median amount of net income of \$1,981<sup>16</sup> that misreporting taxpayers underreported. Some taxpayers who misreported did so in a way that may not have affected the amount of income tax they owed but may have affected the amount of employment tax they owed, as discussed later in this report.

**Table 1: Distribution of the Estimated Amount of Net Misreported Income from Rental Real Estate by Individual Taxpayers, Tax Year 2001**

Net misreported amount	Number of misreporting taxpayers (millions)	Percentage of misreporting taxpayers	Net misreported income (billions of dollars)
<b>Overreporting taxpayers</b>			
Less than \$1,000	0.7	16	-\$0.2
\$1,000 and greater	0.4	9	-1.9
<b>Underreporting taxpayers</b>			
Less than \$1,000	1.2	24	0.4
\$1,000 to \$9,999	2.1	45	7.8
\$10,000 and greater	0.3	6	6.3
<b>Total</b>	<b>4.8</b>	<b>100</b>	<b>\$12.4</b>

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

Notes: Figures for the number of misreporting taxpayers do not sum to the total because of rounding. Percentage estimates have margins of error of less than 5 percentage points. Value estimates have margins of error of less than 40 percent.

<sup>15</sup> Estimate has a margin of error of less than 44 percent.

<sup>16</sup> Estimate has a margin of error of less than 26 percent.

In terms of income levels, the distribution of taxpayers who misreported rental real estate activity did not vary greatly from the income levels for all taxpayers who reported rental real estate activity for tax year 2001, as shown in table 2. However, taxpayers who reported—and misreported—rental real estate activity were generally of higher income levels than all individual taxpayers. Most of the misreporting, in dollar terms, was attributed to taxpayers with more than \$50,000 of adjusted gross income.

**Table 2: Estimated Distribution of All Individual Taxpayers and Individual Taxpayers Who Reported and Misreported Rental Real Estate Activity and Associated Net Misreported Amounts by Adjusted Gross Income, Tax Year 2001**

Adjusted gross income	Percentage of all individual taxpayers	Percentage of individual taxpayers reporting rental real estate activity	Percentage of individual taxpayers misreporting rental real estate activity	Net misreported income (billions of dollars)
Less than \$25,000	46	24	20	\$2.5
\$25,000 to \$49,999	25	22	23	1.7
\$50,000 to \$99,999	20	31	34	3.9
\$100,000 or greater	9	24	23	4.3
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>\$12.4</b>

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

Notes: Estimates for individual taxpayers reporting rental real estate activity do not sum to 100 percent because of rounding. For misreporting taxpayers, estimates have margins of error of less than 5 percentage points. For taxpayers reporting rental real estate activity and all individual taxpayers, estimates have margins of error of less than 2 percentage points. For net misreported amounts, estimates have margins of error of less than 49 percent.

### Misreporting of Rental Real Estate Expenses Was the Most Common Type of Misreporting We Found That IRS Detected during NRP Examinations

As shown in table 3, misreporting of rental real estate expenses was the most common type of misreporting that we found through our file review that IRS detected through the NRP examinations of taxpayers with rental real estate activity. The figures in table 3 do not include additional misreporting that IRS assumes to have taken place, which it takes into account when estimating the tax gap. Following table 3 we discuss the specific types of misreporting that we found IRS to have detected through NRP.

**Table 3: 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	Number of misreporting taxpayers (millions)	Estimated percentage of taxpayers with rental real estate activity who misreported	Net misreported income (billions of dollars)
Misreported rental real estate expenses	3.9	43	\$9.0
Misreported rent received	1.3	15	<sup>a</sup>
Reported activity on an incorrect part of the individual tax return	0.5	6	<sup>a</sup>
Misreported loss from rental real estate	<sup>a</sup>	2	<sup>a</sup>
Other types of misreporting	0.4	5	<sup>a</sup>
All types of misreporting	4.8	53	\$12.4

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

Notes: Some taxpayers misreported rental real estate activity for more than one type of misreporting. As such, estimates for types of misreporting do not sum to totals. Estimates in this table do not include some instances of misreporting from 10 cases where we could not determine the type of misreporting. Other types of misreporting included taxpayers who made errors elsewhere on their tax returns that led to errors in reporting rental real estate activities or errors that were made by taxpayers' paid tax return preparers. Estimates for numbers of taxpayers have margins of error of less than 34 percent. Estimates for percentages of taxpayers have margins of error of less than 4 percentage points. The estimate for net misreported income due to misreported rental real estate expenses has a margin of error of less than 24 percent.

<sup>a</sup>We could not provide a reliable estimate for this type of misreporting.

### Misreported Rental Real Estate Expenses

The most common reason why taxpayers misreported their rental real estate expenses was because they lacked documentation to substantiate some of the expenses they deducted, as shown in table 4.<sup>17</sup>

<sup>17</sup>For the purposes of this report, we characterize taxpayers who could not substantiate expenses that IRS ultimately disallowed as having misreported.

**Table 4: Estimated Frequency of Types of Misreporting of Rental Real Estate Expenses by Individual Taxpayers, Tax Year 2001**

Type of expense misreporting	Number of misreporting taxpayers (millions)	Estimated percentage of taxpayers with rental real estate activity who misreported	Net misreported income (billions of dollars)
Did not substantiate a reported expense	2.1	24	\$5.2
Did not report or fully report an allowed expense	1.7	19	-2.6
Miscalculated depreciation	1.0	11	<sup>a</sup>
Improperly deducted personal expenses	1.0	11	3.2
Deducted an expense in full that should have been depreciated	0.5	5	1.7
Misreported rental expenses for other reasons	1.0	12	1.9
All types of misreporting of expenses	3.9	43	\$9.0

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

Notes: Some taxpayers misreported rental real estate activity for more than one type of misreporting. As such, estimates for types of expense misreporting do not sum to totals. Estimates for numbers of taxpayers have margins of error of less than 32 percent. Estimates for percentages of taxpayers have margins of error of less than 3 percentage points. Dollar estimates have margins of error of less than 41 percent.

<sup>a</sup>We could not provide a reliable estimate for net misreported income from miscalculated depreciation.

For taxpayers who did not substantiate expenses, some may have incurred the expenses they could not document while other taxpayers may simply have made up expenses. Generally, we could not discern from our case file review why taxpayers did not substantiate reported expenses.

We found two scenarios for taxpayers who did not report or fully report all allowable expenses. During the course of IRS’s examinations, some taxpayers discovered additional expenses for properties that they reported on their tax returns. For other taxpayers, unreported expenses were related to properties for which they received rent that they did not report on their tax returns—and that IRS subsequently identified. For these properties, IRS required the taxpayers to report the rent that they received and allowed them to deduct related expenses that they could document. We could not estimate the frequency of these scenarios because we could not always determine whether the unreported expenses were related to unreported rent.

Taxpayers misreported depreciation expenses in a variety of ways. We estimate that about 166,000 taxpayers included the value of their land

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within the depreciable basis of their properties.<sup>18</sup> Other types of misreported depreciation included taxpayers deducting depreciation for properties that they had already fully depreciated or miscalculating depreciation by using an incorrect length of time (useful life) over which to depreciate property.

Additional ways in which taxpayers misreported rental real estate expenses included the following:

- Deducting expenses in full that should have been depreciated. For example, taxpayers deducted expenses related to improving a property or deducted the full expense of buying an item, such as a washing machine, instead of depreciating these costs.
- Improperly deducting personal expenses. Some taxpayers deducted expenses that were completely personal in nature while others made errors in how they divided expenses that were for both personal and rental real estate purposes.
- Other types of misreporting of expenses. These included taxpayers deducting unallowable expenses, such as penalties or interest related to real estate taxes, or making mathematical errors on their tax returns.

## Misreported Rent Received

We identified three scenarios for taxpayers who misreported rent received.

- Taxpayers who did not report any rental activity.
- Taxpayers who reported receiving rent for some properties but not for others.
- Taxpayers who reported receiving rent for all of their properties but reported incorrect rent amounts. Some examples of misreporting rent in this manner included taxpayers failing to count certain items as rent, such as expenses paid by tenants or kept security deposits, or having inadequate records.

We could not estimate the frequency of these scenarios because we could not always determine the exact nature of the misreported rent.

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<sup>18</sup>Estimate has a margin of error of less than 17 percent. We could not reliably estimate net misreported income for taxpayers who included the value of land within depreciable basis because of the small number of cases in our sample for which we identified this type of misreporting.

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**Reported Activity on an  
Incorrect Part of the Individual  
Tax Return**

This type of misreporting includes taxpayers who reported income or expenses as rental real estate activity on Part I of Schedule E that they should have reported elsewhere on their tax returns and taxpayers who reported an activity elsewhere on their tax returns that they should have reported on Part I of Schedule E. For example, some taxpayers reported business activities as rental real estate activities on Part I of Schedule E that IRS determined should have been reported on the schedule to the individual tax return for profit and loss from business (Schedule C). We also found taxpayers who reported income or expenses on Schedule C that should have been reported as rental real estate activity on Part I of Schedule E. This type of misreporting may not have affected the calculation of the amount of income tax owed. However, reporting activities on the wrong schedule could have affected the amount of self-employment tax these taxpayers owed, as net income from a trade or business is subject to self-employment tax whereas net income from rental real estate reported on Schedule E generally is not. IRS estimated that underreported self-employment tax accounted for \$39 billion of the 2001 tax gap.

**Misreported Loss from Rental  
Real Estate**

The most common reason why taxpayers misreported loss from their rental real estate activities was because they also used their rental property as a residence—including taxpayers who rented their properties at less than a fair rental price—and claimed a loss to which they were not entitled. Other reasons why taxpayers misreported loss were because they were not actively participating in their rental real estate activities or

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exceeded applicable income limitations for deducting a loss from rental real estate.<sup>19</sup>

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## Limited Information Reporting and Complexity Hinder Compliance, and Various Options Exist for Improving Compliance

Limited information reporting, complexity, and the number of taxpayers misreporting are challenges IRS faces in ensuring compliance with rental real estate reporting. IRS receives information returns for a relatively small number of taxpayers with rental real estate activity. For tax year 2001, for example, IRS received Forms 1099-MISC reporting rent received for about 327,000 taxpayers who reported rent on their tax returns.<sup>20</sup> By comparison, there were about 8.2 million taxpayers who reported rent on their tax returns for whom IRS did not receive a corresponding Form 1099-MISC from a third party reporting the rent. For taxpayers who deduct rental real estate expenses, IRS generally receives information returns from third parties only for mortgage interest that taxpayers pay. For tax year 2001, about 55 percent of taxpayers who reported rental real estate activity deducted mortgage interest, accounting for about 36 percent of the total amount of all rental expenses, including depreciation, that taxpayers deducted for that year. As a result, about 64 percent of the total amount of all rental real estate expenses taxpayers reported may not have been subject to information reporting.

IRS enforcement officials cited limited information reporting as a major challenge in ensuring compliance for the reporting of rental real estate activities because without third-party information reporting it is difficult

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<sup>19</sup>Rental real estate activities are generally considered passive activities, and the amount of loss that taxpayers can deduct for these activities is limited. Generally, taxpayers cannot deduct losses from rental real estate activities unless they have income from other passive activities. Taxpayers may be able to deduct some rental real estate losses without regard to whether they have income from other passive activities if they actively participate in their rental activities (such as by selecting tenants or deciding on rental terms) and own at least 10 percent, by value, of their rental properties. Taxpayers who actively participate in a rental real estate activity can deduct up to \$25,000 of loss from their nonpassive income (\$12,500 for taxpayers who are married but file separate tax returns) if they do not exceed certain income limits. Losses for taxpayers who are real estate professionals and materially participated in their rental activities are not limited by these passive activity rules. To qualify as a real estate professional for the purposes of this exception, taxpayers must perform more than 750 hours of services in real property trades or businesses in which they materially participate during the tax year and more than half of all the personal services they perform during the tax year must have been for real property trades or businesses in which they materially participated. They also must materially participate in each of their rental activities for the activities to be considered nonpassive. 26 U.S.C. § 469.

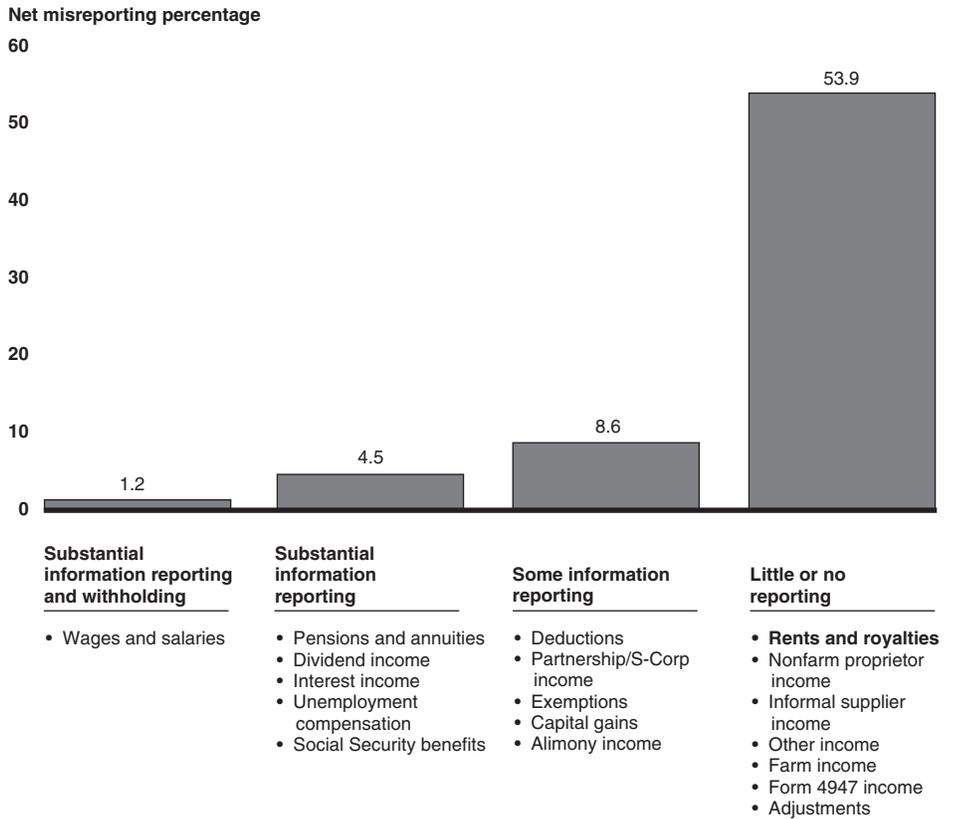
<sup>20</sup>Estimate has a margin of error of less than 11 percent.

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for IRS to systematically detect taxpayers who fail to report any rent or determine whether the rent and expense amounts taxpayers report are accurate. The officials also told us that because third parties are not required to include on Form 1098 the address of the property for which they are reporting mortgage interest, IRS is less able to determine if the interest is for a property used for rental or personal purposes.

In addition, limited information reporting on rental real estate activities results in lower levels of taxpayer voluntary compliance in reporting rental real estate activities when compared to other types of income or activities covered by more extensive information reporting. Taxpayers tend to more accurately report income that third parties report on information returns—such as Forms 1099-MISC and 1098—because the income is transparent to taxpayers as well as to IRS. As shown in figure 1, individual taxpayers misreport receiving rent to a greater extent than they misreport income subject to more extensive information reporting.

**Figure 1: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Information Reporting, Tax Year 2001**



Source: IRS.

Although information reporting tends to lead to high rates of compliance, requiring all individuals who pay rent to report to IRS the annual amount of rent they pay to property owners or their intermediaries is not practical. Officials at IRS and representatives from the tax return preparation industry told us that although such a requirement would likely improve compliance, it would place a substantial burden on taxpayers, who may not have any incentive to comply. Likewise, the requirement would be very difficult for IRS to enforce given the large number of potential information return filers.

IRS compliance officials and representatives of the paid tax return preparer industry told us that the complexity involved in reporting rental real estate activities also hampers compliance. For example, the rules

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surrounding whether to file Forms 1099-MISC or how to accurately depreciate property may be challenging for some taxpayers to understand.

Due to limited information reporting and the complexity of reporting for rental real estate activity, IRS primarily addresses rental real estate misreporting through field and office examinations. IRS supplements examination coverage for rental real estate misreporting through AUR, to a limited extent, based on rental income amounts reported on Form 1099-MISC or mortgage interest reported on Form 1098.<sup>21</sup>

Given the limited extent of information reporting, it can be difficult for IRS to identify misreporting taxpayers. Also, field examinations are resource intensive and on average address relatively large amounts of misreporting compared to the misreported amounts for most taxpayers who misreported rental real estate activity. For example, for fiscal year 2006, the average tax assessment IRS recommended for field examinations of individual taxpayers was about \$18,000 per taxpayer. We found that taxpayers who underreported their net income from rental real estate misreported an average of \$4,055.<sup>22</sup> As a consequence, field examinations may not be a cost-effective tool for targeting most rental real estate misreporting. Further, the number of individual taxpayers misreporting rental real estate activity (4.8 million) is large relative to the approximately 300,000 field examinations of individual taxpayers IRS conducted in fiscal year 2006. According to IRS's examination program, relatively small amounts of misreporting are more likely to be addressed through correspondence examinations.

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## Various Options Exist for Improving Rental Real Estate Reporting Compliance

Although as previously discussed, implementing broad, new third-party information reporting requirements for rental real estate activities is not practical, changing existing requirements is one of various options that could improve rental real estate reporting compliance. One change to current information reporting requirements that could improve rental real estate income reporting compliance is to require third parties to include mortgaged property addresses when reporting taxpayers' mortgage

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<sup>21</sup>Rent and royalty information is combined in AUR. Through AUR, IRS assessed an average of about \$12 million in additional taxes for about 5,100 taxpayers who misreported rent and royalties from 2001 through 2005. We could not determine how often IRS assessed additional taxes for taxpayers who misreported mortgage interest for their rental properties because Form 1098 does not indicate if reported mortgage interest is from rental properties versus other types of properties, such as personal residences.

<sup>22</sup>Estimate has a margin of error of less than 15 percent.

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interest payments on Form 1098. As previously noted, not having property addresses on Form 1098 hinders IRS's efforts to enforce rental real estate reporting compliance. IRS officials told us that having third parties consistently report property addresses on Form 1098 would help them in their enforcement efforts, for example, by allowing them to better distinguish between owner-occupied and rental properties. Also, taxpayers who receive Forms 1098 that include the addresses of their rental properties could be deterred from failing to report activity for their properties. Representatives of the mortgage banking industry told us that it would be feasible to report property address information on Form 1098 because mortgage lenders maintain this information. The representatives also told us that reporting this information would involve costs because lenders would have to change their reporting systems. They said that such costs would be lessened if lenders were only required to send property address information to IRS, which they would send electronically, and not to taxpayers, for whom the lenders may send Forms 1098 on paper, as changing systems for electronic submissions is less costly than changing systems for printed forms. However, excluding property address information from Forms 1098 sent to taxpayers might eliminate any deterrent effect.

Another potential change to existing information reporting requirements is to expand the requirement for taxpayers to file Forms 1099-MISC for certain payments they deduct as expenses, for example, when taxpayers pay contractors to perform repair work on their rental properties. Existing law on whether taxpayers must file information returns on selected rental real estate expenses they incur requires a case-by-case analysis that depends on the facts and circumstances for each taxpayer. Currently, only taxpayers whose rental real estate activity is considered a trade or business are required to report payments on Form 1099-MISC. However, the law for filing information returns<sup>23</sup> does not clearly spell out how to determine whether taxpayers' rental real estate activity should be considered a trade or business, and IRS must make this determination on a case-by-case basis. Without concrete statutory language, it may be difficult for taxpayers who report rental real estate activity to determine if they are required to file Forms 1099-MISC for certain expense payments they make. As a result, it is possible that some taxpayers who should file Forms 1099-MISC for payments they make in the course of renting out real estate may not file the forms. IRS does not have data on the number of taxpayers who

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<sup>23</sup>26 U.S.C. § 6041.

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file Form 1099-MISC reporting expense payments from rental real estate activities. Taxpayers are not required to indicate on Form 1099-MISC the type of activity for which they are filing the form (e.g., business activity on Schedule C versus rental real estate activity on Schedule E). Therefore, under current statutory and regulatory guidance, it is not possible for IRS to determine the activities for which Forms 1099-MISC are filed.

Although it would be a departure from the trade or business requirement, making all taxpayers with rental real estate activity subject to the Form 1099-MISC filing requirement would provide clear guidance for who must file Forms 1099-MISC.<sup>24</sup> Such clarity could benefit both IRS and taxpayers. Taxpayers would have clear direction on whether they had to file the form. As previously discussed, we found through our file review that a large amount of misreported net income from rental real estate was from taxpayers for whom IRS disallowed expenses that the taxpayers could not substantiate. It is likely that some of these taxpayers reported on their tax returns expenses that they did not incur. Requiring taxpayers to file information returns for certain rental real estate expense payments could deter these taxpayers from reporting expenses they did not incur because IRS would have a record of expenses it could use as part of an enforcement action. Given the magnitude of misreporting for taxpayers who could not substantiate some rental real estate expenses they deducted, even small improvements in compliance could yield substantial revenue.

Also, a change to the Form 1099-MISC filing requirement would put taxpayers reporting rental real estate on par with other individual taxpayers, such as sole proprietors of other types of trades or businesses, who are generally required to file Forms 1099-MISC. Currently taxpayers reporting rental real estate expenses whose activities are not considered a trade or business and sole proprietors of other types of business who generate similar amounts of gross income from their activities are treated differently based on the information return statutes. For example, a taxpayer with rental real estate activities not considered a trade or business would not have to file an information return reporting a payment made to an individual contractor for repair services whereas a sole proprietor engaged in a trade or business would have to file for a similar service, assuming the payments exceeded the minimum reportable amount

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<sup>24</sup>An expansion of this requirement could also apply to other entities that report rental real estate activity, such as partnerships.

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threshold. It is questionable whether, without additional statutory authority, IRS can require all taxpayers with rental real estate activities to report expense payments on Forms 1099-MISC regardless of whether their activities are trades or businesses.

An expansion of the Form 1099-MISC filing requirement could have the added benefit of improving compliance among payment recipients, such as contractors who are sole proprietors, because additional payments would be transparent to IRS and the payment recipients. IRS estimated that sole proprietors misreport at a relatively high rate and accounted for a significant portion—\$68 billion—of the tax gap for tax year 2001.

Extending the Form 1099-MISC filing requirement to additional taxpayers who report rental real estate involves costs and burdens for taxpayers. Many taxpayers who were not required to file in the past or were unaware of the filing requirement would have to learn the reporting rules and file Form 1099-MISC. However, not all individual taxpayers with rental activity would have to file Form 1099-MISC because not all will have paid \$600 or more to a single individual during the tax year, which is the threshold for the reporting requirement.<sup>25</sup> One way to further limit the number of taxpayers with rental real estate activity that would be required to file Form 1099-MISC would be to increase the exemption amount for payments to a single person. The \$600 or more threshold for reporting payments made in the course of a trade or business has not been updated since the 1950s, and as such a greater percentage of payments are likely subject to reporting than when the requirement was first put in place because of inflation.

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<sup>25</sup>For example, for tax year 2001, an estimated 5.3 million taxpayers reported expenses of \$600 or more for any line item on Part I of Schedule E, not including mortgage interest, which is already reported by third parties, and taxes, because tax payments to municipal governments generally do not have to be reported on information returns. By comparison, 8.9 million individual taxpayers reported rental real estate activity on Part I of Schedule E. The 5.3 million figure likely overstates the number of taxpayers who paid \$600 or more to a single individual because (1) some expenses reported on Part I of Schedule E could have related to royalty rather than rental real estate activity and (2) some expenses of \$600 or more in the aggregate for a given line item may have been for payments to multiple individuals. For example, if a taxpayer reported a repair expense of \$1,000 dollars, we concluded that the taxpayer could have been required to file a Form 1099-MISC because he or she could have contracted the repair service from one individual. However, this taxpayer may have paid two separate individuals \$500 each, in which case the taxpayer would not have had to file Forms 1099-MISC reporting the payments for either individual. It is also possible, however, that a taxpayer could have made payments to a single individual that the taxpayer reported on more than one line item.

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One obstacle for taxpayers in determining if they are required to file Form 1099-MISC is that generally taxpayers do not have to file the forms for payments made to corporations. As such, taxpayers must figure out whether the persons or businesses to which they make payments are incorporated to determine whether they need to file Form 1099-MISC. A way to remove this obstacle is to expand information reporting to include payments made to corporations. In the past, we have identified requiring information reporting on payments made to corporations as a way to improve compliance.<sup>26</sup> Also, the administration in its fiscal year 2009 budget proposed requiring information reporting on payments to corporations.<sup>27</sup>

Additionally, IRS would need to inform taxpayers and others of the expanded Form 1099-MISC filing requirement. Communicating the requirement could be complicated by the different deadlines for filing Form 1099-MISC and the individual tax return. Taxpayers must send Form 1099-MISC to payment recipients by January 31, whereas the deadline to file tax returns is April 15.<sup>28</sup> Filing Form 1099-MISC past the deadline may result in a penalty. Taxpayers who are newly required to file Form 1099-MISC may not learn of the requirement until they begin to prepare their tax returns, which some may not begin to do until after the January 31 Form 1099-MISC filing deadline. IRS compliance officials told us that taxpayers who realize that they are late in filing required Forms 1099-MISC may choose not to file them rather than run the risk of incurring penalties from filing late. One way to lessen the impact of potential penalties on taxpayers who are newly required to file Form 1099-MISC would be to waive penalties for late filers the first year they are required to file.

We are examining issues involved with filing Form 1099-MISC in a forthcoming report. As such, we did not examine in depth some of the issues involved with filing Form 1099-MISC that we highlighted in this report, such as increasing the reporting threshold, requiring reporting for payments made to corporations, and penalties.

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<sup>26</sup>GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, [GAO-06-1000T](#) (Washington, D.C.: July 26, 2006).

<sup>27</sup>Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*.

<sup>28</sup>Taxpayers must file Forms 1099-MISC with IRS by February 28 or by March 31 if filing electronically.

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## Requiring Taxpayers to Report Additional Information on Tax Returns for Rental Real Estate Activity Could Improve Rental Real Estate Reporting Compliance

Requiring taxpayers to report additional information on their tax returns for their rental real estate activity could improve rental real estate reporting compliance by eliciting more accurate information from taxpayers and providing IRS with additional information to detect misreporting. As previously discussed, the requirements for reporting rental real estate activities are complex. Such complexity may be why individual taxpayers reporting this activity use paid preparers more frequently than other individual taxpayers. For example, for tax year 2001, an estimated 77 percent of individual taxpayers reporting rental real estate activity used a paid tax return preparer.<sup>29</sup> By comparison, an estimated 56 percent of all individual taxpayers used a paid preparer for that tax year.<sup>30</sup> As we have said in past reports, paid preparers are a critical quality-control checkpoint for the tax system and the quality of service they provide is important.<sup>31</sup> However, taxpayers with rental real estate activity who used a paid preparer were statistically as likely to have misreported as taxpayers with rental real estate activity who prepared their returns themselves.<sup>32</sup>

One of the challenges that paid preparers encounter when preparing returns for taxpayers with rental real estate activity is that the preparers do not always receive complete or accurate information from taxpayers. Requiring preparers to verify taxpayers' documentation of rental real estate expenses or perform increased due diligence of taxpayers' rental real estate activities could improve the accuracy of what taxpayers report. However, both of these requirements would involve substantial costs and

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<sup>29</sup>For 2005, use of paid preparers by taxpayers with rental real estate activity was about 81 percent. In addition, an unknown number of taxpayers who self-prepared their tax returns may use tax return preparation software.

<sup>30</sup>For 2005, use of paid preparers by all individual taxpayers was about 60 percent.

<sup>31</sup>GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, [GAO-08-38](#) (Washington, D.C.: Nov. 15, 2007).

<sup>32</sup>Fifty-three percent of taxpayers who had rental real estate activity and used a paid preparer misreported their rental real estate activity (estimate has a margin of error of less than 5 percentage points), and 55 percent of taxpayers who had rental real estate activity and prepared their own returns misreported (estimate has a margin of error of less than 8 percentage points). The difference between these two estimates is not statistically significant. We previously reported that some tax return preparers made serious errors when completing returns. See GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, [GAO-06-563T](#) (Washington, D.C.: Apr. 4, 2006).

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burdens for paid preparers, taxpayers, and IRS that could outweigh any related compliance benefits.

Requiring taxpayers to report additional information for their rental real estate activities on their tax returns is an alternative way to elicit more accurate and complete information from taxpayers who use paid preparers—as well as taxpayers who self-prepare. These additions would add a level of due diligence because paid preparers would have to obtain additional information on taxpayers' income and expenses in order to complete the taxpayers' returns. For example, requiring taxpayers to report on Part I of Schedule E if they filed a Form 1099-MISC for one or more deducted expenses, such as through a check-the-box question, could increase taxpayer awareness of the requirement and prompt paid preparers to ask taxpayers questions about the nature of their clients' expenses, which could improve the accuracy of the expenses taxpayers report. IRS compliance officials were uncertain if having this information for use in its enforcement efforts would provide additional compliance benefits. As we are examining issues involved with filing Form 1099-MISC in a forthcoming report, we did not examine whether requiring taxpayers to indicate on their tax returns if they filed a Form 1099-MISC would be a cost-effective way to improve compliance.

As previously mentioned, about 166,000 taxpayers improperly included the value of land when depreciating their rental properties. Requiring taxpayers to report on their tax returns the basis amount attributed to land versus structure when depreciating rental property could further improve compliance. With such a requirement, IRS could identify taxpayers who depreciated land or may have undervalued their land when calculating depreciation.<sup>33</sup> This requirement would not be unprecedented, as IRS currently requires taxpayers to report the value of their land when determining the amount of depreciation to deduct for the business use of their homes.<sup>34</sup>

Also, through our file review, we found that taxpayers do not always report on their tax returns the type of property they rented out. The instructions to Schedule E currently provide the example of “townhouse” as the type of information taxpayers should report on property type on

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<sup>33</sup>An IRS technical advisor told us that allocating the value of a property attributed to land can vary greatly depending on the type and location of the property.

<sup>34</sup>Taxpayers use Form 8829 to deduct business expenses from the use of their homes.

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Part I of Schedule E. The instructions do not ask the taxpayer to report if the house was rented for residential, vacation, commercial, or other purposes, for example. If IRS is to use information on property type in its enforcement efforts, it needs to receive consistent information, such as that which taxpayers could provide by answering a check-the-box question that included the various types of properties taxpayers might rent out.

Although such a check-the-box question would provide IRS with more consistent information on property type, including such a question on Part I of Schedule E would involve challenges. For example, IRS would need to clearly define the different types of properties taxpayers might report, and some rental properties could be used for multiple purposes. Also, IRS compliance officials were uncertain to what extent IRS could use this information in its enforcement efforts.

Finally, we found that about 36 percent of taxpayers reporting rental real estate activity did not include the complete address of their rental properties on their tax returns for tax year 2001. Although the instructions to Schedule E direct taxpayers to report the street address, city or town, and state for their properties (the instructions state that taxpayers do not have to report zip codes), the language on the actual form directs taxpayers to list the “location” of their rental real estate properties. Specifically directing taxpayers to report complete property addresses could increase the number of taxpayers reporting addresses, rather than general location information. According to IRS examination officials, having complete address information would allow IRS examiners to use commercially available data sources on property values to help determine fair rental prices for taxpayers whose returns are selected for examination. Whether having complete address information could also cost effectively enhance IRS’s examination selection process is less clear, according to the officials.

Providing Taxpayers with Additional Guidance on Rental Real Estate Reporting Requirements Could Improve Compliance, Although to What Extent Is Difficult to Measure

Another way to help taxpayers to more accurately report their rental real estate activities is by providing them with additional guidance to help them complete their tax returns. The impact on the tax gap from providing additional guidance may be difficult to measure, as IRS researchers have found it difficult to determine the extent to which taxpayer services, such as tax form instructions, improve compliance among taxpayers who want to comply. Likewise, providing taxpayers with additional guidance does not guarantee that the taxpayers will actually read the guidance, especially those who use paid preparers, and would not affect taxpayers who willfully misreported. Regardless, providing taxpayers with additional guidance could produce compliance benefits among taxpayers who want

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to comply that exceed the related implementation costs, which may be low relative to other actions IRS could take to improve compliance, such as increased enforcement efforts. Providing additional guidance could be particularly helpful for taxpayers who use tax return preparation software to prepare their returns if the software included or is based on the guidance.

For example, regardless of whether the requirement for who must file a Form 1099-MISC changes in the future, at least some taxpayers who reported rental real estate activity are currently required to file. However, the instructions to Schedule E do not discuss this requirement. Including guidance on the Form 1099-MISC filing requirement in the instructions to Schedule E could inform taxpayers of the requirement and could result in more taxpayers filing the form.

Likewise, IRS's publication on residential rental property<sup>35</sup> discusses that land cannot be depreciated and provides guidance on how taxpayers can determine the value of their land. Although the instructions to Schedule E also state that land cannot be depreciated, they do not provide guidance on how to determine the value of land. Representatives from the tax return preparation industry told us that taxpayers are more likely to review tax form instructions than IRS publications. As such, providing guidance on resources available to taxpayers for determining how to distinguish between the cost of land versus the cost of structures in the instructions to Schedule E could help taxpayers more accurately determine the value of their land, which could help them more accurately report depreciation.

With regard to recordkeeping, IRS produces a publication with general guidance for individual taxpayers.<sup>36</sup> However, recordkeeping requirements for expense deductions are only discussed in the instructions to Part I of Schedule E with regard to deducting mortgage or other interest. Providing general guidance on recordkeeping requirements in the instructions to Part I of Schedule E could encourage taxpayers to keep better records, which could lead to more accurate reporting. The instructions could also include language similar to that in IRS's publication on recordkeeping, explaining that taxpayers who, upon IRS examination, cannot produce records to substantiate items they report on their tax returns may be

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<sup>35</sup>IRS Publication 527, *Residential Rental Property*, and IRS Publication 946, *How to Depreciate Property*.

<sup>36</sup>IRS Publication 552, *Recordkeeping for Individuals*.

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Outreach to Taxpayers and Other Stakeholders Could Improve Understanding of Reporting Requirements and Common Types of Misreporting

subject to additional taxes and penalties. Including this language could increase voluntary compliance by deterring taxpayers from reporting expenses they did not incur.

Given that some taxpayers may not read IRS's guidance, an additional way to inform taxpayers of the reporting requirements is to send them notices covering key requirements and common mistakes taxpayers make with regard to reporting rental real estate activity. In addition to making taxpayers aware of the reporting requirements, such notices could serve as a reminder to taxpayers that IRS is aware that they have rental real estate activity, which in turn could serve as a deterrent to intentional misreporting. These notices could be sent to some taxpayers, such as taxpayers reporting rental real estate for the first time, or all taxpayers who report rental real estate activity. Sending these notices to taxpayers could also help inform paid preparers of the requirements and common types of misreporting given that taxpayers who received such notices would likely share them with their paid preparers, according to representatives of the tax return preparation industry.

However, the cost-effectiveness of sending notices like these is not clear. IRS would have to dedicate resources to take calls from taxpayers who receive the notices and have questions, which would be a likely scenario according to IRS communications officials and representatives of the tax return preparation industry. Producing and sending the notices would also involve costs. Also, IRS would not necessarily be able to target taxpayers who potentially misreported their rental real estate activities when sending the notices. Given these limitations, it would be important for IRS to test the effectiveness of sending notices to taxpayers to determine if they can increase compliance in a cost-effective manner.

A way to indirectly inform taxpayers of the reporting requirements and common types of misreporting for rental real estate is for IRS to enhance its focus on rental real estate in its outreach efforts to paid preparers and other external stakeholders. Outreach to paid preparers could be particularly important given that about 80 percent of individual taxpayers who report rental real estate use a paid preparer,<sup>37</sup> but these taxpayers were as likely to have misreported as taxpayers who self-prepared their tax returns. As previously discussed, IRS produced and disseminated a

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<sup>37</sup>As previously discussed, 77 percent and 81 percent of individual taxpayers who reported rental real estate activity used paid preparers in 2001 and 2005, respectively.

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fact sheet on the requirements for reporting rental real estate activity, although the fact sheet did not include information on common types of misreporting. Providing additional information on the common types of misreporting, such as those we found that IRS identified through NRP examinations, in outreach efforts could help paid preparers assist individual taxpayers to comply with the reporting requirements.

An IRS examination official told us that outreach, such as contacting national paid preparer groups or providing information at IRS Nationwide Tax Forums and other conferences that paid preparers attend to fulfill their continuing professional education requirements, could be a good approach to improving paid preparer due diligence. An IRS official involved with outreach to external stakeholders told us that although in the past IRS had targeted its outreach efforts primarily to individual paid preparers, IRS is starting to reach out to tax return preparation companies and tax preparation software vendors as well. These outreach efforts could include providing information on common types of rental real estate misreporting. Likewise, IRS compliance and stakeholder liaison officials suggested including property managers within IRS outreach efforts for this area of compliance.

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## Conclusions

The disparity in individual taxpayer reporting compliance between net income from sources subject to minimal information reporting, such as rental real estate, and income that is subject to extensive information reporting, such as wages, results in substantial revenue loss and undermines the fairness of our tax system. However, significant obstacles stand in the way of improving tax compliance by owners of rental real estate. There are few practical opportunities for additional third-party information reporting. Some taxpayers may not fully understand the complex rules governing the reporting of rental real estate activity, in part because their heavy reliance on paid preparers means that many taxpayers may not read IRS guidance. Detecting misreporting often requires face-to-face examinations, which are costly to IRS and reach relatively few individual taxpayers.

Nevertheless, opportunities exist to improve compliance by individual taxpayers who own rental real estate. First, existing information reporting requirements could be improved. For example, under current law, only taxpayers whose rental real estate activity is considered a trade or business are required to report expense payments on Form 1099-MISC, but the law for filing the form does not clearly spell out how to determine whether taxpayers' rental real estate activity should be considered a trade

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or business. To hold taxpayers with rental real estate to the same requirements for filing Form 1099-MISC as taxpayers whose activities are considered a trade or business would provide clarity about who is required to file. Likewise, requiring property addresses on Forms 1098 that report mortgage interest could provide IRS with additional information to identify taxpayers who may not have reported rental real estate activity and could deter taxpayers from failing to report. Second, requiring taxpayers to report additional information on their tax returns for their rental real estate activities could force taxpayers to pay more attention to IRS guidance or seek advice from paid preparers, act as a deterrent to intentional misreporting, and compel paid preparers to obtain more accurate income and expense information from taxpayers. Third, although it is unclear the extent to which individual taxpayers read guidance on reporting requirements, especially taxpayers who use paid preparers, enhancements to IRS's guidance on rental real estate reporting requirements could reduce unintentional misreporting. Such enhancements might also be useful to paid preparers and could be reflected in tax preparation software. Fourth, improving outreach efforts could also improve compliance. Given the uncertainty about whether individual taxpayers read IRS guidance, researching the effectiveness of outreach to taxpayers could be beneficial. Also, given the heavy reliance on paid preparers by owners of rental real estate, additional outreach to paid preparers, among others, could be an effective way to indirectly reach large numbers of taxpayers.

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## Matter for Congressional Consideration

To provide clarity for which taxpayers with rental real estate activity must report expense payments on information returns and to provide greater information reporting, Congress should consider amending the Internal Revenue Code to make all taxpayers with rental real estate activity subject to the same information reporting requirements as other taxpayers operating a trade or business.

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## Recommendations for Executive Action

We are making nine recommendations to the Commissioner of Internal Revenue.

To help IRS identify taxpayers who may have misreported their rental real estate activity, we recommend that the Commissioner of Internal Revenue require third parties to report mortgaged property addresses on Form 1098 mortgage interest statements.

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To elicit more accurate information from taxpayers on their rental real estate activities, we recommend that the Commissioner of Internal Revenue

- require taxpayers to report on the individual tax return the basis amount attributed to land versus structure when depreciating rental real estate;
- determine if IRS uses property type information that taxpayers currently report on Schedule E in its efforts to enforce rental real estate reporting compliance, and
  - if it is determined that IRS uses the information, the Commissioner should require taxpayers to provide specific information on Part I of Schedule E about the type of properties for which they are reporting activity, for example by answering a check-the-box question, and
  - if it is determined that IRS does not use the information, the Commissioner should not require taxpayers to report any property type information; and
- require taxpayers to report the exact “address” of their rental real estate properties on Part I Schedule E instead of property “location,” as currently worded, and require taxpayers to report property zip codes.

To help taxpayers understand the requirements related to certain aspects of reporting rental real estate activities, we recommend that the Commissioner of Internal Revenue include guidance within the instructions to Part I of Schedule E on

- the requirement for some taxpayers with rental real estate activity to report on Form 1099-MISC certain payments made in the course of renting out real estate;
- resources available to taxpayers for determining how to distinguish between the cost of land versus the cost of structures; and
- recordkeeping requirements and the potential for disallowed expenses and penalties if taxpayers cannot produce documentation for reported expenses upon examination by IRS.

To enhance IRS’s outreach efforts, we recommend that the Commissioner of Internal Revenue

- evaluate whether sending notices to some or all taxpayers who report rental real estate activity would be a cost-effective way to reduce misreporting of some types of rental real estate activity and

- 
- expand outreach efforts to external stakeholders, such as paid tax return preparers, tax return preparation software providers, and industry groups related to rental real estate, to include common types of misreporting for rental real estate activity, such as those identified in this report.

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## Agency Comments and Our Evaluation

In written comments on a draft of this report, which are reprinted in appendix II, IRS agreed with seven of our nine recommendations. However, IRS agreed only to consider implementing our recommendation to require third parties to report mortgaged property addresses on Form 1098 mortgage interest statements citing the burden the requirement could place on third parties. Although it is important to take third-party burden into account when considering whether to require information reporting, representatives of the mortgage banking industry told us that it would be feasible to report property address information on Form 1098 because mortgage lenders already maintain this information. Also, IRS disagreed with our recommendation to require taxpayers to report on the individual tax return the basis amount attributed to land versus structure when depreciating rental real estate properties. Specifically, IRS stated that taxpayers report depreciation on Form 4562 and not on Schedule E to the individual tax return, and that the basis of land is not used in calculating depreciation. However, taxpayers are not required to report the basis amount attributable to land on Form 4562. Further, we did not specifically recommend on which form or schedule taxpayers should be required to report the value of their land for properties they depreciate. Also, we believe that, in effect, the basis of land is used in calculating depreciation because taxpayers must subtract the value of land from the overall basis of their properties. We found that for tax year 2001, about 166,000 individual taxpayers included the value of land when calculating depreciation for their rental properties. We believe that requiring taxpayers to report the value of land in conjunction with reporting depreciation calculations—whether on Form 4562, Schedule E, or elsewhere—would serve to reduce the number of taxpayers who improperly include the value of land when calculating depreciation for their rental properties. We agree with IRS that more guidance to taxpayers is needed about allocating basis to land.

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested

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parties. Copies will be made available to others upon request. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions, please contact me at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive, flowing style.

James White  
Director, Tax Issues  
Strategic Issues Team

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# Appendix I: Scope and Methodology

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To provide information on the extent and primary types of individual taxpayer misreporting of rental real estate activities, we relied on data and examination case files from the Internal Revenue Service's (IRS) most recent National Research Program (NRP) study of individual taxpayers. Through NRP, IRS selected and reviewed a stratified random sample of 45,925 individual income tax returns from tax year 2001. We selected a sample of cases that included taxpayers with rental real estate activity from this NRP sample. The NRP sample is divided across 30 strata by the type of individual tax return filed and income levels. IRS accepted as filed some of the NRP returns, accepted others with minor adjustments, and examined the remainder of returns either through correspondence or face-to-face meetings with taxpayers. If IRS examiners determined that taxpayers misreported any aspect of the selected tax returns, they adjusted the taxpayers' income accordingly and assessed additional taxes.

IRS captured data from tax returns and examination results in the NRP database, including data for rental real estate activities. However, because taxpayers report expenses from both rental real estate and royalty activities on the same lines of Part I of Schedule E, it is not possible to determine with certainty whether adjustments examiners made in the NRP database to these expense lines were for rental real estate or royalty activities. Likewise, the data do not include detailed information on why examiners made adjustments to rental real estate activities. Therefore, to distinguish between misreporting for rental real estate versus royalty expenses and to identify the primary types of misreporting of rental real estate activities, we selected a statistical sample of NRP examination case files to review.

We selected a sample of 1,202 cases from the tax returns IRS examined from its NRP sample. We selected tax returns for taxpayers who reported rental real estate or royalty activity on Part I of Schedule E.<sup>1</sup> Our sample was made up of four groups: (1) taxpayers for whom IRS made adjustments to rental real estate activity, (2) taxpayers who reported rental real estate activity for whom IRS did not make adjustments to rental real estate activity, (3) taxpayers for whom IRS made adjustments to royalty activity, and (4) taxpayers who reported royalty activity for whom IRS did not make adjustments to royalty activity. We included cases for taxpayers who accurately reported rental real estate activity in order to make comparisons between taxpayers for whom IRS did and did not make

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<sup>1</sup>We used IRS's database of NRP results to identify these taxpayers.

adjustments to rental real estate activity. We selected cases with royalty activity to estimate misreporting from royalties, which IRS combines with misreporting from rental real estate to estimate the tax gap for these two activities.

The first group of cases consisted of 752 cases of taxpayers for whom IRS made an adjustment to rents received, expenses, or loss reported on Part I of Schedule E. Within this group we included, where possible, the 10 cases in each stratum for which the adjustments examiners made had the largest impact on the total amount of these adjustments for all taxpayers when weighted for the entire population of individual taxpayers (a total of 204 cases). We focused on cases with the largest adjustments, in weighted terms, because including these cases would improve the level of confidence of any estimates of the total amount of adjustments to taxpayers' rental real estate activities. We selected the remaining 548 cases in this first group of cases at random and in proportion to the number of NRP returns for which IRS made adjustments to taxpayers' rent, expenses, or loss reported on Part I of Schedule E. Because our sample is a subsample of the NRP sample and is subject to sampling error, we added cases, where applicable, to ensure that each stratum contained a minimum of 5 randomly selected cases.

For the second group of cases we selected 248 cases for taxpayers who reported rents received, expenses, or loss on Part I of Schedule E that IRS did not adjust. We selected these cases at random and in proportion to the NRP sample through an iterative process ensuring, where possible, that a minimum of 5 cases was included in each stratum.

The third group of cases included 102 cases where IRS made an adjustment to taxpayers' royalties received. The aggregate of these 102 cases and 30 cases with adjustments to royalties received selected as part of the first group of cases account for all 132 cases in the NRP database where examiners made adjustments to taxpayers' royalties received. The fourth group consisted of 100 cases, selected at random and in proportion to the NRP sample, for taxpayers who did not report rents received and reported royalties received that IRS did not adjust. We ensured, where possible, that a minimum of 5 cases were included in each stratum.

Of the 1,202 cases we selected for our sample, we reviewed 1,000 cases. We did not review the remaining 202 cases because either IRS did not provide the files in time to include in our review (185 cases) or the files did not contain examination workpapers essential to determine if or why examiners made adjustments to taxpayers' rental real estate activities (17

cases).<sup>2</sup> We requested the cases at two points, in late-May 2007 and late-June 2007, and periodically checked on the status of our requests with IRS. We were only able to review cases that arrived by January 11, 2008, in order to meet our agreed-upon issue date for the report.

We recorded information from the case files using a data collection instrument (DCI) that we developed. To ensure that our data collection efforts conformed to GAO's data quality standards, each DCI entry that a GAO analyst completed was reviewed by another GAO analyst. The reviewers compared the data recorded within the DCI entry to the data in the corresponding case file to determine whether they agreed on how the data were recorded. When the analysts' views on how the data were recorded differed, they met to reconcile any differences.

The estimates we included in this report were based on the NRP database and the data we collected through our file review and were generated using statistical software. All computer programming for the resulting statistical analyses were checked by a second, independent analyst. Our final sample size was large enough to generalize the results of our review for the entire population of individual taxpayers with rental real estate activity or had margins of error small enough to produce meaningful estimates, unless otherwise noted in the report.<sup>3</sup>

Because we followed a probability procedure based on random selection, our sample is only one of a large number of samples that we might have selected. Since each sample could have resulted in different estimates, we express our confidence in the precision of our particular sample's results as a 95 percent confidence interval, plus or minus the margin of error. These intervals would contain the actual population value for 95 percent of the samples we could have selected. Unless otherwise noted, all percentage estimates have a margin of error of less than 5 percentage points; value estimates have a margin of error of less than 8 percent.

We assessed whether the examination results and data contained in the NRP database were sufficiently reliable for the purposes of our review.

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<sup>2</sup>We previously reported on difficulties IRS has had in managing paper case files. See GAO, *Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files*, [GAO-07-1160](#) (Washington, D.C.: Sept. 28, 2007).

<sup>3</sup>We considered margins of error of less than 10 percentage points for percentage estimates and less than 50 percent for value estimates small enough to produce meaningful estimates.

For this assessment, we interviewed IRS officials about the data, collected and reviewed documentation about the data and the system used to capture the data, and compared the information we collected through our case file review to corresponding information in the NRP database to identify inconsistencies. Based on our assessment, we determined that the NRP database was sufficiently reliable for the purposes of our review.

We also used IRS's Statistics of Income (SOI) file for individual taxpayers from tax years 2001 through 2005, which relies on a stratified probability sample of individual income tax returns, to develop estimates on characteristics for taxpayers who reported rental real estate activity. Where possible, we compared our analyses against published IRS data to determine that the SOI database was sufficiently reliable for the purposes of our review.

To identify challenges IRS faces in ensuring rental real estate reporting compliance and to assess options for increasing compliance, we reviewed IRS forms, publications, and other taxpayer guidance related to reporting rental real estate activity and documents from IRS's enforcement programs. We also reviewed data from the Automated Underreporter program and published data on examinations to determine the extent of IRS's enforcement efforts. We also examined data on individual taxpayers from SOI to determine the extent to which (1) individual taxpayers use paid tax return preparers and (2) third parties report information on rental real estate activity on Form 1099-MISC. In addition, we interviewed officials from IRS's Small Business/Self-Employed; Wage and Investment; and Research, Analysis, and Statistics divisions who have knowledge of rental real estate compliance issues. We also spoke with representatives of the American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Residential Property Managers, and Mortgage Bankers Association to get their perspectives on issues related to rental real estate reporting compliance.

We conducted this performance audit from May 2007 through August 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

August 26, 2008

James R. White  
Director, Tax Issues  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to review the Government Accountability Office (GAO) draft report entitled "Tax Gap – Actions That Could Improve Rental Real Estate Reporting Compliance (GAO-08-956)."

We appreciate your comprehensive report and the suggestions to address noncompliance in this area. They will assist us as we strive to address the tax gap through a balanced approach.

We agree there are opportunities to expand our outreach efforts regarding proper reporting for rental real estate activity. We will issue an updated fact sheet on rental real estate, which will include common types of misreporting. We will post this fact sheet on [irs.gov](http://irs.gov) and include the information on the real estate industry web page. This message will also be used in educational outreach to tax professionals and software providers, and appropriate industry organizations, such as rental owner associations.

We also appreciate your suggestions to revise several forms and instructions related to real estate reporting. Unfortunately, due to the complexity of rental real estate issues and limitations of the forms, we are unable to implement all of them.

The enclosed response addresses each of your recommendations separately.

If you have any questions, please contact Christopher Wagner, Acting Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

A handwritten signature in cursive script that reads "Linda E. Stiff".

Linda E. Stiff

Enclosure

Enclosure

GAO Recommendations and IRS Responses to  
GAO Draft Report: Tax Gap – Actions That Could Improve Rental Real Estate  
Reporting Compliance  
GAO-08-956

**RECOMMENDATION:** Require third parties to report mortgaged property addresses on Form 1098 mortgage interest statements.

**Comments:** We will consider requiring third parties to report mortgaged property addresses on Form 1098 mortgage interest statements. Currently, the Form 1098 provides optional reporting of the mortgaged property address. However, it will be an increase in burden to the third parties.

**RECOMMENDATION:** Require taxpayers to report on the individual tax return the basis amount attributed to land versus structure when depreciating rental real estate.

**Comments:** We do not agree with this recommendation. The depreciation calculation is reported on Form 4562, *Depreciation and Amortization*, and not on Schedule E (Form 1040) and the basis of land is not used to compute depreciation. However, we will add information to the instructions for Schedule E (Form 1040) about allocating basis to land.

**RECOMMENDATION:** Determine if IRS uses property type information that taxpayers currently report on Schedule E in its efforts to enforce rental real estate reporting compliance. If it is determined that IRS uses the information, the Commissioner should require taxpayers to provide specific information on Part I of Schedule E about the types of properties for which they are reporting activity, for example by answering a check-the-box question. If it is determined that IRS does not use the information, the Commissioner should not require taxpayers to report any property type information.

**Comments:** We agree to evaluate the use of property type information, currently reported by the taxpayer on Schedule E, in our compliance efforts. As recommended, if it is determined IRS uses property type information in its efforts to enforce rental real estate reporting compliance, we will revise Part I of Schedule E (Form 1040). If it is determined the IRS does not use the information, we will not require taxpayers to report any property type information.

**RECOMMENDATION:** Require taxpayers to report the exact "address" of their rental real estate properties on Part I Schedule E instead of property "location," as currently worded, and require taxpayers to report property zip codes.

2

Comments: We agree that reporting the exact "address" versus "location" of rental real estate will elicit more accurate information from taxpayers on their rental real estate activities, while not imposing a burden. We will change the wording on Part I Schedule E to read, "address, city, state, and zip code."

RECOMMENDATION: Include guidance within the instructions to Part I of Schedule E on the requirement for some taxpayers with rental real estate activity to report on Form 1099-MISC certain payments made in the course of renting out real estate.

Comments: We agree to adopt this recommendation.

RECOMMENDATION: Include guidance within the instructions to Part I of Schedule E on resources available to taxpayers for determining how to distinguish between the cost of land versus the cost of a structure.

Comments: We agree to add guidance in the instructions to Part I of Schedule E (Form 1040) on how to allocate the basis between land versus the cost of a structure.

RECOMMENDATION: Include guidance within the instructions to Part I of Schedule E on recordkeeping requirements and the potential for disallowed expenses and penalties if taxpayers cannot produce documentation for expenses upon examination by the IRS.

Comments: We agree to add guidance within the general instructions of the Schedule E (Form 1040) on recordkeeping requirements and penalties.

RECOMMENDATION: Evaluate whether sending notices to some or all taxpayers who report rental real estate activity would be a cost-effective way to reduce misreporting of some types of rental real estate activity.

Comments: We agree with this recommendation and will conduct a test of approximately 31,000 soft notices for tax year 2007. The sample will include some rent and royalty information documents. IRS will evaluate the results of the soft notice test in FY 2009 and make decisions on its effectiveness and whether it should be expanded in subsequent years.

RECOMMENDATION: Expand outreach efforts to external stakeholders, such as paid tax return preparers, tax return preparation software providers, and industry groups related to rental real estate, to include common types of misreporting for rental real estate activity, such as those identified in this report.

3

Comments: We agree that we can further expand our outreach efforts regarding proper reporting for rental real estate activity. We will issue an updated fact sheet on rental real estate, which will include common types of misreporting. We will post this fact sheet on irs.gov and will include the information on the real estate industry web page. We will also utilize this message in educational outreach to tax professionals, software providers, and to appropriate industry organizations, such as rental owner associations.

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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

James White, (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov)

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## Acknowledgments

In addition to the contact named above, Charlie Daniel, Assistant Director; Jeff Arkin; Ellen Grady; Laura Henry; Shirley Jones; Winchee Lin; John Mingus; Karen O'Connor; Ellen Rominger; Jeff Schmerling; Andrew Stephens; and Elwood White made key contributions to this report.

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# Related GAO Products

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*Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential.* [GAO-08-703SP](#). Washington, D.C.: June 2008.

*Tax Administration: The Internal Revenue Service Can Improve Its Management of Paper Case Files.* [GAO-07-1160](#). Washington, D.C.: September 28, 2007.

*Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance.* [GAO-07-1014](#). Washington, D.C.: July 13, 2007.

*Using Data from the Internal Revenue Service's National Research Program to Identify Potential Opportunities to Reduce the Tax Gap.* [GAO-07-423R](#). Washington, D.C.: March 15, 2007.

*Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap.* [GAO-07-488T](#). Washington, D.C.: February 16, 2007.

*Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap.* [GAO-07-391T](#). Washington, D.C.: January 23, 2007.

*Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches.* [GAO-06-1000T](#). Washington, D.C.: July 26, 2006.

*Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting.* [GAO-06-851T](#). Washington, D.C.: June 13, 2006.

*Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed.* [GAO-06-603](#). Washington, D.C.: June 13, 2006.

*Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions.* [GAO-06-453T](#). Washington, D.C.: February 15, 2006.

*Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance.* [GAO-06-208T](#). Washington, D.C.: October 26, 2005.

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*Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap.* [GAO-05-753](#). Washington, D.C.: July 18, 2005.

*Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies.* [GAO-05-527T](#). Washington, D.C.: April 14, 2005.

*Tax Administration: IRS Is Implementing the National Research Program as Planned.* [GAO-03-614](#). Washington, D.C.: June 16, 2003.

*Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains.* [GAO-02-769](#). Washington, D.C.: June 27, 2002.

*Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance.* [GAO-01-535](#). Washington, D.C.: June 18, 2001.

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