

by Gene Steuerle

Improved Information Reporting for Capital Gains

The tax reform commission has not been afraid to tackle some fairly big and controversial tax issues, including reform of many of the deductions, exclusions, credits, and other tax preferences in the tax code. One less exciting but clearly relevant issue deserves its attention as well. Even when tax preferences make sense, and options for alternative ways of calculating net income are reasonable, maintaining them should be dependent on the ability of the IRS to administer them. Not only has the agency been assigned far more to do than is humanly possible, but in many cases compliance could be improved and taxpayer burdens lowered with better reporting systems in place. The reform commission, therefore, should consider making recommendations for improved information reporting wherever it deems private costs are reasonable relative to the improved compliance and taxpayer simplification that would result. Where time constraints are binding, it should at least suggest that the IRS formally be tasked with making recommendations in this area on a regular basis. In this note, I suggest one ripe area for expanded reporting involves capital gains, particularly from mutual funds and brokerage houses.

In the 1980s Congress was faced with a severe deficit situation, although nothing nearly as threatening as the current one, since there was no impending drop in revenue growth with the retirement of the baby boomers. Through the leadership of Sen. Robert Dole and others, Congress chose to try to increase revenues through better reporting rather than to increase tax rates on all taxpayers, including those who were already compliant. As a result, reporting was extended to such items as capital gains receipts and tip income. My guess is that in searching for deficit reduction packages in the future — and there will be such searches, believe me — improved compliance will be high on Congress's list.

Research has shown for some time that both noncompliance and error rates are lowest when there is in place a system of withholding, as in the case of wages. Next in line in terms of lower noncompliance rates are those items where taxpayers and the IRS get similar statements at the same time as to the income earned by the taxpayer. When interest and dividends became subject to information reporting, for instance, the noncompliance rate appears to have declined significantly.

One area in which reporting has improved but is still inadequate is capital gains. Intermediaries such as mutual funds, brokerage houses, and trust departments must report total payments from sales of capital gains property, but they do not need to report the net amount of gain received. Accordingly, the IRS cannot do computer matches on net capital gains. With audit rates

typically below 1 percent of all individual taxpayers, there are almost certainly substantial amounts of capital gains reported with error, sometimes because of outright cheating, often because of the complexity of the calculation. The current system also forces taxpayers to make many more calculations than are reasonable.

Mutual funds have become a very common form of investment for millions of ordinary American families. Many families do not understand the alternative ways that their capital gains from those funds can be reported. It is foolish to allow multiple choices of how to report those gains when those choices deter making better use of the computer-matched reports on which the Service increasingly relies. I first wrote about this problem in 1990 (*Tax Notes*, Apr. 30, 1990, pp. 609-10). One consequence, I am told, was that the mutual fund industry did take some valuable steps to try to improve reporting to taxpayers.

But time, information systems, and our knowledge of what the IRS can and cannot do well all have advanced over the succeeding 15 years. The system is still unnecessarily confusing and convoluted for most taxpayers and still results in an excessive and unnecessary amount of time for recordkeeping and dealing with tax preparers. There are few mutual fund accounts that should not now have information on the original cost for most or all the purchases in the accounts. In any case, a grace period could be allowed for taxpayers to report basis to the mutual fund (technically, they need to know it anyway for the IRS) for those few cases in which the information is not available or the mutual fund has discarded it.

One response to my 1990 article was that this type of requirement would disadvantage mutual fund holders relative to direct holders of stock. That is incorrect. The stockholder who wishes to separate his stock into separate piles (for example, so that the first purchased stock of a company can be claimed to be the one that was sold) now has to keep separate records and, sometimes, for accounting convenience, separate accounts. The mutual fund holder who wants to avoid some common rule (such as average cost accounting) can also avail himself of multiple options simply by opening up more than one account.

I suggest also that the reform would be good news for many mutual fund companies. Take the case of savers who want to invest their liquid assets in funds that are fairly safe but do not necessarily provide complete protection of value. For instance, with exact reporting they would invest in funds holding one- and two-year bonds, which generally provide a higher rate of return than money-market funds. If those investors make regular deposits to those accounts, write checks against those accounts, and redeposit dividends back into those accounts, the amount of recordkeeping required over time

for what on average amounts to zero capital gains can be extraordinary. My guess is that many simply do not report those gains correctly, or don't invest in the funds because of the complicated tax calculations that would be required — and that the IRS auditors, as well, check up on those calculations even less than for other capital gains because of the modest amount likely to be at stake and because of the time-consuming complications they themselves would face in cross-checking the taxpayers' information.

Fortunately, many mutual funds are now offering to provide a calculation of net gains to the shareholder if he wants it. But the IRS still has no report on which to match net gains. For that type of fund, money in and out can be very high relative to gains received (which tend to be zero or relatively small). It's time to take the next step: With few exceptions, give taxpayers one number to file with the IRS and be done with it. And give the IRS a number it can administer.

Because so many taxpayers make use of mutual funds, I suggest mutual fund reporting reform even in the absence of other capital gains reporting reform. Nonetheless, I also suggest that brokerage houses and other financial intermediaries also be required to begin reporting net capital gains to the IRS. To achieve that goal, it is also necessary to move toward one system of reporting for capital gains for multiple purchases of the same stock — at least within any one account. The reasons are similar to those expressed above for mutual funds — most brokerage houses and financial intermediaries now have the information in place to do the job. And if they don't, they are not serving their customers well, especially at the end of the year when those customers call them for help in reporting capital gains on their tax returns. For that matter, reform would probably relieve them of much expensive communication with customers over how to calculate basis and net gains to be reported to the IRS.

Take a taxpayer who buys and sells stock on occasion, but also participates in a dividend reinvestment plan. Again, the amount of recordkeeping can be extraordinary, if done by hand, over time. And the taxpayer who doesn't know what to do or doesn't have the time to do it may pay some accountant unnecessary fees simply to make the calculations. The fees themselves can easily be

in excess of the amount of additional tax due. The advancement of computers and accounting systems by brokerage and other firms must be used to simplify reporting here. I suggest, therefore, that each firm be required to report a figure to the taxpayer for the gains on the account holding that stock, using one single legislatively required method. Specific identification of which stock was sold would no longer be allowed within any one account. Once again, a grace period can be allowed for taxpayers to report basis to those firms who do not have the information available. And, once again, it is painfully obvious that this is the only way the IRS will ever be able to attain high compliance levels and minimum error rates on net gains from sales of stocks with multiple purchase dates.

Still, some flexibility must be allowed. A taxpayer, for instance, could hold the same stock with two different brokerage companies, just as he could hold similar stock with two different mutual fund companies. Each brokerage may be able to report one number for capital gains for any one account, but would have no way of knowing whether that was, say, the average cost basis for all stocks held by the individual. So be it. If a taxpayer wants to go to the trouble of opening multiple accounts, let him. Stopping him probably cannot be enforced easily.

As with all information reporting, there would still be some exceptions for which the individual taxpayer would be required to make adjustments, as in the case of wash sales across accounts. And some transition rules inevitably would be required. For the vast majority of transactions, however, the net capital gains report would be used just as are reports on dividends and interest by most taxpayers. Accuracy rates, I am confident, would shoot up almost immediately.

The main goals of this proposal are simplification for the taxpayer and an improvement in compliance. The IRS could match net gains from information reports with what taxpayers report on their returns, taxpayers would not be faced with multiple choices, they would not have to pay extra fees to their tax preparers to track down additional data, and financial intermediaries would get fewer requests for information from taxpayers at the end of the year. When it comes to capital gains reporting, it really is time to move forward.