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Report to the Joint Committee on Taxation

May 2009

REAL ESTATE TAX DEDUCTION

Taxpayers Face Challenges in Determining What Qualifies; Better Information Could Improve Compliance

GAO

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GAO-09-521

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Highlights

Highlights of GAO-09-521, a report to the Joint Committee on Taxation

Why GAO Did This Study

The Joint Committee on Taxation identified improved taxpayer compliance with the real-estate tax deduction as a way to reduce the federal tax gap—the difference between taxes owed and taxes voluntarily and timely paid.

Regarding the deduction, GAO was asked to examine (1) factors that contribute to taxpayers including nondeductible charges, (2) the extent that taxpayers may be claiming such charges, (3) the extent that Internal Revenue Service (IRS) examinations focus on the inclusion of such charges, and (4) possible options for improving taxpayer compliance. GAO surveyed a generalizable sample of local governments, studied taxpayer compliance in two jurisdictions that met selection criteria, reviewed IRS documents, and interviewed government officials and others. Addressing the complexity of current tax law on real-estate tax deductions was outside the scope of this review.

What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue change IRS guidance to taxpayers, revise IRS guidance for auditing the deduction, identify a cost-effective means of obtaining information on tax bill charges, and conduct outreach to local governments and others on options for helping taxpayers comply. IRS agreed with most of the recommendations, but disagreed with changing guidance for auditing the deduction. GAO continues to believe it should be improved.

View GAO-09-521 or key components.
For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

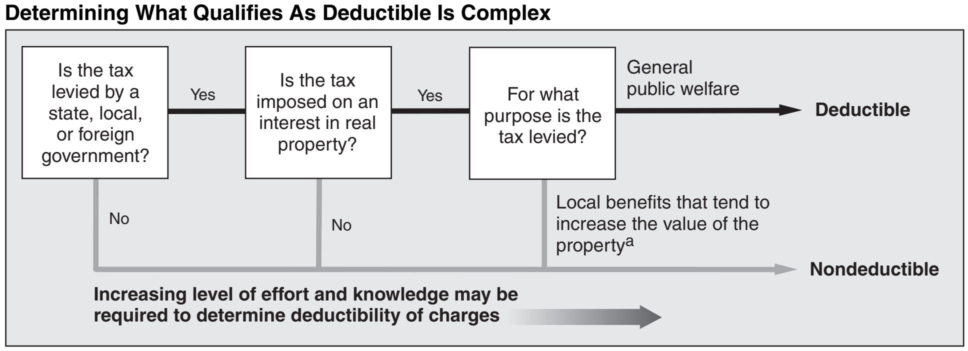
Taxpayers who itemize federal income-tax deductions and whose local real-estate tax bills include nondeductible charges face challenges determining what real-estate taxes they can deduct on their federal income tax returns. Neither local-government tax bills nor mortgage-servicer documents identify what taxpayers can properly deduct. Without such information, determining deductibility can be complex and involve significant effort. While IRS guidance for taxpayers discusses what qualifies as deductible, it does not indicate that taxpayers may need to check both tax bills and other information sources to make the determination. In addition, tax software and paid preparers may not ensure that taxpayers only deduct qualified amounts.

There are no reliable estimates for the extent of noncompliance caused by taxpayers claiming nondeductible charges, or the associated federal tax loss. However, GAO estimates that almost half of local governments nationwide included generally nondeductible charges on their bills. While the full extent of overstatement is unknown due to data limitations, GAO estimates that taxpayers in two counties collectively overstated their deductions by at least $23 (or $46 million using broader matching criteria).

IRS examinations of real-estate tax deductions focus more on whether the taxpayer owned the property and paid the taxes than whether the taxpayer claimed only deductible amounts, primarily because nondeductible charges are generally small. IRS guidance does not require examiners to request proof of deductibility or direct them to look for nondeductible charges on tax bills.

Various options could improve compliance with the real-estate tax deduction, such as providing taxpayers with better guidance and more information, and increasing IRS enforcement. However, the lack of information regarding the extent of noncompliance and the associated tax loss makes it difficult to evaluate these options. If IRS obtained information on real-estate tax bill charges, it could find areas with potentially significant noncompliance and use targeted methods to reduce noncompliance in those areas.

Determining What Qualifies As Deductible Is Complex



Source: GAO analysis of Internal Revenue Code provisions.

[a]Charges for the repair or maintenance of local benefits and associated interest are deductible.

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Abbreviations

IRS	Internal Revenue Service
NRP	National Research Program
QPTS	Quarterly Property Tax Survey
SSN	Social Security number

United States Government Accountability Office
Washington, DC 20548

May 13, 2009

The Honorable Charles B. Rangel
Chairman
Joint Committee on Taxation
House of Representatives

The Honorable Max Baucus
Vice Chairman
Joint Committee on Taxation
United States Senate

Voluntary compliance with federal tax laws is a critical component of the federal tax system. Each year, however, a gap arises between tax amounts that were voluntarily reported and paid on time and those that should have been paid. The Internal Revenue Service's (IRS) most recent estimate is that the gross federal tax gap for tax year 2001 was $345 billion.[1]

In 2006, the Joint Committee on Taxation identified overstated real-estate tax deductions as a potential area of taxpayer noncompliance that could be improved to reduce the tax gap, referencing our 1993 report in which we had determined that taxpayers may have overstated the federal income tax deductions they claimed for real-estate taxes.[2] In our 1993 report, we stated that two reasons for noncompliance were: (1) real-estate tax bills that did not distinguish between deductible taxes and nondeductible user fees; and (2) inadequate IRS education and enforcement activities with respect to the deduction for real-estate taxes.

In 2006, individuals' federal deductions of real-estate taxes amounted to about $156 billion. Because of your interest in the extent, if any, to which individual taxpayers may have overstated their federal income tax deduction for real-estate tax payments by including nondeductible real-

[1]IRS estimates that the net tax gap is $290 billion, assuming that it will eventually recover some of the gross tax gap through late payments.

[2]See GAO, *Tax Administration: Overstated Real Estate Tax Deductions Need To Be Reduced*, GAO/GGD-93-43 (Washington, D.C.: Jan. 19, 1993).

estate-related charges and the reasons for any overstated deductions,[3] you asked that we do the following:

- Describe factors that contribute to the inclusion of nondeductible charges in real-estate tax deductions.
- Describe the extent that taxpayers may be overstating real-estate tax deductions by including nondeductible charges.
- Describe the extent that IRS examinations of real-estate tax deductions focus on the inclusion of nondeductible charges.
- Assess possible options for improving voluntary taxpayer compliance with the real-estate tax deduction.

Background

Real-estate taxes in the United States are levied by a number of different taxing authorities, including state and local governments, but mostly by local governments. Local governments, such as counties, can levy and collect taxes on behalf of smaller jurisdictions within their boundaries. For example, a county could collect real-estate taxes on behalf of a city within the county. In 2006, local-government property tax revenue[4] was about $347 billion, compared to about $12 billion for state-government property tax revenue.[5] Local governments can use property tax revenues to fund local services, such as road maintenance and law enforcement. In 2006, property taxes made up an average of 45 percent of general own-source revenue for local governments nationwide.[6]

According to the Congressional Research Service, the real-estate tax deduction was the most frequently itemized federal income tax deduction

[3]Taxpayers can overstate or understate their real-estate tax deduction. Although examining understatements of this deduction is outside of the scope of this review, we provide a few examples of reasons for understating this deduction later in this report.

[4]Property taxes are made up of real-estate taxes and personal-property taxes, such as taxes on vehicles. In 2006, personal-property taxes accounted for only about $6.5 billion, or approximately 2 percent of the total of about $359.1 billion for property taxes, meaning that real-estate taxes accounted for about 98 percent of property taxes collected by state and local governments. These 2006 numbers are based on data that the U.S. Census Bureau received from state and local governments about their respective fiscal years that ended from July 1, 2005, to June 30, 2006.

[5]These were the most current estimates available from the U.S. Census Bureau at the time we conducted our work.

[6]Own-source revenue is all revenues collected by the local governments from their own sources, and it excludes federal transfers. These were the most current estimates available at the time we conducted our work.

claimed by individual taxpayers from 1998 through 2006; the deduction was claimed on approximately 31 percent of all individual tax returns, and on about 87 percent of all returns with itemized deductions.[7] The real-estate tax deduction provides a benefit to homeowners and also provides an indirect federal subsidy to local governments that levy this and other deductible taxes, since it decreases the net cost of the tax to taxpayers. Deductible real-estate taxes also may encourage local governments to impose higher taxes, which may allow them to provide more services than they otherwise would without the deduction. In 2006, individual taxpayers claimed about $156 billion in real-estate taxes as an itemized deduction. By allowing taxpayers to deduct qualified real-estate taxes, the federal government forfeits tax revenues that it could otherwise collect.[8]

Taxpayers can claim paid real-estate taxes as an itemized deduction on Schedule A of the federal income tax return for individuals.[9] In addition, the *Housing and Recovery Act* signed July 30, 2008, included a provision that allowed non-itemizers to deduct up to $500 ($1,000 for joint filers) in real-estate taxes paid for tax year 2008.[10] Taxpayers can also deduct paid real-estate taxes on other parts of the tax return, including as part of a deduction for a home office or in calculating net income from rental properties.[11] For purposes of this report, references to the real-estate tax deduction mean the itemized deduction on Schedule A.

Taxpayers may deduct state, local, and foreign real-property taxes from their federal tax returns if certain conditions are met.[12] Taxpayers may

[7]See Congressional Research Service, *Federal Deductibility of State and Local Taxes* (Washington, D.C.: Sept. 30, 2008).

[8]The Joint Committee on Taxation estimated that real-estate tax deductions in 2006 cost the federal government $20 billion in lost tax revenue.

[9]*IRS Form 1040, Schedule A – Itemized Deductions.*

[10]See Congressional Research Service, *Federal Deductibility of State and Local Taxes* (Washington, D.C.: Sept. 30, 2008).

[11]There are multiple ways in which taxpayers should report the use of their property for business purposes. Taxpayers who rent a property or a part of this property are instructed to report this rental income on Schedule E, and to deduct real-estate taxes related to that property on that form. Taxpayers who use a portion of their home as the primary place of conducting business are instructed to use Form 8829 to calculate the real-estate taxes that they can deduct as a business expense, and to record that amount on Form 1040 Schedule C.

[12]26 U.S.C. § 164(a)(1).

only deduct real-estate property taxes paid or accrued in the taxable year.[13] To be deductible, real-estate taxes must be imposed on an interest in real property.[14] Taxes based on the value of property are known as *ad valorem*.[15] Further, real-estate taxes are only deductible when they are levied for the general public welfare by the proper taxing authority at a like rate against all property in the jurisdiction.[16] Real-estate-related charges for services are not deductible. Examples of such charges for services include unit fees for water usage or trash collection. In addition, taxpayers may not deduct taxes assessed against local benefits of a kind tending to increase the value of their property.[17] Such local benefit taxes include assessments for streets, sidewalks, and similar improvements. However, local benefit taxes can be deductible if they are for the purpose of maintenance and repair of such benefits or related interest charges.[18]

IRS estimates that on income tax returns for 2001, all overstated deductions taken together resulted in $14 billion in tax loss. IRS estimated the amount of misreporting of deductions, but did not estimate the resulting tax loss for each deduction. However, according to data from IRS's National Research Program, which is designed to measure individual taxpayer reporting compliance, in 2001 about 5.5 million taxpayers overstated their real-estate tax deductions, which resulted in a total overstatement of about $5.0 billion. The median overstatement was $436, or about 23 percent of the median claimed deduction amount of $1,915. We estimate that 38.8 million taxpayers claimed this deduction in 2001. While about 5.5 million taxpayers overstated their deductions, about 3.3 million understated their deductions. Taken as a whole, about 8.8 million taxpayers on average overstated their deductions by about $85 each, which resulted in a net total overstatement of about $2.5 billion.

[13]Payment of taxes during the tax year is a requirement for those taxpayers who file their returns on a cash basis. Most taxpayers are cash-basis taxpayers.

[14]26 C.F.R. § 1.164-3(b).

[15]Not all *ad-valorem* taxes may be deductible because they may not meet the other requirements for deductibility.

[16]26 C.F.R. § 1.164-4(a).

[17]26 U.S.C. § 164(c)(1); 26 C.F.R. §§ 1.164-3(b), 1.164-4(a).

[18]26 U.S.C. § 164(c)(1); 26 C.F.R. § 1.164-4(b)(1). In such cases, the burden is on the taxpayer to show the amounts assessed for maintenance, repair, and associated interest. 26. C.F.R. § 1.164-4(b)(1).

Taxpayers can overstate or understate their real-estate tax deductions in a number of ways. For example, they can overstate their deduction by not meeting such eligibility requirements as property ownership and payment during the tax year, or by inappropriately deducting the same taxes on multiple parts of the income tax return. Taxpayers can also overstate by claiming such real-estate tax-related amounts as local benefit taxes and itemized charges for services, which, as noted earlier, are not deductible. Taxpayers can also understate their real-estate deduction. For example, first-time homeowners may understate this deduction because they are not aware that they are entitled to claim it. Similarly, taxpayers who buy and sell a home in the same year could understate this deduction out of confusion over how much in taxes they can deduct for the old and new homes.[19]

Our 1993 report found that a majority of the local real-estate tax bills that we reviewed included nondeductible items, such as service charges, in addition to deductible real-estate taxes.[20] Our report also indicated that local governments had increased their use of service charges in reaction to events that had reduced their revenues, such as local laws that restricted growth in real-estate taxes. By increasing user fees to finance services, local governments could keep their tax rates lower. We also reported that some local jurisdictions did not clearly indicate nondeductible items on real-estate tax bills and combined all types of payments (e.g., deductible and nondeductible real-estate taxes) into a total amount, which may lead taxpayers to claim this total amount on the bill as deductible and thereby overstate their deduction.

Most taxpayers rely upon either paid preparers or tax software to file their tax returns. Recent estimates indicate that about 75 percent of taxpayers used either a paid preparer (59 percent) or tax software (16 percent) to file their 2007 taxes.[21] Any evaluation of the factors that contribute to

[19]For example, buyers and sellers should divide paid real-estate taxes between them according to the number of days in the appropriate year that each owned the property. The taxes can still be deducted even if either the buyer or seller did not actually make the payment to the taxing authority.

[20]See GAO, *Tax Administration: Overstated Real Estate Tax Deductions Need To Be Reduced*, GAO/GGD-93-43 (Washington, D.C.: Jan. 19, 1993).

[21]See GAO, *Tax Administration: IRS's 2008 Filing Season Generally Successful Despite Challenges, although IRS Could Expand Enforcement During Returns Processing*, GAO-09-146 (Washington, D.C.: Dec. 12, 2008).

taxpayers overstating the real-estate tax deduction would need to take paid preparers and tax software into consideration.

Scope and Methodology

To describe factors that contribute to the inclusion of nondeductible charges in real-estate tax deductions, we conducted a number of analyses and spoke with various external stakeholders, as follows.

- To determine what information local governments report on real-estate tax bills relating to federal deductibility, we surveyed a generalizable sample of over 1,700 local governments.[22] We also reviewed about 500 local-government real-estate tax bills provided to us by survey respondents.[23] We also interviewed officials with organizations representing local governments, including the National Association of Counties; the National Association of County Collectors, Treasurers, and Financial Officers; and the Government Finance Officers Association. To determine what mortgage servicers report on mortgage documents,[24] we interviewed representatives from the mortgage industry from the Consumer Mortgage Coalition, the Mortgage Bankers Association, and the three largest mortgage servicing companies in 2007.
- We reviewed three IRS publications for tax year 2007 that provide guidance to individual taxpayers claiming the real-estate tax deduction as an itemized deduction on their federal income tax returns: the instructions for IRS Form 1040, Schedule A, the form and schedule where taxpayers can deduct real-estate taxes and other items from their taxable income; IRS Publication 17, which provides information for individuals on general rules for filing a federal income tax return; and IRS Publication 530, a guide for homeowners. We checked whether each of these publications explained the factors that taxpayers need to consider in determining deductibility and guided taxpayers on where they could obtain additional information necessary for determining deductibility.
- To determine the extent that tax-preparation software and paid professional tax preparers assisted taxpayers in only claiming deductible real-estate taxes, we reviewed online software versions of the three largest tax-preparation software programs in 2008—TaxAct, TaxCut, and

[22]For more details on the methodology of this survey, see app. I.

[23]For more details on the methodology of this review, see app. II.

[24]Mortgage servicers assist borrowers to pay real-estate-related charges, because they collect funds from the property owners whose mortgages they service (borrowers) and hold these funds in escrow accounts. They then draw from the funds to pay real-estate taxes and related charges on the properties as they are due.

TurboTax—and interviewed representatives from those three companies and representatives from the National Association of Enrolled Agents.

We used the results of our survey of over 1,700 governments to determine the extent to which local governments send real-estate tax bills with certain generally nondeductible charges. To get an indication of the extent to which taxpayers may be overstating their real-estate tax deductions by including such nondeductible charges, we conducted case studies on five large local governments, collecting and analyzing tax data from them and IRS. Specifically, we worked with IRS to determine which charges on the five local governments' tax bills were likely deductible. While conducting these five case studies of taxpayer noncompliance in claiming the real-estate tax deduction, we identified challenges in determining what charges qualify as deductible real-estate taxes. Then, to the extent possible, for two jurisdictions we compared the amounts that were likely deductible to the amounts the taxpayers claimed as deductions on Schedule A of their 2006 federal tax returns. Appendix III provides details on the methodology for this case study, including jurisdiction selection.[25]

To describe the extent that IRS examinations of the real-estate tax deduction focus on potential overstatements due to taxpayer inclusion of nondeductible charges, we reviewed IRS guidance for examiners related to the real-estate tax deduction, and interviewed IRS examiners about the standard procedures and methods they use for auditing this deduction. We reviewed guidance in the Internal Revenue Manual, which serves as the handbook for IRS examiners, to determine how clearly it instructs examiners to verify the deductibility of charges on real-estate bills when auditing this deduction. Our interviews with IRS examiners focused on the extent to which examiners determine the deductibility of charges on real-estate bills when auditing this deduction, challenges faced by examiners auditing this deduction, and whether examiners have information about local jurisdictions with large nondeductible charges on their real-estate tax bills. The examiners we interviewed included examiners and managers based in IRS offices across the United States.

To assess possible options for improving voluntary taxpayer compliance with the real-estate tax deduction, we interviewed members of organizations representing local governments and IRS officials about

[25]We selected 5 of the largest 41 local governments that met our selection criteria for our analysis. We then analyzed taxpayer noncompliance in 2 of these 5 local governments because of constraints in resources and usability of local data. See app. III for details.

potential options. We also identified potential options along with their benefits and trade-offs based on our other work for this report.

We conducted this performance audit from October 2007 through May 2009, 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.

Taxpayers Face Challenges Determining What Real-Estate Taxes They Can Deduct for Their Federal Income Tax Returns

Local governments generally do not inform taxpayers what charges on real-estate tax bills qualify as deductible real-estate taxes, which creates a challenge for taxpayers attempting to determine what they can deduct. Groups representing local governments told us that local governments do not identify on real-estate tax bills which charges are deductible, and our review of almost 500 real-estate tax bills supplied by local governments[26] supports this. In our review, we found no instances where the local government indicated on the bill what amounts were deductible for federal real-estate tax purposes. Furthermore, while IRS requires various entities to provide information about relevant federal tax items to both taxpayers and IRS on statements known as information returns, local governments are not required to provide information returns on real-estate taxes paid.

Local government groups told us that local governments do not identify what taxes are deductible because they cannot easily determine whether their charges meet federal deductibility requirements. They said that local government tax collectors do not have the background or expertise to determine what items are deductible according to federal income-tax law and may lack information necessary for making such determinations for

[26]The almost 500 bills are associated with a stratified, random sample of about 1,700 localities. We did not generalize the results of the review because not all respondents to the survey sent in a bill as requested and we did not know how the bill we reviewed was selected. Although none of the bills that we reviewed indicated what amounts were deductible for federal real-estate taxes, it is possible there are localities that do provide this information on their bills. See app. II for details.

charges billed on behalf of another taxing jurisdiction.[27] As a result, local governments did not want to make such determinations.

Taxpayers with mortgages may also receive information about real-estate tax bill charges paid on their behalf by mortgage servicers, but this information generally does not identify what taxes can be deducted. To protect a mortgage holder's interest in a mortgaged property, mortgage servicers often collect funds from property owners whose mortgages they service (borrowers) and hold them in escrow accounts. They then draw from the funds to pay real-estate taxes and related charges on the properties as they are due. Mortgage servicers provide borrowers with annual statements summarizing these and other deposits and withdrawals of escrow account funds. In addition, mortgage servicers have the option of reporting such escrow payments on information returns relating to paid mortgage interest, but can choose to report other information instead.[28]

Mortgage industry representatives we spoke with stated that when reporting escrow payments, mortgage servicers usually report the total amount paid at any given time to local governments from escrow accounts and do not itemize the specific types of charges paid for, regardless of the statement used. As a result, any nondeductible charges paid for would be embedded in this payment total and reported as "property taxes" or "real-estate taxes" on mortgage servicer documents, including IRS forms.

According to mortgage industry representatives, mortgage servicers only report a total because most only track and receive information on the total payment amount due. Mortgage servicers are interested in total amounts because local governments can place a lien on a mortgaged property if all billed charges are not paid. In addition, not all mortgage servicers receive detailed information about charges. Our survey of local governments on real-estate tax billing practices showed that an estimated 43 percent[29] of

[27]Some larger local governments (e.g., counties) include taxes and other charges imposed by smaller entities (e.g., school districts, cities, townships) within the larger jurisdiction on one bill.

[28]Mortgage interest is reported on IRS's Form 1098. Because the space for escrow payments on the form is optional and can be used to include the address of the mortgaged property or insurance paid from escrow instead of taxes paid from escrow, IRS does not track or otherwise use this information.

[29]This estimate of 43 percent has a 95 percent confidence interval of 36 to 50.

local governments provide mortgage companies with only total amounts owed for requested properties.[30]

That annual mortgage statements report only totals is significant because not all property owners receive tax bills. Based on responses to our local government survey, an estimated 25 percent[31] of local governments do not send property owners a copy of their tax bill if the taxpayer escrows their taxes through a mortgage company. Even though real-estate tax bills do not indicate what charges are deductible, tax bills can contain information on the types of charges assessed on a property, which is a starting point for taxpayers in determining what they can deduct.

Determining What Items Qualify as Deductible Real-Estate Taxes Can Be Complicated and Require Significant Effort

In the absence of information identifying deductible real-estate taxes, determining whether certain amounts on the tax bills are deductible can be complex and require significant effort. Taxpayers generally cannot be assured that their real-estate tax bill has enough information to determine which of the charges listed are deductible for federal purposes. Deductible real-estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare by the proper taxing authority at a like rate against all property in the jurisdiction. Charges for services and charges for improvements tending to increase the value of one's property are generally not deductible.

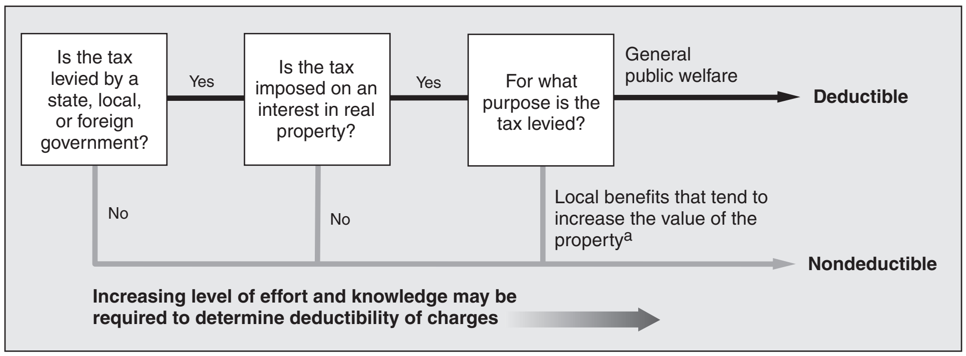
However, even if a real-estate tax bill labels a charge as a "tax" or "for services," the designation given by a local government does not determine whether a charge on a real-estate tax bill is deductible. For example, a charge that is labeled a tax on a local real-estate tax bill, but is not used for public or governmental purposes such as police or fire protection, likely would not be deductible; whereas a charge that is labeled a fee could be considered a deductible tax if the charge is imposed at a uniform rate based on the value of the real estate and is used for the general public welfare. Complicating the matter is that local benefit taxes, which are

[30]Local governments can disclose information about charges to mortgage servicers in a variety of ways. Based on the responses from our survey, we estimate that only 36 percent break out all line items on a bill for mortgage servicers (with a 95 percent confidence interval of 29 to 43).

[31]This estimate of 25 percent has a 95 percent confidence interval of 15 to 37. We estimate that 66 percent of local governments (with a 95 percent confidence interval of 53 to 79) do provide property owners a courtesy copy of their tax bill. We are not clear what the remaining 8 percent do because of survey responses that were not straightforward.

generally not deductible, can be deductible if the revenue raised is used to maintain or repair existing improvements. Figure 1 depicts some of the questions that taxpayers need to be able to answer for each real-estate-tax-related charge they wish to deduct. Taxpayers who are unsure how to answer these questions (as well as others) with respect to a given charge cannot be assured of the charge's deductibility.

Figure 1: Determining What Qualifies As Deductible Is Complex



Source: GAO analysis of Internal Revenue Code provisions.

[a]Charges for the repair or maintenance of local benefits and associated interest charges are deductible.

Because determining what qualifies as deductible can be complex, we asked IRS's Office of Chief Counsel to help us determine the deductibility of amounts on tax bills in five large local governments as part of case studies on taxpayer compliance with the real-estate tax deduction. We asked attorneys in IRS's Office of Chief Counsel what information they would need to determine whether charges that appear on real-estate tax bills in the jurisdictions were deductible. IRS's Office of Chief Counsel indicated that it would need information on the questions indicated in figure 2.

Figure 2: Information Requested by IRS's Office of Chief Counsel to Make Deductibility Determinations

(1) Is the tax imposed by a State, possession, or political subdivision thereof, against interests in real property located in the jurisdiction for the general public welfare?
(2) Is the assessment an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power? Is payment optional or avoidable?
(3) The purpose of the charge. Is it collected for the purpose of raising revenue to be used for public or governmental purposes?
(4) Is the tax assessed against all property within the jurisdiction?
(5) Is the tax assessed at a uniform rate?
(6) Whether the payer of the assessment is entitled to any privilege or service as a result of the payment. Is the assessment imposed as a payment for some special privilege granted or service rendered? Is there any relationship between the assessment and any services provided or special privilege granted?
(7) Is use of the funds by the tax authority restricted in any way? Are the funds earmarked for any specific purpose?
(8) Is the assessment for local benefits of a kind tending to increase the value of the property assessed? Does the assessment fund improvements to or benefiting certain properties or certain types of property? If so, is a portion of the assessment allocable to separately stated interest or maintenance charges?

Source: IRS Office of Chief Counsel.

To provide IRS with this information, we searched local government Web sites for information on each charge that appeared on tax bills. We also interviewed local government officials, collected and analyzed additional documentation related to the charges, and identified sections of local statutes that provided the authority to impose the charges on the local tax bills. We summarized this information in summary documents that totaled over 120 pages across the five selected local governments.

Despite this level of effort, the information was not sufficient to allow IRS to make a judgment as to the deductibility of all of the charges in the five selected jurisdictions. While local government officials we spoke with provided us with significant support in our research, some of the information we asked for was either unavailable or impractical to obtain due to format or volume. The main challenge we faced was that each of the five local governments had over 100 taxing districts—cities, townships, school districts, special districts, etc.—and gathering detailed information for each district, such as how each district calculates the rate it charges, was difficult and time-consuming. As a result, IRS attorneys were not able to make determinations on some charges in three of the five jurisdictions.[32]

Because individual real-estate tax bills in these jurisdictions would likely include only a subset of the amounts we researched, taxpayers in these jurisdictions would not necessarily need to apply the same total level of effort that we did. However, they would still face similar challenges in determining whether the amounts on their tax bills qualified as deductible. For example, one county official told us that not all charges are itemized on their tax bills and as a result, it is nearly impossible for a taxpayer in her county to find out the nature and purpose of those charges for which they are assessed.

Taxpayer Guidance for Deducting Real-Estate Taxes Explains What Taxpayers Can Deduct, but Does Not Direct Taxpayers to Consult Appropriate Resources to Determine Deductibility

IRS instructions and guidance for taxpayers on claiming the real-estate tax deduction explain generally what taxpayers can deduct, but lack more specific information on how to comply. IRS instructions for claiming the real-estate tax deduction on the federal income-tax return for individuals explain that real-estate taxes are deductible if they are based on the value of property, they are assessed uniformly on property throughout the jurisdiction, and proceeds are used for general governmental purposes.[33] The instructions also indicate that per-unit charges for services and charges for improvements that tend to increase the value of one's property are generally not deductible. The IRS general guide for individuals filing an income tax return and the IRS guide for first-time homeowners similarly explain what taxpayers can deduct,[34] and also provide examples of nondeductible charges for services and local benefit taxes.

However, these three IRS publications do not inform taxpayers that they should check both real-estate tax bills and available local government resources with information about the nature and purpose of specific charges. While the two IRS guides alert taxpayers that they should check

[32]For more details on the results, see app. III.

[33]These are the instructions for Schedule A of the IRS Form 1040—the section of the income tax return for individuals relating to itemized deductions, including the deduction for real-estate taxes.

[34]The general guide for individuals filing an income tax return is IRS Publication 17 and the guide for first-time homeowners is IRS Publication 530.

real-estate taxes bills, IRS's instructions for deducting real-estate taxes are silent on what taxpayers need to check. None of the publications inform taxpayers that they may also need to consult local government Web sites, pamphlets, or other available documents with information about the nature and purpose of specific charges to determine what amounts qualify as deductible real-estate taxes. Without specific instruction to do otherwise, taxpayers could believe that they are getting deductible amounts from their mortgage servicer.

Searching for more information may not be conclusive for all charges, but may be sufficient for determining the deductibility of many charges, as we found while examining charges in five local governments with IRS. Similarly, even though some taxpayers may be unable to determine the deductibility of a few charges on their tax bills after consulting available local government resources, they likely need such information on other charges to comply with requirements of the real-estate tax deduction. Taxpayers need to know that they may need to consult available local government resources because more information may be required before they can determine which charges they can deduct from their tax bill.

Tax-Preparation Software and Paid Tax Preparer Assistance May Not Be Sufficient to Help Ensure That Taxpayers Only Deduct Qualified Real-Estate Taxes

Tax-preparation software and assistance provided by paid tax preparers may not be sufficient to help ensure that taxpayers only deduct qualified real-estate taxes. At the time of our review, two of the three most frequently used tax-preparation software programs for 2008—TaxAct, TaxCut, and TurboTax—did not alert taxpayers to the fact that not all charges on real-estate tax bills may qualify as deductible real-estate taxes.[35] The sections of these two programs where users entered real-estate taxes paid lacked an alert informing users that not all charges that appear on a real-estate tax bill may qualify as deductible real-estate taxes. While all three of the programs contained information about what qualified as deductible real-estate taxes in various screens, users had to proactively click on buttons to access these sections to learn that some charges on their tax bill may not have been deductible.[36]

[35]These 3 companies are among 34 tax-preparation companies that electronically file tax returns.

[36]ll three programs provided information on nondeductible charges in screens accessible from their sections on real-estate taxes via links.

One software-program representative indicated that alerts need to be carefully tailored to have the intended effect. He cautioned that too much information can actually have undesirable effects that do not lead to improved compliance. Specifically, to the extent that they are not relevant to taxpayers whose bills do not contain nondeductible items, overly broad or irrelevant alerts can result in taxpayers reading less, thereby creating confusion, causing errors to be made, and unnecessarily increasing taxpayer burden by increasing the time and complexity involved in taxpayers preparing their returns.

Nevertheless, software-program representatives we spoke with were receptive to potential improvements that could be made to their software programs. Prior to our review, none of the three largest software programs contained an alert informing users that not all items on real-estate tax bills may be deductible. In addition, one of the three programs did not discuss the fact that deductible real-estate taxes are based on the assessed value of property and that charges for services and local benefit taxes are generally not deductible. In response to our discussions with them on these issues, all three tax software programs made changes to their programs. One program added an alert to users indicating that not all charges on real-estate tax bills may be deductible and the other two programs added information about what qualifies as real-estate taxes or made such information more prominent in the guidance accessible from their sections on real-estate taxes.

Paid preparers we spoke with indicated that they invested only limited time and energy making sure that taxpayers included only qualified real-estate taxes in their deductions.[37] Most taxpayers do not understand that some charges assessed against a property may not be deductible, and often only provide preparers with mortgage interest statements or cancelled checks to local governments that contain only total payment amounts, making it difficult for the preparers to identify potentially nondeductible charges. Some preparers indicated that from their experience such charges are relatively small, and may have negligible impacts on a taxpayer's tax liability, especially after other parts of the tax return are considered. As a result, even if they thought that clients may be claiming nondeductible charges, they often did not consider identifying

[37]We spoke with a group of paid tax preparers at a conference sponsored by the National Association of Enrolled Agents, which represents paid tax preparers, to understand what steps they took to ensure that taxpayers only deducted qualified real-estate taxes.

such charges to be worth the effort. The paid preparers that we spoke with also indicated that more information from local governments or IRS on what taxes are deductible would be helpful in improving taxpayer compliance with the deduction.

Many Bills Contain Generally Nondeductible Charges, and Taxpayers in Two Jurisdictions Likely Overstated Their Deductions, but the Full Extent of Overstatement Is Unknown

As mentioned earlier, deductible real-estate taxes are generally *ad valorem* or based on the assessed value of property. We used the *ad-valorem*/non-*ad-valorem* distinction as a rough proxy to indicate potential deductibility in our survey of local governments' real-estate billing practices. The *ad-valorem*/non-*ad-valorem* distinction is not a perfect indicator of deductibility, since, under certain circumstances, some *ad-valorem* charges could be nondeductible and some non-*ad-valorem* charges could be deductible. However, based on the information we provided, IRS's Office of Chief Counsel determined that all non-*ad-valorem* charges in our case study jurisdictions were not deductible.[38]

We estimate that almost half of local governments nationwide included charges on their real-estate tax bills that were generally not deductible, based on responses to our survey. We surveyed a sample of over 1,700 local governments identified as collecting real-estate taxes and asked them whether their real-estate tax bills included non-*ad-valorem* charges, that is, charges that are not based on the value of property and therefore generally not deductible. Examples of such charges include fees for trash and garbage pickup. Based on responses, we estimate that 45 percent of local governments nationwide included such charges on their tax bills.[39] The property taxes[40] collected by local governments with non-*ad-valorem* charges on their bills represented an estimated 72 percent of the property taxes collected by local governments nationwide.[41]

[38]We did not identify any examples of deductible non-*ad-valorem* charges in any of our research. When we discussed this issue with IRS's Office of Chief Counsel, they also did not identify any specific examples of a deductible non-*ad-valorem* charge.

[39]This estimate of 45 percent has a 95 percent confidence interval of 31 to 59.

[40]We cannot determine the proportion of this property tax revenue that consists of non-*ad-valorem* charges. We used the results of the Census Bureau's Quarterly Property Tax Survey to develop these estimates. The Census data include both real-estate and personal-property taxes for both residential and commercial properties and do not separate out any of these taxes.

[41]This estimate of 72 percent has a 95 percent confidence interval of 60 to 85.

Of the local governments surveyed that included non-*ad-valorem* charges on their bills, only 22 percent reported that they label such charges as non-*ad valorem*.[42] As a result, even if taxpayers owning real estate in the other 78 percent of these locations review their tax bills, they may not be able to identify which charges, if any, are non-*ad valorem* and likely nondeductible.

Full Extent of Overstated Real-Estate Taxes from Claiming Nondeductible Items Is Unknown Due to Data Limitations

In identifying how much taxpayers may have overstated real-estate tax deductions from individual taxpayers claiming nondeductible charges, we encountered data limitations that constrained our analysis and made it impossible to develop nationwide estimates of these overstatements.[43] Some of the main limitations follow:

- The jurisdictions we selected did not maintain their tax data in a way that allowed us to itemize all of the charges on individuals' tax bills. They also did not always maintain information on those charges necessary for IRS and us to determine deductibility. As a result, we were not able to account for all potentially nondeductible *ad-valorem* charges. Similarly to the approach we took in our survey of local governments, we categorized all *ad-valorem* charges as deductible and all non-*ad-valorem* charges as nondeductible in identifying how much taxpayers overstated their real-estate tax deductions.
- The selected jurisdictions also did not track the real-estate tax liabilities and payments by individuals' Social Security number (SSN), which is the unique identifier used in the IRS tax return data for each taxpayer. Consequently, we used available information—name, address, and zip code—to calculate for each taxpayer the total amount billed by the local government and compare the amount billed to the amount claimed as a real-estate tax deduction on Schedule A of the taxpayer's return. This process was very time- and resource-intensive.[44]
- We could not explicitly account for other income tax deductions or adjustments to income that could influence the amount taxpayers are

[42]This estimate of 22 percent has a 95 percent confidence interval of 13 to 33. We estimate from survey responses that 78 percent of local governments (with a 95 percent confidence interval of 67 to 87) do not label their charges as non *ad-valorem*.

[43]We attempted this analysis because IRS's last measurement of individual tax compliance, which was developed through its National Research Program for tax year 2001, did not estimate how much of the overstated real-estate tax deduction was attributable to individuals claiming nondeductible charges.

[44]We limited our estimates to two jurisdictions because of these practical limitations.

eligible to claim on the Schedule A, such as the home-office deduction and rental real-estate income.[45] IRS did not have information readily available on how much real-estate taxes taxpayers in our case-study jurisdictions claimed as a home-office deduction, nor did it have information on the locations of other rental real-estate properties owned by a taxpayer, which could have been in multiple jurisdictions. We aimed to mitigate these issues by only analyzing records where (1) the amount claimed in the IRS data was roughly equivalent to the total amount billed to the taxpayer in the local government data, or (2) the amount claimed was less than 15 percent greater than the total billed amount.[46]

Because of these limitations, we were able to match only 42 percent of the individuals (195,432 of 463,066) who itemized their real-estate tax deductions on their tax returns to the data we received from two counties, as table 1 shows (see app. III for a more detailed discussion of our methodology). The counties—Alameda County, California and Hennepin County, Minnesota—were among the largest taxing jurisdictions in the United States that had non-*ad-valorem* charges, such as fees for services, special assessments, and special district charges, on their real-estate tax bills in 2006.[47]

Table 1: Taxpayer Records from Alameda County Data and Hennepin County Data Matched to Tax Returns with Claimed Real-Estate Tax Deductions

	Alameda County		Hennepin County		Total	
	Number	Percent	Number	Percent	Number	Percent
IRS records[a] with claimed real-estate tax deduction	221,543	100.0	241,523	100.0	463,066	100.0
County records matched to IRS records	99,630	45.0	95,793	39.7	195,423	42.2

Source: GAO analysis of IRS, Alameda County, and Hennepin County data.

[45]Taxpayers who have a home office can choose to deduct real-estate taxes as part of a home-office deduction. Taxpayers who own real estate for which they receive rental income can reduce their net income by the amount of applicable real-estate taxes.

[46]We excluded those records where the amount claimed was more than 15 percent greater than the billed amount to minimize the likelihood of including a deduction for real-estate taxes paid for multiple properties. See app. III for more details.

[47]Of those local governments that do have such items on their bills, some local governments limit these charges to a small population or to a few properties in a specific geographic area (for example, one or two new construction developments). Such governments did not meet our criteria for selection.

[a]Each IRS record is based on an individual tax return for tax year 2006 with a real-estate tax deduction on Schedule A.

Table 2 shows that of the 195,423 matched taxpayer records in the two counties, 56 percent, or 109,040 individuals had non-*ad-valorem* charges on their local bills. However, over 99 percent of the Alameda County bills had non-*ad-valorem* charges compared to only about 10 percent of the Hennepin County bills.

Table 2: Matched Taxpayer Records with Non-*Ad-Valorem* Charges

	Alameda County		Hennepin County		Total	
	Number	Percent	Number	Percent	Number	Percent
County records matched to IRS records	99,630	100.0	95,793	100.0	195,423	100.0
Matched records with non-a*d-valorem* charges	99,521	99.9	9,519	9.9	109,040	55.8

Source: GAO analysis of IRS, Alameda County, and Hennepin County data.

Taxpayers in Two Jurisdictions Collectively May Have Overstated Millions of Dollars in Real-Estate Tax Deductions by Including Nondeductible Charges

Our analysis of the 109,040 individuals in the two counties who had non-*ad-valorem* charges on their bills that could be matched to IRS data indicates that almost 42,000 (38.3 percent) collectively overstated their real-estate tax deductions by at least $22.5 million (i.e., “very likely overstated”) for tax year 2006. When one includes over 37,000 taxpayers who had non-*ad-valorem* charges and overstated their deductions up to 15 percent greater than their total amounts billed in 2006 (i.e., “likely overstated”) the amount of potential overstatement increases to $46.2 million. Table 3 summarizes the results on overstated deductions from claiming nondeductible charges for the two counties.

Table 3: Number and Dollar Amounts of Likely Overstated Real-Estate Tax Deductions by Individual Taxpayers in Alameda County and Hennepin County for Tax Year 2006

	Very likely overstated[a]		Likely overstated[b]		Total	
	Number	Dollars in millions	Number	Dollars in millions	Number	Dollars in millions
Alameda County	37,168	20.9	35,651	23.2	**72,819**	**44.1**
Hennepin County	4,603	1.6	1,494	0.5	**6,097**	**2.1**
Total	**41,771**	**22.5**	**37,145**	**23.7**	**78,916**	**46.2**

Source: GAO analysis of IRS, Alameda County, and Hennepin County data.

[a]We defined "very likely overstated" as those taxpayers who claimed a deduction that is within $2 of total billed amount in 2006.

[b]We defined "likely overstated" as those taxpayers who claimed a deduction that was greater than $1 less than the *ad-valorem* amount billed in 2006 but less than 1.15 times the total billed amount.

While 72.4 percent of taxpayers (78,916 of 109,040) with non-*ad-valorem* charges that we could match to tax returns overstated their real-estate tax deduction, these overstated amounts on average only involved amounts in the hundreds of dollars. According to our analysis, the median "very likely" overstatement was $414 in Alameda County and $241 in Hennepin County. The median "likely" overstatement was $493 for Alameda County and $179 for Hennepin County.

It is important to recognize that these overstated deduction amounts are not the tax revenue loss. The tax revenue loss would be much less and depend, in part, on the marginal tax rates of the individuals who overstated their deductions as well as other factors that we did not have the data or resources to model appropriately. Those factors would include the amount of real-estate taxes and local-benefit taxes that should be allocated to other schedules on the tax return and other attributes such as the amount of refundable and nonrefundable credits. As a result, while many taxpayers are erring in claiming nondeductible charges, the small tax consequences of such overstatements may not justify the cost of IRS enforcement efforts to pursue just these claims.

Examinations of Real-Estate Tax Deduction Focus on Other Noncompliance Rather Than on the Inclusion of Nondeductible Charges

IRS's guidance to examiners does not require them to check documentation to verify that the entire real-estate tax deduction amount claimed on Schedule A of Form 1040 is deductible. Such documentation would indicate whether taxpayers claim nondeductible charges. Rather, IRS's guidance gives examiners discretion on which documentation to request from taxpayers to verify the real-estate tax deduction. Examiners are authorized to request copies of real-estate tax bills, verification of legal property ownership, copies of cancelled checks or receipts, copies of settlement statements, and verification and an explanation for any special assessments deducted. Because of the discretion in the guidance, examiners are not required to request or examine each form of documentation.

The guidance also does not direct examiners to look for all potentially nondeductible charges in real-estate tax bills. Some IRS examiners we interviewed considered Form 1098 for mortgage interest paid to be appropriate documentation if the taxpayer failed to provide a real-estate tax bill because this form could demonstrate that the taxpayer paid the taxes through an escrow account set up with the mortgage company. However, as noted earlier, Form 1098 shows payments to local governments for all real-estate tax-related charges billed, including any nondeductible charges. In other words, Form 1098 does not conclusively demonstrate deductibility.

Rather than focusing on the nature of charges claimed, IRS examinations of real-estate tax deductions focus on other issues, such as evidence that the taxpayer actually owned the property and paid the real-estate taxes claimed during the year in question. IRS examiners told us that they focus on proof of ownership and payment because, in their experience, taxpayer noncompliance with these requirements could result in larger overstatements. For example, a taxpayer residing in the home owned by his or her parent(s) could incorrectly claim the real-estate tax deduction for the property. It is also common for first-time homebuyers to improperly claim the full amount of real-estate taxes paid for the tax year, even though the seller had paid a portion of these taxes.

Examinations of the real-estate tax deduction usually take place as part of a broader examination of inconsistent claims across the individual tax return. In examining deductions on the Schedule A, IRS examiners have found cases in which some taxpayers incorrectly include real-estate taxes as personal-property taxes on Schedule A, sometimes deducting the same tax charges as both personal-property taxes and real-estate taxes. Furthermore, IRS examiners might find claims on other parts of the return that prompt them to check the real-estate tax claimed on Schedule A, or find overstated real-estate tax deductions on Schedule A that indicate noncompliance elsewhere on the return. For instance, a taxpayer might claim the real-estate tax deduction for multiple properties on Schedule A, but fail to report any rental income earned from these properties on the Schedule E form, which is used to report income or loss from rental income.[48] Also, a taxpayer might claim the total amount of real-estate taxes paid on Schedule A, but improperly claim these taxes again as part of the business expense deductions on the Schedule E or Schedule C forms, or both.[49] IRS guidance instructs taxpayers to deduct only real-estate taxes paid for their private residences on Schedule A, and to deduct any real-estate taxes paid on rental properties on Schedule E. If taxpayers use a part of their private residence as the principal place for conducting business, they should divide the total real-estate taxes paid on the property accordingly, with the portion of real-estate taxes paid for the business deducted on Schedule C.

As noted earlier, the format and the level of detail about charges on local real-estate bills vary greatly across local governments. IRS examiners told us that they do not focus on the deductibility of most real-estate charges when auditing real-estate tax deductions because determining deductibility from looking at such bills can take significant time and effort. They also said that when they detect apparent nondeductible charges claimed in the real-estate tax deduction, the amounts are usually small. As a result, the examiners we interviewed generally contended that determining the deductibility of every charge on a bill could be an inefficient use of IRS resources. Examiners reasoned that the amount of nondeductible charges on a real-estate tax bill would have to be quite high to justify an examination and adjustment of tax liability.

IRS does not have information about which local governments are likely to have large nondeductible charges on their real-estate tax bills. IRS examiners also told us that if they had this information, they could use it

[48]Form 1040 Schedule E *Supplemental Income and Loss* is used to report income or loss from rental real-estate, royalties, partnerships, S corporations, estates, trusts, and other entities.

[49]Form 1040 Schedule C *Profit or Loss From Business* is used to report income or loss from a business that the respective taxpayer operated or from a profession practiced as a sole proprietor. Taxpayers who use a portion of their home as the primary place of conducting business are instructed to use Form 8829 to calculate the real-estate taxes that they can deduct as a business expense, and to record that amount on Schedule C.

to target any examination of the real-estate tax deduction toward large deductions claimed by taxpayers in these specific jurisdictions. Several examiners told us that they look for large nondeductible charges that are commonly claimed as real-estate taxes, but they only know about these nondeductible items from personal experience. For example, IRS examiners located in Florida and California indicated that some taxpayers attempt to improperly deduct large homeowners' association fees as part of the real-estate tax deduction. Absent information about potentially nondeductible charges, some examiners told us that when they are examining a real-estate tax deduction, they might research taxpayer information accessible from the respective county assessor's Web site, such as information about real-estate bill charges, or from other databases, such as how many properties a taxpayer owns and the amount of taxes paid for each property.

Some Options Could Improve Compliance with the Real-Estate Tax Deduction; Better Information Is Needed to Assess Other Options

Various options could help address one or more of the identified problems that make it hard for individual taxpayers to comply by only claiming deductible charges when computing their real-estate tax deduction, and improve IRS's ability to check compliance.[50] Given the general difficulty in determining deductibility, one option would be to change the tax code. Changing the tax code could affect both taxpayers who overstate and those who understate their deductions. Depending on the public policy goals envisioned for the real-estate tax deduction, policymakers may wish to consider changes to balance achieving those goals and make it simpler for individuals to determine how much of their total amount for local charges can be deducted. Changing the law to help taxpayers correctly claim the deduction could be done in different ways. However, assessing such changes to the law and their effects was beyond the scope of this review. Thus, we have not included nor will we further discuss in this report an option for changing the tax code.

Assuming no statutory changes are made to clarify how much of local charges on real-estate tax bills can be deducted, table 4 lists some broad options under three areas involving improved information, guidance, and

[50]We developed the options by reviewing our prior reports and other reports, analyzing local government bills that include nondeductible charges, and interviewing knowledgeable local government and IRS officials, as well as other knowledgeable stakeholders. This work, along with our efforts to match data from a few large localities to federal real-estate tax deduction data, helped to identify trade-offs and challenges to consider in implementing the options.

enforcement to address the problems. The options we discuss are concepts rather than proposals with details on implementation and likely effects. These options would likely affect both those taxpayers who overstate and those who understate their real-estate tax deductions. A combination of these options would be needed to address the four main problems.

Table 4: Options That Could Address Problems in Tax Compliance with and the IRS Enforcement of the Real-Estate Tax Deduction

	Tax compliance and IRS enforcement problems addressed			
Options	**Deductibility of amounts not indicated**	**Incomplete information on charges**	**Incomplete guidance on deductibility**	**Incomplete examination guidance**
More information				
Local governments report deductible amounts on:				
Information returns to taxpayers/IRS	X	X	X	
Local real-estate tax bills provided to taxpayers	X	X	X	
Local governments provide IRS with lists of their charges on bills to use in determining deductibility	X	X	X	
Local governments change tax bills to show:				
Ad-valorem charges		X		
A disclaimer that some charges may not be deductible		X		
Better guidance				
IRS enhances its taxpayer guidance		X	X	
IRS reaches out to third parties on disclaimers (i.e., nondeductible charges) and on IRS guidance		X	X	
Enhanced enforcement				
IRS clarifies its examination guidance on seeking evidence of deductibility				X

Source: GAO analysis.

Note: Not all of the options in the table would have the same degree of impact on the respective problem. For example, although the option of having local governments include a total for the deductible amount on real-estate tax bills after receiving assistance from IRS on determining deductibility and the option of having local governments include disclaimers on real-estate tax bills both address the problem of incomplete information on charges, the first option would more completely address the problem.

In considering the options, it is important to know how many individual taxpayers claim nondeductible charges from real-estate tax bills and how much federal revenue is lost. Such knowledge could signal how urgently solutions are needed. However, the extent of taxpayer noncompliance and related federal revenue loss is not known, and we could not estimate this with the resources available for our review. If many taxpayers overstate the deduction and the aggregate revenue loss is high enough, pursuing options to reduce noncompliance would be more important. Conversely, fewer taxpayers making errors and lower revenue losses might lead to a decision to not pursue any options or only options that have minimal costs and burdens. Ultimately, policymakers in concert with tax administrators will have to judge whether concerns about noncompliance justify the extent to which options, including those on which we make recommendations, should be pursued to help taxpayers comply.[51]

Compliance could be measured in different ways, which could yield better information at increasing cost. For example, IRS has research programs that are designed to measure compliance. One option is to modify IRS's National Research Program (NRP) studies that IRS planned to launch in October 2007, which were designed to annually examine compliance on about 13,000 individual tax returns. NRP staff could begin to collect information through this annual study to compute how much of the overall amount of noncompliance with claiming the real-estate tax deduction is caused by taxpayers claiming nondeductible charges.[52] If pursued, IRS would need to consider how much additional time and money to invest in its annual research to measure taxpayer compliance in claiming only deductible charges in the real-estate tax deduction. IRS also could consider focusing its compliance efforts on local governments that put large nondeductible charges on real-estate tax bills.

[51]Policymakers may also want to consider the extent to which taxpayers are understating their real-estate tax deductions. Any estimates of taxpayer compliance or noncompliance with the real-estate tax deduction should take understatements into consideration.

[52]NRP face-to-face audits were designed to resemble enforcement audits in that NRP examiners were to determine whether the information reported on an audited return was accurate, and to assess additional taxes if they determined that a taxpayer's tax liability was understated. Unlike enforcement audits however, NRP audits were not limited to line items initially identified for audit. Further, NRP examiners were expected to document all tax changes, regardless of amount, but not to ask taxpayers to pay additional taxes owed that fell below a predetermined amount. Given the research purpose of the NRP, IRS also created additional guidelines, training, and procedures to, for example, ensure specialized reviews of the quality of the audit and data.

Lacking information on the potential compliance gains compared to potential costs and burdens makes it difficult to assess whether most options are justified. Even so, some of these options could improve compliance with the real-estate tax deduction while generating lower costs and burdens for IRS and third parties. Although we did not measure the benefits and costs, the following discussion describes key trade-offs to be considered for each option, such as burdens on IRS, local governments, and other third parties, as well as implementation barriers.

Providing More Information about Local Charges

Taxpayers are responsible for determining which charges are deductible. The burden to be fully compliant can be significant, depending on how many charges are on the real-estate tax bill, how quickly information can be accessed on how the charge is computed and used, and how long it takes taxpayers to use that information to determine deductibility. In the absence of data, a simple illustration can provide context, recognizing that taxpayer experiences would vary widely. To illustrate, if we use an IRS estimate that roughly 43 million taxpayers claimed the real-estate tax deduction in 2006,[53] and assume that each taxpayer spent only 1 hour to access and use information about charges on the bill to make determinations about deductibility,[54] then a total of 43 million taxpayer hours would be used to calculate this deduction. If we further assume that the value of a taxpayer's time averaged $30 per hour, which is the figure used by the Office of Management and Budget,[55] the value of this compliance burden on taxpayers for the real-estate tax deduction would total $1.29 billion.

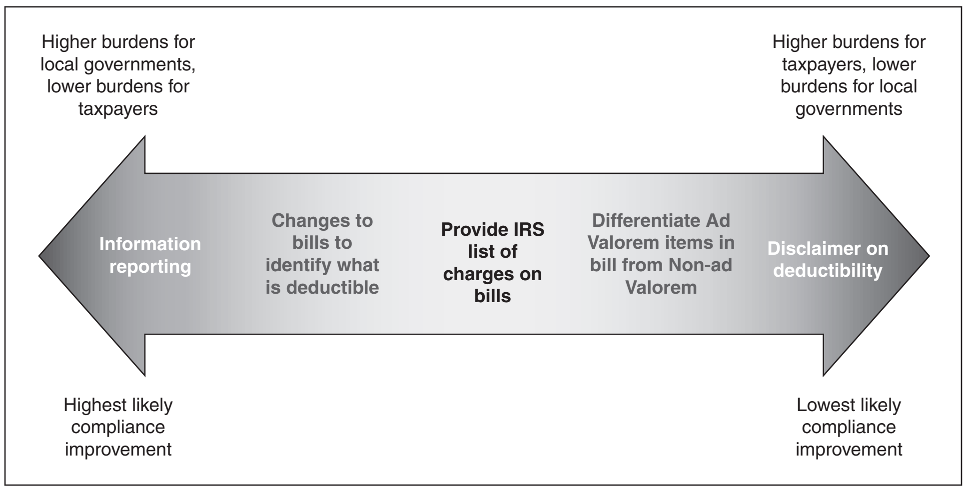
[53]IRS's Statistics of Income data for individual returns filed for tax year 2006 estimated that about 43 million individuals deducted about $156 billion in real-estate taxes.

[54]In our illustrative example, we assume that each taxpayer would need an hour to access information and use this information to make determinations about the charges in question. In reality, some taxpayers would not need this much time because they have few questionable charges on their bills, the bills are clear, and any needed information is readily accessible. At the other extreme, some taxpayers would need more time if they have many questionable charges on unclear bills and have difficulties accessing the necessary information. Also, taxpayers may not have to expend the same amount of time in future years, unless the local charges on the bills change. Because many taxpayers likely do not take all the necessary steps to ensure compliance, the actual burdens borne could be less than what would be needed in order for taxpayers to full comply.

[55]See Office of Management and Budget, *Draft Report to Congress on the Costs and Benefits of Federal Regulations*, 67 *Fed. Reg.* 15014 (Mar. 28, 2002).

The options for providing information about the local charges generally would lessen the burden on individual taxpayers while likely increasing compliance levels. However, depending on the option, the burden would shift to local governments. Although the local-government representatives we interviewed did not have data on the costs for any option and said that the costs and burdens could vary widely across local governments, they had views on the relative burdens for each option. Figure 3 provides a rough depiction of this burden shifting.

Figure 3: Relative Burden of Options to Provide Information on Local Charges



Source: GAO.

Local Governments Report Information on Deductible Charges

Given the complexity of determining the federal deductibility of local charges, a problem we found was that taxpayers are not told how much of the total amount of charges on the local bill can be deducted. Two options for reporting information on deductible charges are (1) information reporting, or (2) changing the local real-estate tax bills.[56]

Information reporting on deductible amounts

Requiring information reporting in which local governments determine in their opinion which charges are federally deductible and report the

[56]These two options for reporting information on deductible charges would address both overstatements and understatements of the real-estate tax deduction.

deductible amount to their taxpayers and to IRS would provide very helpful information related to deductibility. A barrier to any information reporting is that 19 of the 20 local-government tax collectors that we interviewed did not maintain records by a unique taxpayer identifier, such as the SSN. For IRS to check compliance in claiming only deductible charges, IRS would need an unambiguous way of matching the local data to the federal data, which traditionally relies on the SSN. Local-government representatives said significant challenges could arise in collecting and providing SSNs to IRS, given concerns about privacy, and possible needed changes to state laws.

Local-government representatives that we interviewed viewed information reporting as having the highest costs and burdens of the options that we discussed for providing additional information to taxpayers. One example of a potentially high cost that local governments would incur is the cost associated with computer reprogramming to enable them to report the information. One way to reduce the costs for many local governments would be to require information reporting for larger local governments only or for those that have nondeductible charges on their real estate bills. Requiring information reporting only selectively would eliminate the cost for some local governments, but would not reduce the costs for those that still have to report to IRS and would not eliminate concerns about providing the SSN.

Reporting deductible amounts on local real-estate tax bills

Another option for providing taxpayers with information about deductibility would be to report the deductible amounts on the local government bills provided to taxpayers only. This would eliminate the concerns about collecting and providing SSNs as well as the costs of reporting to IRS. Local-government representatives we interviewed said that their costs still could be high if major changes are required to local computer systems and bills. For example, they might have to regroup and to subtotal charges based on deductibility. Furthermore, not all local governments provide a copy of their bills to taxpayers who pay their real-estate taxes through mortgage escrow accounts. These taxpayers would need to receive an informational copy of their bills or be alerted to the nondeductible charges in some other manner.

Whether providing information on deductibility through information reporting or changing local bills, a major concern for local governments was determining deductibility. Local-government representatives expressed concerns about local governments protecting themselves from legal challenges over what is deductible, given the judgment necessary to determine deductibility. Local-government representatives and officials told us that local governments do not want to become experts in the federal tax code and would oppose making any determination of deductibility without assistance.

Providing a List to IRS on the Types of Charges on Local Real-Estate Tax Bills

Given local governments' concern about determining deductibility, local governments could provide information to IRS about the types of charges on their bills and IRS could use that information to help local governments determine deductibility, reducing their burden and concern somewhat while increasing costs to IRS. Even if IRS took on the responsibility of determining the federal deductibility of local government real-estate charges, local governments probably would still need to be involved. The IRS officials that we spoke with for the purpose of this job did not have extensive knowledge about charges on local tax bills. Local-government representatives indicated that local governments' willingness to work with IRS would greatly depend on IRS's approach. After determining deductibility, IRS and local governments could pursue cost-effective strategies for making information on deductibility available to taxpayers, such as posting this information on their respective Web sites.

IRS's processing costs could be large if tens of thousands of local governments reported on many types of specific charges. Even if IRS had some uniform format for local governments to use in reporting, the amount of information to be processed likely would be voluminous and diverse given variation in local charges. IRS also would incur costs to analyze the information and work with local governments that appear to have nondeductible charges. These IRS costs would vary with the breadth and depth of involvement with the selected local governments. IRS could mitigate costs if it could identify jurisdictions with significant dollar amounts of nondeductible charges, and work only with those jurisdictions.

Changing Real-Estate Tax Bills to Provide Information about Local Charges

In addition to not being given information on which local charges were deductible, another problem we found was that taxpayers do not receive enough information about the charges on real-estate tax bills to help them determine how much to deduct. Knowing about the basis for the charges, how the charges were used, and whether they applied across the locality are key pieces of information that could help taxpayers determine deductibility. We found that some local governments provided some of this information on their real-estate tax bills but many did not.

An alternative for informing taxpayers about local charges would be for local governments to identify which charges on its tax bills are *ad valorem* and non-*ad valorem*. Our work with IRS attorneys on the charges on tax bills in five large counties indicated to us that non-*ad-valorem* charges usually would be nondeductible because they generally are not applied at a uniform rate across a locality. Similarly, many *ad-valorem* charges would be deductible but with exceptions, such as when charges were not applied at a uniform rate across the locality or when they generated "local benefits" for the taxpayer. Because not all *ad-valorem* charges are deductible and not all non-*ad-valorem* charges are nondeductible, taxpayers still would be required to make the determinations.

If taxpayers claimed only the *ad-valorem* charges listed on their bills, compliance would likely improve for those who otherwise would deduct the full bill amount that includes nondeductible charges. Local governments that do not currently differentiate *ad valorem* from non–*ad valorem* would incur costs that would vary with how much the bill needs to change and the space available to report the information. However, representatives of local governments with whom we spoke saw this option as less burdensome than determining and reporting the deductible amounts.

Changing Local Bills to Provide Disclaimers That Some Charges May Not Be Deductible

A final option involving information on local tax bills could generate the lowest costs but would provide less information for taxpayers than other options related to changing local tax bills. That option is for local governments to place disclaimers on real-estate tax bills to alert taxpayers that some charges may not be deductible for federal income tax purposes.[57] Local-government representatives said that the direct costs would be minimal to the extent that the disclaimer was brief and that space was available on the bill. Adding pages or inserts to the bill would increase printing, handling, and mailing costs. Because the disclaimers would not provide any information to taxpayers to help them determine deductibility, some taxpayers would likely seek that information by calling the local governments. Handling a large volume of calls could be costly for local governments.

Improving Guidance to Taxpayers

Even if taxpayers were to receive more information about the local charges on their real estate bills, we found that taxpayers may not receive

[57] As discussed in the next option, mortgage companies could place similar disclaimers on their mortgage-related documents that report payments to local governments from escrow accounts.

enough guidance from IRS and third parties to help them determine how much to deduct and to alert them to the presence of nondeductible charges. For example, although IRS's guidance to taxpayers discusses what qualifies as deductible real-estate taxes, we found a few areas in which it was incomplete given that determining deductibility can be complex. Furthermore, third parties in the mortgage and tax-preparation industries did not regularly alert taxpayers through disclaimers and other information that not all charges may be deductible.

Options for helping taxpayers to apply information in order to determine which local charges are deductible include (a) enhancing IRS's existing guidance to individual taxpayers, and (b) having IRS engage in outreach to mortgage-servicer and tax-preparation industries about nondeductible charges and about any enhanced IRS guidance.

Enhancing IRS's Guidance to Taxpayers

Although IRS's guidance publications provided basic information to taxpayers about what could be deducted as a real-estate tax and the types of charges that could not be deducted, we found areas that, if improved, might help some taxpayers to comply. Those include

- placing a stronger disclaimer early in the guidance to alert taxpayers about the need to check whether all charges on their real-estate tax bill are deductible; across the IRS publications we reviewed, such an explicit disclaimer either was made near the end of the guidance or not at all;
- clarifying that a real-estate tax bill may not be sufficient evidence of deductibility if the bill includes nondeductible charges that are not clearly stated; our work showed that some bills could not be relied upon to prove deductibility but we found nothing that explicitly told taxpayers that they could not always rely on the bills as such evidence; and
- providing information or a worksheet on possible steps to take to obtain information about whether bills include nondeductible charges and what those charges are; to the extent that taxpayers may not know where to find the information necessary to determine whether any charges on their local bills are nondeductible, the guidance could suggest steps to help taxpayers start to get the necessary information.

The cost of IRS enhancing its guidance would vary based on the extent that IRS made changes in its written publications and electronic media, but these changes would not necessarily be costly to make. Taxpayer compliance could improve for those who have nondeductible charges on their local bills but who are not aware about the nondeductible charges and how to find them. Taxpayers also could spend some time and effort to discover whether any of the local charges are nondeductible but that time and effort would largely be a onetime investment unless the local government changes the charges on the real estate bills from year to year.

Having IRS Outreach to Third Parties on Disclaimers and IRS's Guidance

IRS could conduct outreach to two types of third parties that provide information or offer assistance to individual taxpayers about the real-estate tax deduction. First, IRS could engage mortgage servicers in how they might alert taxpayers that real-estate payments made through escrow accounts could include nondeductible charges, including those reported on IRS forms. The trade-offs discussed for putting disclaimers on local real-estate tax bills would apply here as well. Mortgage servicers would likely use a generic disclaimer on all escrow statements because currently the servicers do not receive information about nondeductible local charges that appear on the bills and usually only receive total amounts to be paid. However, if mortgage servicers happen to receive itemized information about local charges from local governments, they could report these details on escrow statements to inform taxpayers who may not receive a copy of their local real estate bill because their local charges are paid through the escrow. Doing so would generate some computing costs for the servicers.

Also, IRS could reach out to the tax-preparation industry—those who develop tax-preparation software as well to those who help individuals prepare their tax returns. The goals would be to ensure that those who provide guidance to taxpayers are alerted to the potential presence of nondeductible charges on real-estate tax bills and to ensure that they understand IRS's guidance, particularly if it is enhanced. IRS also could solicit ideas on ways to improve guidance to help individual taxpayers. The tax-preparation software companies could incur some costs if conversations with IRS result in revisions to their software. Other types of tax preparers, such as enrolled agents, would likely not incur many monetary costs but may experience resistance from individual taxpayers who do not wish to comply.

Enhancing IRS Enforcement of Compliance

If the implementation barriers to information reporting on this deduction were resolved and local governments were required to report information on real-estate taxes to IRS, IRS could expand its existing computer-matching system to include the real-estate tax deduction. If this option were chosen, IRS would incur the costs of processing and checking the adequacy of the local data, developing matching criteria, generating notices to taxpayers when significant matching discrepancies arise, and providing resources to interact with taxpayers who respond to the notices.

However, such matching programs have proven to be effective tools for addressing compliance.

IRS already conducts tens of thousands of examinations annually that check compliance in claiming the real-estate tax deduction. IRS could do more examinations of this deduction. However, the costs involved may not be justified given the current lack of information about the extent of noncompliance caused by claiming nondeductible charges and the associated tax loss.

Given that IRS is already doing so many examinations that audit the real-estate tax deduction, an option that could be less burdensome for IRS would be to ensure that its examiners know about this issue of nondeductible local charges whenever they are assigned to audit the deduction. Specifically, IRS could require its examiners to verify the deductibility of real-estate charges claimed whenever the examiners are examining a real-estate tax deduction with potentially large, unusual, or questionable nondeductible items.[58] Currently, examiners have the discretion to request evidence on the deductibility of real-estate charges, but are not required to request it. Furthermore, the guidance to examiners lists cancelled checks, mortgage escrow statements, Forms 1098 on mortgage interest amounts, and local government real-estate tax bills as acceptable types of evidence of deductibility. However, none of these documents necessarily confirm whether all local charges can be deducted. Since IRS is already examining the deduction, the marginal cost to IRS would stem from the fact that some examinations might take slightly longer if examiners take the time to ask taxpayers to provide the correct type of evidence to substantiate their real-estate tax deduction. However, this cost could be justified to ensure compliance with the existing law. IRS also may incur some costs to expand its existing training if examiners are not adequately informed about the deduction.

A Targeted Option to Improve Information, Guidance, and Enforcement

We identified one option that cuts across the problems facing both taxpayers and IRS and targets actions in the three areas of improving information, guidance, and enforcement. As discussed earlier, local governments could provide IRS a list of the types of charges on local real-estate tax bills that IRS could then use to help local governments determine deductibility if some charges appear to be nondeductible.

[58]Taxpayers are responsible for determining which charges are deductible.

However, that would impose reporting costs on all local governments and could inundate IRS with a lot of information to process, analyze, and use.

In this crosscutting option, IRS would limit its data collection to larger local governments that have apparent larger nondeductible charges on their real-estate tax bills. Our work initially focused on 41 of the largest local governments because they were most likely to have large property tax revenue and because smaller local governments would have a harder time compiling the information.

IRS could choose from a number of ways to identify larger local governments that appear to have larger nondeductible charges on their bills. A starting point could be the Census data we used to identify those local governments that collect the most property tax (see app. III of this report). Using these data, IRS could identify the larger local governments on which IRS could focus its data-collection efforts. For example, as an alternative to, or in addition to, requiring local governments to report the types of charges listed on their local bills, as discussed earlier, IRS could send a survey to selected local governments;[59] collect the data through its annual NRP research on individual tax compliance for a sample of tax returns; choose to do a separate research project; collect data from annual operational examinations that touch on the real-estate tax deduction; or query its employees on the types of charges on their own local tax bills.

Having received information from local governments, IRS could identify local governments whose bills have nondeductible charges that are large and unusual enough to make noncompliance and larger tax revenue losses likely to occur. Knowing which local governments have large nondeductible charges, IRS could also consider whether and how to use the data in a targeted fashion. IRS's costs would vary with the uses pursued and the number of local governments involved. IRS could use this data to

- design compliance-measurement studies for those localities;
- begin outreach with these local governments to help determine deductible charges and help affected taxpayers correctly compute the deduction;

[59] IRS could survey the selected local governments itself, or it could have the U.S. Census Bureau's Governments Division, which already surveys local governments on a quarterly basis, survey the local governments on its behalf.

- target guidance such as mailings or public service announcements to direct taxpayers to a list of nondeductible charges, or create a tool to help taxpayers determine a deductible amount for a locality;
- outreach with other third parties such as tax preparers and mortgage servicers to help them better inform[60] and guide taxpayers; and
- check the real-estate tax deduction for individual tax returns that have been selected for examination from taxpayers in those localities or, at a minimum, use the information when considering whether to examine one of these returns.

Conclusions

To fully comply with the current federal law on deducting local real-estate taxes, many individual taxpayers would need to apply significant effort to determine whether all charges on a real-estate tax bill are federally deductible. However, it is likely that some taxpayers do not invest sufficient time or energy in trying to comply with federal law for determining deductibility, or may not understand how to comply, or both. Nevertheless, the total compliance burden taxpayers would bear to properly comply is one useful reference point for judging the merits of alternative means of increasing compliance.

Taxpayers are responsible for determining which charges are deductible, and the burden to be fully compliant can be significant. This burden to properly comply with current federal law could be shifted from taxpayers to local governments, IRS, or third parties, or some combination of each. Along a continuum, this burden shifting could be major, such as through information reporting, or fairly minor, such as through providing taxpayers with better information or guidance to help them determine deductibility. In either case, taxpayer compliance is likely to improve and the overall compliance burden to society could possibly be lower to the extent that IRS, local governments, and other third parties can reduce the costs of overall compliance through economies of scale.

Because the extent of the compliance problem is not known and some of the options we identified could significantly increase local-government or IRS burdens in order to achieve significant compliance gains, a sensible starting point is options that impose less burden shifting. Providing taxpayers better guidance on how to comply, including the information

[60]If mortgage firms received information on local governments having potentially nondeductible charges on bills, they could target their disclaimers regarding nondeductible charges to particular escrow statements.

sources they need to consider, is among the least burdensome and costly means to address noncompliance with the real-estate tax deduction. Because taxpayers still would have to exercise considerable effort to comply fully, improved guidance may not materially reduce noncompliance. Providing taxpayers somewhat better information, such as real-estate bills that clearly identify *ad-valorem* and non-*ad-valorem* charges would shift more burden to local governments, but likely would have a larger effect on reducing noncompliance. Providing taxpayers traditional information reports, that is, documents that clearly identify federally tax deductible charges, would shift considerable burden to local governments and possibly IRS, but also would considerably reduce taxpayers' compliance burden and likely result in significant compliance gains. If local governments, possibly with IRS assistance, could determine deductibility for less cost than the sum of each taxpayer's costs in doing so, the net compliance burden for society may go down even as compliance increases.

Significant reductions in noncompliance might also be achieved with minimum shifting of burdens through targeted use of the identified options for addressing noncompliance. Targeting, however, requires information about localities where there are significant risks of taxpayers claiming large nondeductible charges. If IRS learned which jurisdictions have the largest dollar amounts of nondeductible charges on their bills, it could take a number of targeted actions, such as outreach to the local governments to help them determine deductible charges, targeted outreach to taxpayers in those jurisdictions to help them correctly compute the deduction, targeted outreach to the tax-preparation and mortgage-servicer industries, and targeted examinations of the real-estate tax deduction in these localities. Low-cost options are available to obtain this information, such as collecting tax bills as part of examinations of the real-estate tax deduction that already occur annually.

In terms of IRS's examinations, IRS could send a more useful signal to taxpayers of the importance of ensuring that only deductible real-estate taxes are claimed if IRS examinations more frequently covered which charges are deductible. At a minimum, IRS can take steps to ensure that its examiners know about the problems with nondeductible charges and how to address the noncompliance.

Recommendations for Executive Action

We are making 10 recommendations to the Commissioner of Internal Revenue:

To enhance IRS's guidance to help individual taxpayers comply in claiming the correct real-estate tax deduction, we recommend that the Commissioner of Internal Revenue

- place a stronger disclaimer early in the guidance to alert taxpayers to the need to check whether all charges on their real-estate tax bill are deductible;
- clarify that real-estate tax bills may be insufficient evidence of deductibility when bills include nondeductible charges that are not clearly stated; and
- provide information or a worksheet on steps to take to get information about whether bills include nondeductible charges and about what those charges are.

To help ensure that individual taxpayers are getting the best information and assistance possible from third parties on how to comply with the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue reach out to

- local governments to explore options for clarifying charges on the local tax bills or adding disclaimers to these bills that some charges may not be deductible;
- mortgage servicers to discuss adding disclaimers to their annual statements that some charges may not be deductible; and
- tax-preparation software firms and other tax preparers to ensure that they are alerting taxpayers that some local charges are not deductible and that they are aware of any enhancements to IRS's guidance.

To improve IRS's guidance to its examiners auditing the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue revise the guidance to

- indicate that evidence of deductibility should not rely on mortgage escrow statements, Forms 1098, and cancelled checks (which can be evidence of payment), and may require more than reliance on a real-estate tax bill; and
- require examiners to ask taxpayers to substantiate the deductibility of the amounts claimed whenever they are examining the real-estate tax deduction and they have reason to believe that taxpayers have claimed nondeductible charges that are large, unusual, or questionable.

To learn more about where tax noncompliance is most likely, we recommend that the Commissioner of Internal Revenue

- identify a cost-effective means of obtaining information about charges that appear on real-estate tax bills in order to identify local governments with potentially large nondeductible charges on their bills; and
- if such local governments are identified, obtain and use the information, including uses such as compliance research focused on nondeductible charges; outreach to such local governments to help them determine which charges are deductible charges and help affected taxpayers correctly compute the deduction; targeted outreach to the tax-preparation and mortgage-servicer industries, and targeted examinations of the real-estate tax deduction in the localities.

Agency Comments and Our Evaluation

On April 22, 2009, IRS provided written comments on a draft of this report (see app. IV). IRS noted that the report accurately reflects the difficulty that many taxpayers face when local jurisdictions include nondeductible charges on real-estate tax bills, particularly when these charges can vary and are not described in detail. IRS also noted that determining deductibility can be complex and that neither the local real-estate tax bills nor mortgage service documents tell taxpayers what amounts are deductible.

IRS agreed with 7 of our 10 recommendations and identified actions to implement them. Specifically, IRS agreed with 2 recommendations on enhancing guidance to taxpayers, saying it would change various publications to (1) highlight an alert to taxpayers to check for nondeductible charges on their real-estate tax bills and (2) caution that the bills may be insufficient evidence of deductibility.

IRS also agreed with three recommendations on outreach to third parties to ensure that taxpayers are getting the best information possible to comply in claiming the real-estate tax deduction. IRS agreed to contact local governments, mortgage servicers, and tax software firms to explore options to alert taxpayers that some charges might not be deductible. IRS also said it would work with local governments to clarify charges on their real-estate tax bills.

Further, IRS agreed with two recommendations on learning more about where noncompliance in claiming nondeductible charges is most likely and then taking action to improve compliance. IRS agreed to identify a cost-effective way to identify local governments that have potentially large nondeductible charges on their real-estate tax bills. After identifying these local governments, IRS also agreed to reach out to them to help determine the deductibility of their charges and help the affected taxpayers correctly claim the deduction. As part of this set of actions, IRS agreed to reach out to the tax preparation and mortgage servicing industries with customers in these localities.

IRS disagreed with three recommendations. However, for one of the recommendations, IRS did agree to take action consistent with the intent of the recommendation. We recommended that IRS enhance its guidance to taxpayers by providing information or a worksheet on steps taxpayers could take to find out if any charges on a real-estate tax bill are nondeductible. IRS said its Publication 17 already had a chart providing guidance on which real-estate taxes can be deducted but agreed to add a caution advising taxpayers that they must contact the taxing authority if more information is needed on any charge. We believe such an action will enhance IRS's current education efforts related to this issue and may help improve taxpayer compliance, especially if the addition provides guidance on situations in which a taxpayer may need to contact the taxing authority.

The other two recommendations IRS disagreed with related to improving IRS's guidance to its staff who audit the real-estate tax deduction. IRS did not agree to revise the guidance to clarify that mortgage escrow statements, cancelled checks, Forms 1098, and real-estate tax bills may not be sufficient evidence of deductibility. IRS also did not agree that examiners should ask taxpayers for evidence of deductibility whenever they are auditing the deduction and believe that the taxpayers have claimed nondeductible charges that are large, unusual, or questionable. IRS said that the guidance for examiners is sufficient and that examiners are to use their judgment and consider all available evidence in coming to a determination.

We appreciate that examiners must exercise judgment about the scope of an audit. However, in reviewing over 100 examination files and in talking with examiners, we found that not all examiners focus on the deductibility of the real-estate charges or ask the taxpayer for adequate evidence of deductibility, even in situations where deductibility may be in question. Therefore, when examiners have reason to believe that taxpayers claimed nondeductible charges that are large, unusual, or questionable, we continue to believe they should ask taxpayers for adequate support. We also continue to believe that the guidance to examiners should clearly state that real-estate bills should be examined and that other information on the nature and purpose of tax bill charges may also be needed. This improved guidance may be especially pertinent when IRS has implemented our recommendations to identify local governments with large nondeductible charges on their bills and to take related actions to help taxpayers comply. If IRS does targeted examinations of taxpayers in those localities, the IRS examiners will need to clearly understand what evidence is required to determine the deductibility of the various charges on the real-estate bills to ensure that taxpayers are correctly claiming the real-estate tax deduction.

As agreed with your office, 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, Senate Committee on Finance; Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. This report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions, please contact me at (202) 512-9110 or brostekm@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 found in app. V.

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Appendix I: Methodology for Survey of Local Governments

To learn about real-estate tax billing practices and the proportion of local government entities with potentially nondeductible charges on their real-estate tax bills, we conducted a mail-based sample survey of 1,732 local governments primarily responsible for collecting real-estate taxes due on residential properties. In designing the sample for our survey, we used the survey population of the U.S. Census Bureau's Quarterly Property Tax Survey (QPTS) as our sample frame. The QPTS is a mail survey the Governments Division of the U.S. Census Bureau conducts quarterly to obtain information on property taxes collected at the local governmental level.[61] The QPTS is part of a larger data-collection effort that the Census Bureau conducts in order to make estimates of state and local tax revenue. According to QPTS data, 14,314 local governments bill for property taxes.

The QPTS itself uses a stratified, one-stage cluster sample of local governments in 606 county areas with 16 strata.[62] In designing a sample based on the QPTS for our survey, we also used a stratified, one-stage cluster design. Specifically, of the 606 county areas included in the QPTS sample, we selected 192 county areas representing 18 strata.[63] Our sub-sample consists of a random selection of approximately 30 percent of the county areas in the 18 GAO strata with a minimum of 5 county areas selected in each stratum. All of the local governments within the selected county areas are included in the sample. The total number of local governments included in the sample was 1,732. Before constructing our sample, we checked to make sure that QPTS sample data provided to us by the Census Bureau were internally consistent and reliable for our purposes.

In our survey, we asked the local governments whether they included non-*ad-valorem* charges on their real-estate tax bills, how they differentiated non-*ad-valorem* charges from *ad-valorem* charges, and whether and how they alerted taxpayers to the presence of non-*ad-valorem* charges on the bills. We also asked the local governments for a sample residential real-estate tax bill that included information about all possible charges for which property owners in that jurisdiction could be billed.

[61]For the QPTS, property taxes include both taxes on real property and taxes on personal property.

[62]A county area is a contiguous, nonoverlapping area based on county boundaries.

[63]We developed 18 strata from the QPTS' original 16 strata by dividing 1 of the QPTS strata into 3 for our purposes.

We conducted two pretests of our draft survey instrument with officials from Alexandria, Virginia, and Montgomery County, Maryland, to ensure that (1) the survey did not place an undue burden on the respondent's time, (2) the questions and terminology were clear and unambiguous, (3) the respondents were able to obtain data necessary to answer the survey questions, and (4) our method for requesting sample bills matched any preferences offered by the respondents.

In late April 2008, we mailed questionnaires to our survey sample population using addresses of the local government entities provided to us from the Census Bureau's Governments Division. At the end of May, we sent a reminder letter with an additional copy of the questionnaire to all governments in our survey from which we had not yet received a response. If a survey respondent's answers required clarification (e.g., if a respondent did not follow the directions given in the survey), a follow-up call was conducted. Survey answers were then edited to reflect the additional information obtained in the calls.

Of the 1,732 surveys sent, we received 1,450 responses for an unweighted response rate of 84 percent. Response rates for the jurisdictions in each of our 18 strata ranged from 67 percent to 100 percent. All percentage estimates from our survey are surrounded by 95 percent confidence intervals.

In addition to sampling error, the practical difficulties of conducting any survey may introduce errors commonly referred to as nonsampling errors. For example, difficulties in how a particular question is interpreted, in the sources of information that are available to respondents, or in how the data are entered into a database or were analyzed, can introduce unwanted variability into the survey results. We took steps in the development of the questionnaire, the data collection, and the data analysis to minimize these nonsampling errors. For example, a social science survey specialist helped us design the questionnaire. Then, as stated earlier, the draft questionnaire was pretested with two local jurisdictions. Data entry was conducted by a data entry contractor and a sample of the entered data was verified. Finally, when the data were analyzed, independent analysts checked all computer programs.

Appendix II: Methodology for Review of Real-Estate Tax Bills

One of the objectives of this report was to describe factors that contribute to the inclusion of nondeductible items in real-estate tax deductions. In our 1993 report, we determined that one cause of taxpayers overstating their deductions was confusing real-estate tax bills that don't clearly distinguish taxes from user fees.[64] To update our previous work and to determine the extent to which real-estate tax bills currently distinguish between taxes on real property and user fees, we reviewed a sample of real-estate tax bills from local governments across the United States. This appendix outlines the methodology that we used to review these bills.

The sample of real-estate tax bills that we reviewed was a subset of the responses to our mailed survey of local governments, which was a stratified, random sample of 1,732 localities (see app. I). A question in our survey asked whether the local government included non-*ad-valorem* items in their bills, which are generally nondeductible. In another part of our survey, we asked respondents to attach a sample of a real-estate tax bill to their completed survey. We received a total of 1,450 responses to our survey. We did not generalize the results of this bill review because not all survey respondents provided bills as requested,[65] and because we did not know how the bills that were submitted had been selected by the respective responding governments.[66] We received over 643 bills from governments which included nondeductible charges on their bills. Of these bills, we deemed 486 to be usable.[67] We performed two reviews of the usable bills.

First, we used three criteria to determine if a real-estate tax bill clearly distinguished taxes from user fees:

1. Does the bill differentiate *ad-valorem* from non-*ad-valorem* charges?

[64]See GAO, *Tax Administration: Overstated Real Estate Tax Deductions Need To Be Reduced*, GAO/GGD-93-43 (Washington, D.C.: Jan. 19, 1993).

[65]Over 85 percent of the local governments that responded to our survey attached a bill to their survey responses. However, not all of the attached bills were usable for our analysis. We excluded bills that did not include non-*ad-valorem* charges from our bill review.

[66]Because we do not know how respondents to our survey chose the bills they attached, we do not know for sure if the bills we were provided are representative of the bills from those jurisdictions. There may be biases in the bills submitted.

[67]We did no review if the attached bill or item (a) had insufficient information to answer our three criteria, (b) was for a commercial property, (c) was not a real-estate tax bill from a local government in our survey, (d) was blank, (e) was not actually a real-estate tax bill, or (f) had incomplete information.

2. Are all the charges in the bill clearly identified and explained?
3. Does the bill contain a disclaimer warning that some of the charges included in the real-estate tax bill may not be deductible for federal tax purposes?

A bill met our first criterion if either of the following applied:

- The bill differentiated by labeling each item as *ad valorem* or non–*ad valorem*.
- The bill provided millage rates for items.[68]

A bill met our second criterion if all of the line items were individually broken out AND either of the following applied:

- Line item descriptions were spelled out and clearly identified.
- Additional information or explanations regarding line items are available in paper form or electronically.

A bill met our third criterion if either of the following applied:

- The bill contained a disclaimer stating that all items appearing on the bill may not be deductible.
- The bill contained a disclaimer stating that taxpayers should consult IRS code and publications or their tax advisor for assistance in determining deductibility.

Through our review, we found that about 60 percent of the bills satisfied our first criterion, with almost all of these using millage rates to differentiate *ad-valorem* from non-*ad-valorem* charges. Only about 30 percent of bills satisfied our second criterion. The main reason bills did not meet our second criterion was because line-item descriptions were not easily identifiable (e.g., a taxpayer could not determine the respective charge's use based solely on the information on the bill). None of the bills satisfied our third criterion.

In our second bill review, we determined whether the real-estate tax bills provided taxpayers with either of the following:

- A total for the charges that are deductible for federal income tax purposes.
- A warning that some of the charges on the bill may be nondeductible for federal income tax purposes.

[68] A millage rate is a tax rate expressed in dollars per thousand.

Of the 486 usable bills we reviewed, none satisfied either of these two criteria.[69]

Although our sample of real-estate tax bills is not representative of local governments nationally, the results of our review illustrate that many taxpayers would face challenges in determining what is deductible if they were to rely solely on the information provided on their real-estate tax bills.

[69]Although none of the real-estate tax bills that we reviewed indicated what amounts were deductible or warned about potentially nondeductible charges, it is possible that there are localities that do provide this information on their bills.

Appendix III: Methodology for Case Studies of Taxpayer Noncompliance

This appendix describes the methodology, including sample selection, we used to (1) determine the deductibility of charges on tax bills in five counties: Alameda County, California; Franklin County, Ohio; Hennepin County, Minnesota; Hillsborough County, Florida; King County, Washington; and (2) calculate the extent of overstated deductions in two of those counties—Alameda County, California and Hennepin County, Minnesota—for tax year 2006.

Sample Selection

We derived our list of local governments that collect property taxes from the survey population of the U.S. Census Bureau's Quarterly Property Tax Survey (QPTS). The QPTS sample consists of local governments in 606 county areas[70] with 312 of those counties selected with certainty. The 312 counties had a population of at least 200,000 people and annual property taxes of at least $100 million in 1997. We decided that large counties would be best for this study because they were more likely to have large property tax revenue and to maintain property tax data in electronic formats that we could more easily obtain and manipulate than paper records. We started with the 41 largest counties based on property tax revenue. We randomly sorted these 41 large collectors and picked the first 5 from the sorted list that fit the team's inclusion criteria:

(1) presence of user fees, special assessments, special district taxes, or other non-*ad-valorem* items on real-estate tax bills for most or all residential property owners;[71]

(2) willingness of the local government to participate; and

(3) usability and reliability of the data.

Using these criteria, we selected Alameda County, California; Franklin County, Ohio; Hennepin County, Minnesota; Hillsborough County, Florida; and King County, Washington for our initial analyses.[72]

[70]By county areas, we mean counties or their nonoverlapping county-equivalents.

[71]Of the 41 jurisdictions we researched, we determined from interviews and sample bills that we obtained that user fees, special assessments, or other non-*ad-valorem* charges were present on most or all real-estate tax bills in 16 jurisdictions.

Deductibility Determinations

We collaborated with officials from the Internal Revenue Service's (IRS) Office of Chief Counsel to determine the deductibility of charges on the five counties' real-estate tax bills. IRS agreed to review information we provided about the charges on these tax bills in order to provide an opinion on the deductibility of the charges. IRS did not seek additional information from the counties regarding the charges, and IRS based its determinations solely on the materials we submitted. Additional information could result in conclusions different from those IRS reached as a result of the data we provided IRS.

Prior to assembling information for IRS's review, we interviewed officials from IRS's Office of Chief Counsel to gain a better understanding of what information IRS needed to make the determinations. IRS officials provided a list of the types of information they would need to determine whether a particular assessment levied by a taxing jurisdiction was a deductible real-property tax. Specifically, IRS asked us to provide information related to the following for each charge:

(1) Is the tax imposed by a State, possession, or political subdivision thereof, against interests in real property located in the jurisdiction for the general public welfare?

(2) Is the assessment an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power? Is payment optional or avoidable?

(3) The purpose of the charge. Is it collected for the purpose of raising revenue to be used for public or governmental purposes?

(4) Is the tax assessed against all property within the jurisdiction?

(5) Is the tax assessed at a uniform rate?

(6) Whether the payer of the assessment is entitled to any privilege or service as a result of the payment. Is the assessment imposed as a payment for some special privilege granted or service rendered? Is there any

[72] In selecting the five counties we did not include those jurisdictions that charged more than $500 for the needed data. Also, once we selected a jurisdiction from a state, we did not include other jurisdictions from that state to achieve geographical diversity. In addition, due to time constraints, we also included jurisdictions according to the order in which we received data.

relationship between the assessment and any services provided or special privilege granted?

(7) Is use of the funds by the tax authority restricted in any way? Are the funds earmarked for any specific purpose?

(8) Is the assessment for local benefits of a kind tending to increase the value of the property assessed? Does the assessment fund improvements to or benefiting certain properties or certain types of property? If so, is a portion of the assessment allocable to separately stated interest or maintenance charges?

IRS officials also indicated that the following materials would be helpful in making their determinations:

(1) A copy of the statute imposing the tax.

(2) Materials published by the local government or tax-collecting authority describing the levy, including taxpayer guides, publications, or manuals describing the tax.

(3) The forms and instructions relating to the tax.

(4) A printed copy of the Web pages maintained by the jurisdictions related to the tax.

To collect this information, we interviewed county officials and reviewed documentation either provided by county officials or found on county Web sites. Most of the selected counties' Web sites provided tax rate tables or a list of the taxing authorities for the *ad-valorem* charges found on the tax bills; some also had information for the non-*ad-valorem* charges. For each of the year 2006 tax bill charges, we searched the counties' Web sites and used online search engines to collect supporting documentation. We also searched state constitutions and statutes to identify the legal authority for each charge on real-estate tax bills; to a varying degree, county officials provided citations to the specific statutes that provided the legislative authorities for the charges. In addition to the real-estate tax information found online, we interviewed local tax officials in each of the five local counties to gather the requested information.

Based on the materials we submitted, IRS concluded that some charges were deductible, some were nondeductible, and others required information for IRS to determine their deductibility. Table 1 below summarizes the results of IRS's determinations.

Table 5: Summary of IRS's Deductibility Determinations for Five Selected Jurisdictions

IRS determination regarding charges on 2006 tax bills	Local jurisdiction: Alameda County, CA	Hennepin County, MN	Hillsborough County, FL	King County, WA	Franklin County, OH
Bills contained deductible *ad-valorem* charges	X	X	X	X	X
Bills contained nondeductible *ad-valorem* charges		X	X	X	X
Additional information required for IRS to make a determination about at least one *ad-valorem* charge on the bills	X	X		X	
Bills contained nondeductible non-*ad-valorem* charges	X	X	X	X	X

Source: GAO analysis of IRS data.

Computation

Using IRS data on real-estate tax deductions claimed by taxpayers in the selected counties and county data on real-estate taxes billed to property owners, we identified how much taxpayers likely overstated their real-estate tax deductions by claiming nondeductible charges in two counties—Alameda County, California, and Hennepin County, Minnesota—for tax year 2006. We restricted our analysis to these two counties due to limitations in resources. While taxpayers can claim deductions for real-estate taxes paid on multiple IRS schedules, we limited our analysis to the amount claimed on IRS Form 1040, Schedule A, which generally does not include deductions for real estate used for business purposes.

We used the SAS SQL procedure (PROC SQL) to merge the IRS data to the tax-roll data we received from our two selected counties. To conduct the match, we parsed the last name, first name, street address, city, state, and zip code from the IRS data and the local data. We conditioned the PROC SQL merge to include in the output data set only those records in which the parsed first names, last names, and zip codes matched.

Prior to the match, we controlled for taxpayers who own multiple properties within each of our selected jurisdictions by using a unique identifier for each taxpayer and subtotaling the taxpayers' *ad-valorem* and non-*ad-valorem* charges by the unique identifier. To the extent we were able, we used existing, numerical identifiers in the data—such as property number and account numbers—to produce a subtotal for each taxpayer. When the numeric identifiers available in the data were not available, we used the parsed name and address fields to create a unique identifier.

After the PROC SQL merge, we controlled for duplicate records by keeping only those records where the last name, first name, street address, city, state, and zip codes matched. It is still possible that some duplicates exist in the data, since the names and address fields were recorded in disparate ways in the data we received from the counties. We used programming logic to parse the names; due to the inconsistencies in the names and address fields in the data, the name and address information may not have parsed the same way for all taxpayers.

For each taxpayer that we were able to match to the county data, we compared the amount the taxpayer claimed as a real-estate tax deduction on the Schedule A return to the total *ad-valorem* amount each taxpayer was billed by the county and which was due in 2006. We then calculated the difference between the amount claimed on Schedule A and the *ad-valorem* portion of the amount billed by the county for each taxpayer. As indicated above, we worked with IRS to determine which charges billed by the county were deductible under federal tax law. The counties we selected for analysis did not maintain their tax data in a way that would allow us to itemize all of the charges, particularly the *ad-valorem* charges, on individuals' tax bills. As a result, we were not able to take into account *ad-valorem* charges that may not be deductible in our lower-bound computation of overstated real-estate tax deductions. Instead, we used the *ad-valorem* portion of the amount billed as a proxy for the deductible amount. While the proxy is imperfect, it is our understanding that the non-*ad-valorem* charges in our selected counties were not imposed at a uniform rate and thus did not appear to be deductible as taxes under Section 164 of the Internal Revenue Code. Given the limitations of the data, this approach allowed us to take into account those charges that are least likely to be deductible. Also, the approach produced a lower-bound computation of potential noncompliance in our two counties. We can only produce a lower-bound computation due to uncertainty of noncompliance for those taxpayers where we could not match IRS and local records.

To develop the lower-bound computations of potential noncompliance, we excluded those taxpayers whose claimed deduction was greater than 1.15 times the total amount billed; this was chosen as a cutoff point to account for taxpayers who may own multiple properties and therefore deduct on their federal tax return a higher amount than is shown on the local tax bills. We also excluded taxpayers whose claimed deduction was less than the *ad-valorem* portion of the amount billed by the county (within a small margin of error), since we did not have conclusive data to determine whether the taxpayers held only a partial ownership in the real estate covered by the local bill.

We then summed the difference between the claimed Schedule A deduction and the *ad-valorem* portion of the amount billed by the county to develop a lower-bound computation of noncompliance for the population of taxpayers in each county that we were able to match to the county data.

For the purposes of our analysis, we created two separate categories for those taxpayers who claimed a deduction that was approximately equal to the billed amount up to 1.15 times the total amount billed. We defined those taxpayers who claimed a deduction within $2 of the full amount billed, when the bill contained non-*ad-valorem* amounts, as “very likely overstated.” We defined those taxpayers who claimed a deduction that was greater than $1 less than the total *ad-valorem* amount billed but less than 1.15 times the total billed amount as “likely overstated.”

Results

Table 6: Summary of Taxpayer Records Matched from IRS Data to Alameda County Data and Hennepin County Data for 2006

	Alameda County	Hennepin County
Records[a] In IRS data	221,524	241,523
Records matched from county data to IRS data	99,630	95,793
Matched records not included in analysis because amount claimed lower than $2 less than total billed amount or $1 less than the *ad-valorem* amount billed	12,814	23,597
Matched records not included in analysis because amount claimed higher than 1.15 times total billed amount	13,940	11,603
Matched records with non-*ad-valorem* charges	99,521	9,519
Matched records with non-*ad-valorem* charges not included in analysis because amount claimed lower than $2 less than total billed amount or $1 less than the *ad-valorem* amount billed	12,806	2,367
Matched records with non-*ad-valorem* charges not Included in analysis because amount claimed higher than 1.15 times total billed amount	13,896	1,055

Source: GAO analysis of IRS, Alameda County, and Hennepin County data.

[a]Each IRS record is based on an individual tax return for tax year 2006 with a real-estate tax deduction on Schedule A.

Table 7: Number and Dollar Amounts of Likely Overstated Real-Estate Tax Deductions by Individual Taxpayers in Alameda County and Hennepin County for Tax Year 2006

	Very likely overstated[a]		Likely overstated[b]		Total	
	Number	**Dollars in millions**	**Number**	**Dollars in millions**	**Number**	**Dollars in millions**
Alameda County	37,168	20.9	35,651	23.2	**72,819**	**44.1**
Hennepin County	4,603	1.6	1,494	0.5	**6,097**	**2.1**
Total	**41,771**	**22.5**	**37,145**	**23.7**	**78,916**	**46.2**

Source: GAO analysis of IRS, Alameda County, and Hennepin County data.

[a]We defined "very likely overstated" as those taxpayers who claimed a deduction that is within $2 of total billed amount in 2006.

[b]We defined "likely overstated" as those taxpayers who claimed a deduction that was greater than $1 less than the *ad-valorem* amount billed in 2006 but less than 1.15 times the total billed amount.

Appendix IV: Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

April 22, 2009

Mr. Michael Brostek
Director, Tax Issues Strategic Issues Team
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Brostek:

I reviewed your draft GAO report entitled *Real Estate Tax Deduction: Taxpayers Face Challenges in Determining What Qualifies; Better Information Could Improve Compliance: (GAO-09-521)*. The report accurately reflects the difficulty many taxpayers face when their local jurisdictions include nondeductible charges on their tax bills. These charges can vary across local jurisdictions and are often not described in detail on real estate tax bills.

As noted in your report, you surveyed a sample of 1,700 local communities and studied compliance in two jurisdictions. You found that neither local government tax bills nor mortgage service documents identify what taxpayers can properly deduct. As you indicate, without this information, determining deductibility can be complex and involve significant effort. Any significant compliance improvement in this area would require local and other jurisdictions to review and revise their current bills, which they may not be able or willing to do. In order to enhance our current educational and outreach efforts on this issue, we will add a caution to the instructions for Schedule A (Form 1040), Itemized Deductions, advising taxpayers to look closely at their real estate tax bills, as some items may not be deductible, and to contact the taxing authority if they have any questions.

Responses to your specific recommendations are enclosed. We appreciate the continued and valuable support from you and your staff on this issue. If you have any questions, or would like to discuss this response in more detail, please contact Don Mainwaring, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.

Sincerely,

Linda E. Stiff

Linda E. Stiff

Enclosure

Enclosure

Recommendation
To enhance IRS's guidance to help individual taxpayers comply in claiming the correct real-estate tax deduction, we recommend that the Commissioner of Internal Revenue: place a stronger disclaimer early in the guidance to alert taxpayers to the need to check whether all charges on their real-estate tax bill are deductible.

Comment
The IRS agrees with this recommendation. Publication 17, Your Federal Income Tax (For Individuals), and Publication 530, Tax Information for First-Time Homeowners, contain a caution advising taxpayers they must look at their real estate tax bill to determine if any nondeductible charges are included in the bill. The IRS will add this caution to the instructions for Schedule A, (Form 1040) Itemized Deductions.

Recommendation
To enhance IRS's guidance to help individual taxpayers comply in claiming the correct real-estate tax deduction, we recommend that the Commissioner of Internal Revenue: clarify that real-estate tax bills may be insufficient evidence of deductibility when bills include nondeductible charges that are not clearly stated.

Comment
The IRS agrees with this recommendation. As discussed above, the IRS will add a caution to the instructions for Schedule A (Form 1040), Itemized Deductions. This information, in addition to guidance currently available to taxpayers in various publications, should further clarify this issue.

Recommendation
To enhance IRS's guidance to help individual taxpayers comply in claiming the correct real-estate tax deduction, we recommend that the Commissioner of Internal Revenue: provide information or a worksheet on steps to take to get information about whether bills include nondeductible charges and about what those charges are.

Comment
The IRS does not agree with this recommendation. This information is provided in the 2008 Publication 17 in a chart on page 149 entitled "Which Taxes Can You Deduct?" The chart lists various items you either can or cannot deduct for the different taxes, and includes links to obtain additional information. In order to further educate taxpayers, the IRS will add the following sentence to the caution in Publication 17, Publication 530, and the instructions for Schedule A (Form 1040), which advises taxpayers they must look at their real estate tax bill to determine if any nondeductible charges are included in the bill: "Contact the taxing authority if you need additional information about a specific charge on your real estate tax bill."

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Recommendation
To help ensure that individual taxpayers are getting the best information and assistance possible from third parties on how to comply with the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue reach out to local governments to explore options for clarifying charges on the local tax bills or adding disclaimers to these bills that some charges may not be deductible.

Comment
The Wage and Investment Division (W&I) will coordinate with Small Business/Self Employed Division (SB/SE) Communications, Liaison and Disclosure (CLD) to explore options with local governments to clarify charges on the local tax bills or adding disclaimers to these bills that some charges may not be deductible.

Recommendation
To help ensure that individual taxpayers are getting the best information and assistance possible from third parties on how to comply with the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue reach out to mortgage escrow firms to discuss adding disclaimers to their annual statements that some charges may not be deductible.

Comment
The W&I Division will coordinate with SB/SE CLD to explore options with mortgage escrow firms to add disclaimers to these bills that some charges may not be deductible.

Recommendation
To help ensure that individual taxpayers are getting the best information and assistance possible from third parties on how to comply with the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue reach out to tax preparation software firms and other tax preparers to ensure that they are alerting taxpayers that some local charges are not deductible and that they are aware of any enhancements to IRS' guidance.

Comment
The W&I Division will explore options with tax preparation software firms and other tax preparers to ensure they are alerting taxpayers that some local charges are not deductible.

Recommendation
To improve IRS's guidance to its examiners auditing the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue revise the guidance to: indicate that evidence of deductibility should not rely on mortgage escrow statements, Forms

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1098, and cancelled checks (which can be evidence of payment), and may require more than reliance on a real-estate tax bill.

Comment
We do not agree with this recommendation. The guidance available to examiners in IRM 4.19.15.23.2, Taxes Paid, provides sufficient information to properly examine this deduction. Examiners are expected to use their judgment and to consider available documentary evidence, oral testimony, taxpayer credibility, and all facts and circumstances to arrive a correct determination.

Recommendation
To improve IRS's guidance to its examiners auditing the real-estate tax deduction, we recommend that the Commissioner of Internal Revenue require examiners to: ask taxpayers to substantiate the deductibility of the amounts claimed whenever they are examining the real-estate tax deduction and they have reason to believe that taxpayers claimed nondeductible charges that are large, unusual, or questionable.

Comment
We do not agree with this recommendation. The guidance available to examiners in IRM 4.19.15.23.2, Taxes Paid, provides sufficient information to properly examine this deduction. Examiners are expected to use their judgment and to consider available documentary evidence, oral testimony, taxpayer credibility, and all facts and circumstances to arrive a correct determination.

Recommendation
To learn more about where tax noncompliance is most likely, we recommend that the Commissioner of Internal Revenue: identify a cost-effective means of obtaining information about charges that appear on real-estate tax bills in order to identify local governments with potentially large nondeductible charges on their bills.

Comment
The W&I Division will coordinate with SB/SE CLD to identify a cost-effective means of obtaining information about charges that appear on real-estate tax bills in order to identify local governments with potentially large nondeductible charges on their bills.

Recommendation
To learn more about where tax noncompliance is most likely, we recommend that the Commissioner of Internal Revenue: if such local governments are identified, obtain and use the information, including uses such as compliance research focused on nondeductible charges; outreach to such local governments to help them determine which charges are deductible charges and help affected taxpayers correctly compute the deduction; targeted outreach to the tax preparation and mortgage escrow industries

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with customers in the affected localities, and targeted examination of the real estate tax deduction in the localities.

Comment

The W&I Division will coordinate with SB/SE CLD to provide outreach to local governments identified through research activities. Such outreach will assist these local governments, in determining which charges are deductible and help affected taxpayers correctly compute the deduction. In addition, we will provide outreach to the tax preparation and mortgage escrow industries with customers in the affected localities.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Tom Short (Assistant Director), Paula Braun, Jessica Bryant-Bertail, Tara Carter, Hayley Crabb, Sara Daleski, Melanie Helser, Mollie Lemon, and Albert Sim made contributions to this report. Stuart Kauffman, John Mingus, Karen O'Conor, and Andrew Stephens also provided key assistance.

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