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TAX ADMINISTRATION

Improving Compliance With  
Real Estate Tax Deductions

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IMPROVING COMPLIANCE WITH REAL ESTATE TAX DEDUCTIONS  
SUMMARY OF STATEMENT BY  
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The tax losses due to taxpayers' overstating their federal real estate tax deductions are likely to be seriously underestimated, leading to millions of tax dollars not reaching federal, state, and local government treasuries each year. A major reason is taxpayer confusion caused by unclear IRS instructions and local tax bills that lump together the deductible real estate tax with the nondeductible user fees for local services such as trash collection.

GAO believes that IRS can improve taxpayer compliance by cooperatively working with local officials to simplify tax documents and to redirect enforcement efforts. GAO recommended that IRS clarify instructions on this deduction and help local governments rewrite tax bills so taxpayers can identify the nondeductible user fees. GAO also recommended revised enforcement measures, such as working with local governments to collect data on actual real estate payments.

The National Association of Counties (NACo) has offered a proposal that would require IRS to clarify its tax return instructions and require local governments and mortgage companies to clarify their bills and statements. Taxpayers would then receive the information required to comply with the law. If this proposal does not work, Congress may need to consider some form of information reporting or some clarification of the deductibility of local charges to improve compliance.

Information reporting by local governments is one way of encouraging taxpayers to comply with this deduction. GAO has generally supported the use of information reporting to increase tax compliance. However, in the context of the real estate tax deduction, GAO believes that information reporting creates costs for IRS and local governments that may exceed the benefits. Also, federal legislation would be required to enable local governments to effectively collect and report the social security numbers of local property owners. GAO favors trying less complex alternatives first.

GAO also offers brief comments on two other proposals. GAO generally sees merit in the concept of extending information reporting to all financial institutions, as well as in automatically verifying the federal taxpayer identification number (TIN).



Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to offer our views on the need to improve taxpayer compliance with real estate tax deduction law. As you may know, we recently issued a report, requested by Chairman David Pryor, Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service (IRS), that recommended ways to improve the compliance of taxpayers who overstate their tax deductions for real estate tax payments.<sup>1</sup> To conclude my statement, I will briefly comment on two other proposals before the Subcommittee--debt forgiveness and automated verification of taxpayer identification numbers (TIN).

I will make three major points about overstated deductions for real estate tax payments, on the basis of the work we did for our report. These points are:

- Individual taxpayers mostly overstated their deductions for real estate tax payments by including nondeductible payments such as user fees.
- Confusion over which payments were and were not deductible real estate taxes contributed to taxpayer noncompliance.
- IRS can improve taxpayer compliance by simplifying tax documents and redirecting its enforcement efforts, working cooperatively with state and local officials.

#### BACKGROUND

Before discussing these three points, let me describe the deduction for real estate tax payments. Under tax law, taxpayers may deduct real estate tax payments from their federal taxable income. Real estate taxes are uniform payments that are based on the value of a taxpayer's real estate; they are used to fund general services. Other payments to local governments, such as user fees, generally cannot be deducted because they do not meet these criteria. User fees fund the use of specific services such as water, sewerage, and trash collection and are not based on the value of real estate.

#### OVERSTATED REAL ESTATE TAX DEDUCTIONS REDUCED INCOME TAX REVENUES

IRS compliance data showed that individual taxpayers overstated their real estate tax deductions by an estimated \$1.5 billion for 1988. Projecting these results to 1992, we estimated that this noncompliance led to a federal tax loss of \$400 million.

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<sup>1</sup>Tax Administration: Overstated Real Estate Tax Deductions Need to Be Reduced (GAO/GGD-93-43, Jan. 19, 1993).

We believe these estimates understate the scope and tax effect of the noncompliance. We analyzed the IRS audits that generated the compliance data.<sup>2</sup> We found that in one large urban county, IRS auditors identified just 7 percent of the \$21.6 million in overstated real estate taxes for 1 year. As a result, we estimated that the lost federal tax revenue totaled \$6 million and lost county and state tax revenue totaled \$1.6 million.<sup>3</sup>

In this county, taxpayers overstated the \$21.6 million by deducting user fees along with their real estate tax payments. Our 1992 survey of 171 large local governments showed that taxpayers in about half of these localities also were likely to include user fees in their real estate tax deductions. Although we did not have resources to estimate the noncompliance within these localities, we concluded that our \$400 million estimate of the 1992 nationwide tax loss is probably understated.

#### TAXPAYER CONFUSION CONTRIBUTED TO THE OVERSTATED DEDUCTIONS

In reviewing IRS' files, we could not determine whether taxpayers intentionally overstated the deductions. However, we were able to conclude that, at a minimum, two types of confusion contributed to taxpayers' noncompliance.

First, we found that many taxpayers were unaware that they should not deduct user fees. IRS' instructions for 1988 tax returns did not tell taxpayers that user fees were nondeductible. For these taxpayers to find this information, they had to consult multiple IRS publications. In order to comply voluntarily, these taxpayers had to persist in finding and interpreting the publications. We discovered, however, that even private tax return preparers, who are more likely to know, misapplied the deduction rules.

Second, local governments' real estate tax bills created confusion. Although it is not required, these bills often did not distinguish between deductible real estate taxes and nondeductible user fees. We identified 83 of the 171 large, local governments that each collected at least \$100 million annually in real estate taxes and used the same bill for both user fees and real estate taxes. We asked them for copies of their bills. Of the 55 sample bills that we received, we found unclear distinctions between user fees and real estate taxes on

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<sup>2</sup>IRS did these audits to measure compliance through its Taxpayer Compliance Measurement Program (TCMP). TCMP audits constitute a detailed, rigorous examination of taxpayer compliance in reporting all types of income, deductions, credits, etc..

<sup>3</sup>Reducing overstated real estate tax deductions boosts federal tax revenue as well as state and local tax revenue in those states that levy income taxes and use the federal tax liability as a starting point for computing the state income tax liability.

49 bills. Of these 49 bills, 31 made little or no distinction between them.

As a result, taxpayers who relied on these bills to compute their real estate tax deductions could easily, but improperly, deduct their user fees too. We found a similar situation for taxpayers who relied on annual statements from mortgage companies to compute their real estate tax deductions. As with many of the local government bills, these mortgage statements did not distinguish between deductible and nondeductible payments to local governments.

#### IRS CAN WORK WITH LOCAL GOVERNMENTS TO IMPROVE TAXPAYER COMPLIANCE

We concluded that both IRS and local governments had key roles to play in improving taxpayers' compliance. We envisioned these roles being played in tandem as IRS worked cooperatively with local officials. Underlying such cooperation, we recommended ways to improve compliance with the real estate tax deductions. We recommended that IRS

- clarify its rules and instructions on the real estate tax deduction,
- help local governments to revise their bills so that taxpayers could readily identify the nondeductible user fees and know that IRS may also receive this information,
- require IRS auditors to contact local governments to identify the actual real estate tax payments made by the taxpayers being audited, and
- negotiate agreements with local governments to receive data on actual real estate tax payments by each individual taxpayer and use that data to identify taxpayer noncompliance.

Since we issued our report in January 1993, we have continued to talk with IRS and local government officials about improving compliance with real estate tax deductions. We commend IRS for starting to work cooperatively with local government officials, particularly with the National Association of Counties (NACo), which represents almost all the local governments we contacted. Similarly, we are pleased that NACo has acknowledged this compliance problem and has offered a proposal to improve the compliance.

NACo recently approved a resolution that proposed federal legislation to implement the spirit, if not the letter, of our recommendations. As we understand the proposal, IRS would clarify its instructions and tax returns and local governments would clarify their bills. IRS also would work with mortgage companies to help them in clarifying their annual statements to taxpayers. Such clarifications should provide the information that taxpayers need to voluntarily comply. NACo's proposal also

called for federal funding to reimburse local governments for changes they would need to make to their accounting system to track these types of payments and to their tax bills.

Specifically, under NACo's proposal, IRS would help local taxing districts to determine the deductibility of various payments. Then local tax bills would be revised to distinguish between deductible and nondeductible payments. In addition, IRS would clarify the tax return line on which individual taxpayers can claim the real estate tax deduction. Requiring taxpayers to compute the deductible amount by subtracting the nondeductible payments should prompt them to be more compliant.

In our view, NACo's approach approximates the approach that IRS envisions under its current compliance philosophy. That is, if the noncompliance appears to stem from taxpayer confusion, then nonenforcement efforts should be tried first. NACo's approach requires IRS to provide taxpayers with the information needed to comply and to change its tax instructions and returns to clear up any confusion.

Although we have not fully analyzed this proposal, we view it as a reasonable first step. For the first time, taxpayers across the country would begin to receive consistent information that distinguishes between deductible taxes and nondeductible fees or other payments. Besides improving tax compliance and revenues, these changes would add fairness and certainty to our tax system.

We have not received estimates on the amount of money from federal or other sources that local governments would need to change their systems. If the changes are likely to lead to major increases in tax revenues, we believe that a one-time "seed" investment to reimburse local governments, either fully or partially, for their costs makes sense. Because many state governments, as well as some local governments, also will receive increased tax revenues, perhaps they should share a portion of these costs.

If these changes do not improve taxpayer compliance, then IRS and Congress may wish to try another approach. One approach would be to require local governments to file an information return on the amount of real estate tax that a taxpayer may deduct. In requiring reporting, Congress also would have to consider giving local governments the authority to collect taxpayers' social security numbers (SSN) so that the reported information can be used effectively.

In recent years, we have strongly supported information reporting. It helps taxpayers to comply voluntarily and IRS to identify any remaining noncompliance. However, it also imposes costs and burdens on IRS as well as on the third party that reports the information. In the context of real estate tax payments, local governments believe and we agree that the costs of information reporting may, at least initially, exceed its

benefits. For this reason, we prefer trying first the proposals that we and NACo have recommended.

Another approach would be for Congress to eliminate the confusion by either eliminating a deduction for real estate taxes or allowing a deduction for user fees. We have not examined the trade-offs of either denying or expanding the deduction. Because either action would have a significant impact on revenue, we believe that careful consideration would be necessary before choosing this approach.

#### DEBT FORGIVENESS AND AUTOMATED TIN VERIFICATION

Before closing, I would like to comment on two other proposals. These proposals involve debt forgiveness and automated verification of federal TINs. I will be brief, but I am willing to provide more information.

Regarding debt forgiveness, we issued a report in February 1993 on individual taxpayers who had not reported income from having their debts forgiven by the Federal Deposit Insurance Corporation (FDIC) or Resolution Trust Corporation (RTC).<sup>4</sup> We found that individuals' compliance in reporting this income from debts forgiven by FDIC skyrocketed from 1 percent to 48 percent when information returns were filed. We also found that these federally forgiven debts were loans that had been made by private financial institutions that had been forgiving large amounts of debts themselves (\$40 billion in 1990).

We recommended that Congress require FDIC and RTC to file such information returns when the annual forgiven debts totaled \$600 or more. If this information reporting proves to be cost effective, we also suggested that Congress consider extending this reporting to other institutions.

Recently, Congress acted on our recommendations. Congress required FDIC, RTC, and certain other financial institutions and federal agencies to file information returns on forgiven debts of \$600 or more in a calendar year. The Joint Committee on Taxation estimated that this provision would raise \$484 million in fiscal years 1994 through 1998.

We understand that the proposal being considered today would extend such information reporting to all financial institutions that make or acquire loans. The loans forgiven by FDIC and RTC had been made by private financial institutions. We see no reason to believe that individuals' compliance in reporting the income from loans forgiven by these institutions would be any better, without information reporting, than the 1-percent compliance we found in our sample of taxpayers with federal loans

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<sup>4</sup>Tax Administration: Information Returns Can Improve the Reporting of Forgiven Debts (GAO/GGD-93-42, Feb. 17, 1993).

forgiven. Thus, the proposal before you today should improve tax compliance. Further, including all private financial institutions would better ensure that no segments of this community have a competitive advantage by being able to avoid the cost of reporting.

We also have done some reports that discussed the benefits of automatically verifying the federal TIN of taxpayers before sending in an information return on payments made to them.<sup>5</sup> We understand this legislative proposal has been withdrawn for now. Even so, we wish to state our support for such a verification system.

Although IRS still needs to work out technical bugs in the verification system that it is developing, we believe this system will benefit not only IRS but also those who need the valid TIN to file an accurate information return. To the extent that this system allows TINs to be verified in advance rather than years later, the costs and burdens on all affected parties should be reduced. This verification also should limit opportunities for submitting false TINs, which some taxpayers may try to escape federal taxes. Closing off these opportunities is crucial to help ensure that the correct amount of taxes is paid and the millions of honest taxpayers are treated fairly.

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Mr. Chairman, this concludes my statement. Thank you for the opportunity to present our views. I welcome any questions that you may have.

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<sup>5</sup>Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992) and Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept. 22, 1992).

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