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# Debunking the Basis Myth Under the Income Tax

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# Debunking the Basis Myth Under the Income Tax<sup>†</sup>

JOSEPH M. DODGE<sup>\*</sup> AND JAY A. SOLED<sup>\*\*</sup>

*Tax basis is one of the most important, yet least studied, aspects of the income tax. This analysis calls attention to its importance and argues that taxpayers have the motivation, opportunity, and means to inflate the tax basis they have in their assets and, in some cases, to avoid the reporting of gains. We discuss the likely causes of these phenomena, estimate the probable revenue loss, and propose appropriate reforms.*

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## INTRODUCTION

A fundamental linchpin of the income tax system is the computation of gain and loss under Internal Revenue Code section 1001. This Code section provides that the net amount realized less adjusted basis determines a taxpayer's gain or loss.<sup>1</sup> The amount realized is a current "fact" and presents no major conceptual or administrative problem.<sup>2</sup>

A prevailing myth is that basis rules are also as easily and happily understood and complied with so as to be virtually self-executing. After all, a taxpayer's basis appears to be simply the item's acquisition cost less any cost recovery incurred in the form of depreciation or amortization. Thus, \$10,000 is the initial cost basis of a farm tractor

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1. I.R.C. § 1001(a). Gains are includible in gross income under I.R.C. § 61(a)(3), and losses are deductible under I.R.C. § 165(a) in arriving at taxable income, unless (in the case of individuals) the loss involves a personal-use asset (and the loss does not result from casualty or theft). I.R.C. § 165(c). In the case of individuals, capital losses (losses from the "sale or exchange" of a "capital asset") are allowable as deductions in the current year only to the extent of the amount of capital gains for the year plus \$3,000. See I.R.C. § 1211(b).

2. For a detailed discussion of I.R.C. § 1001, see Louis A. Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis*, 26 BUFF. L. REV. 219 (1977).

purchased for that amount; assuming that the taxpayer uses the tractor in its trade or business and depreciates it by \$4,000, the tractor's adjusted basis is \$6,000.

This myth has sacred status among tax academics because of the importance we attach to basis. Indeed, basis, capitalization, and capital recovery are how we differentiate an income tax from other tax models (e.g., a consumption tax), and tax academics rightly think that understanding basis and related issues is a key factor for student comprehension of the income tax.<sup>3</sup> But we should not blithely assume that other players in the tax arena, especially taxpayers and tax return preparers who follow tax return instructions and manuals rather than theory, take the issue of tax basis so seriously and reverently.

In reality, tax basis is commonly overstated (especially in the case of individual taxpayers), whether inadvertently or intentionally, in connection with the reporting of gains and losses on investments. For every dollar of overstated basis in the assets taxpayers sell, there is either one less dollar of gain or one more dollar of loss to report. Aside from the obvious tax-savings motivation, taxpayers have the opportunity and means to overstate basis without running a meaningful risk of sanction. In addition, there are certain opportunities for not reporting transactions that produce gains. Such basis and gain noncompliance causes severe revenue losses amounting to billions of dollars and undermines the integrity of our tax system. In order to protect the government's coffers and to restore integrity to the tax system, we propose various moderate and relatively simple changes in the law to address these problems. Adoption of these changes should have considerable political appeal given that these changes have the potential to raise significant revenue without "raising taxes."<sup>4</sup>

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3. The only monograph on tax basis has 120 pages of text, of which only three pages are devoted to the general issue of basis reporting and record keeping, with no citations to cases involving basis compliance issues. James Maule, *Income Tax Basis: Overview and Conceptual Aspects*, 560 TAX MGMT. PORTFOLIOS (BNA) A118-20 (2000). A perusal of several law school casebooks on individual income tax reveals (at most) minimal mention of basis compliance issues. Currently, for example, the leading law school textbook for introductory income tax contains only six cases, most over a half-century old, that discuss the issue of tax basis—and do so from the purely conceptual angle. JAMES J. FREELAND, DANIEL J. LATHROPE, STEPHEN A. LIND & RICHARD B. STEPHENS, *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 118-28 (13th ed. 2004).

4. It might be said the problem of ascertaining basis disappears under a cash-flow consumption tax, where the cost of investments is fully deductible. See generally William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1136, 1141, 1162-64, 1183-84 (1974) (analyzing the effects of a cash-flow consumption tax on determining basis, particularly for transfers at death and by gift). Similarly, under a wage tax, where only income derived from employment is taxable, basis is also irrelevant because investment returns of all kinds are excludible from the tax base. See generally Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002) (examining the consequences of a "wage tax" in which federal income and payroll taxes were integrated). Alternatively, basis issues would be minimized under the Schanz-Haig-Simons "accretion" income tax model (i.e., where all annual net increases to wealth would be recognized even if not "realized"). See generally ROBERT M. HAIG, *THE FEDERAL INCOME TAX* (1921); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* (1938); GEORG SCHANZ, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1 (1896). Notwithstanding the views these commentators advance, this essay assumes that there is enough

As evidence of the pervasiveness of the tax basis myth, no commentator, to our knowledge, has raised as a major issue whether taxpayers actually understand or comply with basis and gain-recognition rules and, for that matter, whether the IRS has the ability to monitor and enforce such rules.<sup>5</sup> Indeed, only once in this country's history was a basis or gain compliance problem seriously spotlighted. This was when in 1976 the carryover basis rule for assets acquired by reason of death was instituted.<sup>6</sup> In theory, this carryover rule seemed simple enough: estate beneficiaries would step into the decedent's "shoes" insofar as their tax basis in inherited assets was concerned.<sup>7</sup> Yet in response to the institution of this carryover basis rule, there was a tremendous public uproar. Why? There were several reasons: taxpayers found it "impossible" to ascertain a decedent's tax basis in an asset,<sup>8</sup> the complexity of implementing the rule

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political inertia and support to continue the existing "realization" income tax, which itself can be viewed as a political compromise between an accretion income tax and a cash-flow consumption tax. See Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1, 43–86 (2000); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 374–77 (2004). Indeed, the George W. Bush administration, no fan of the current income tax system, seems resolved to maintain its fundamental tenets. See PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), available at <http://www.taxreformpanel.gov/final-report/>.

5. To the contrary, many commentators view the income tax system, despite having its blemishes, as readily administrable by taxpayers and the IRS alike. Compare Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 TAX NOTES 967 (1997) (highlighting the complexities that arise under realization-based tax system), with Jerome Kurtz, *Two Cheers for the Income Tax*, 27 OHIO N.U. L. REV. 161 (2001) (arguing, as former IRS commissioner, for the current income tax over alternatives while urging improved enforcement and simplification of the current tax system), and Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861 (1997) (arguing for a realization-based tax system over an accretion-based alternative). Other authors have written on the topic of tax basis, but the thrust of their articles deals almost exclusively with computational issues. See generally Maurice C. Greenbaum, *The Basis of Property Shall Be the Cost of Such Property: How Is Cost Defined?*, 3 TAX L. REV. 351 (1948) (analyzing computation of cost in various situations); Erik M. Jensen, *The Unanswered Question in Tufts: What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455 (1991) (arguing for considering the acquisition circumstances when determining the basis of an acquisition that is subject to a mortgage exceeding the property's value); Harold Wurzel, *The Tax Basis for Assorted Bargain Purchases or: The Inordinate Cost of "Ersatz" Legislation*, 20 TAX L. REV. 165 (1964) (analyzing problems associated with the Internal Revenue Code's silence on determining basis for bargain purchases).

6. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872–77 (1976) (repealed 1980) [hereinafter Former I.R.C. § 1023]. For a detailed discussion of this provision, see THOMAS J. McGRATH & JONATHAN G. BLATTMACHR, CARRYOVER BASIS UNDER THE 1976 TAX ACT (1977).

7. To illustrate how this rule was to operate, consider the plight of *B*, who purchases ten shares of Company *X* for \$100. Assume *B* dies when Company *X* shares are worth \$1,000. Under Former I.R.C. § 1023, the recipient of Company *X* shares would "carry over" the \$100 tax basis that *B* had in such shares.

8. The purported failure of others to be able to identify the basis that decedents held in their investments made the implementation of the carryover rule suspect. See, e.g., *Carryover Basis Provisions: Hearing Before the House Comm. on Ways and Means*, 96th Cong., 1st Sess. 13 (1979) (statement of American Bankers Association) (Manufacturer's Hanover Trust Company reported that cost basis information for marketable securities was impossible to locate

proved enormous,<sup>9</sup> and the IRS was given few weapons to safeguard its enforcement.<sup>10</sup> These flaws led Congress to retroactively repeal the carryover basis rule in 1980.<sup>11</sup>

The very same attacks that led to the repeal of the 1976 carryover basis rule can readily be lodged against the status quo. That is, under the current income tax regime, (a) taxpayers often lack the acumen and requisite records and information to fulfill their tax basis reporting obligations, (b) the rules themselves are unwieldy and complicated, and (c) the IRS is unable to fulfill its compliance mission insofar as basis and gain monitoring is concerned.<sup>12</sup>

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in 22% of estates, required time and research in 44%, and was readily available in 34%); *id.* at 126–29 (statement of the American Institute of Certified Public Accountants (AICPA)) (offering letters from practitioners indicating the difficulty in reconstructing basis of old stock certificates, closely held stock, and stock that underwent recapitalizations or stock splits). For a detailed look at the tax bar's critique of the carryover basis rule, see Howard J. Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 TAX L. REV. 411, 448–66 (1982). Some of the problems in ascertaining historical basis are discussed in MCGRATH & BLATTMACHR, *supra* note 6, at 191–94, 222–28.

Aside from taxpayers' investments, another concern regarding the efficacy of the carryover basis rules had to do with determining basis for personal-use tangible property. Since losses on such property are usually disallowed, *see* I.R.C. § 165(c), taxpayers rarely keep accurate basis records in such assets. *See, e.g.*, Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 425 (1993) (“[Personal-use tangible personal assets] are the assets for which adequate basis records most likely do not exist. Taxpayers may fail to keep basis records for [such property] because the costs are often trivial, because they do not expect the assets to appreciate, because they know a loss would be nondeductible, and simply because the non-business context of the acquisition makes business type records seem unnecessary.”); Philip R. Stansbury & Doris D. Blazek, *Revamped Basis Rules for Inherited Property Have Far-Reaching Implications*, 46 J. TAX’N 14, 14 (1977) (“... establishing the decedent's basis in [personal-use tangible personal property] is difficult.”).

9. For a detailed exposition of these transition rules, see Richard B. Covey & Dan T. Hastings, *Cleaning up Carryover Basis*, 31 TAX LAW. 615, 621–22, 641–57 (1978); Zelenak, *supra* note 8, at 382–88.

10. *See, e.g.*, Former I.R.C. § 1023(g)(3) (taxpayers were given the opportunity to make reasonable estimates as to their basis in assets).

11. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299 (1980). In order to repeal the estate tax and as part of a political compromise, Congress recently passed a modified carryover basis rule, I.R.C. § 1022, effective for decedents dying after 2009. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 542, 115 Stat. 38, 76 (2001). We suspect that, as the implementation of this rule draws nearer, critics of Former I.R.C. § 1023 will undoubtedly use the same noncompliance fodder to attack the viability of this revised carryover basis rule. *See* TASK FORCE ON FEDERAL WEALTH TRANSFER TAXES, ABA, REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES 29–94 (2004) (presenting exhaustive technical critique of I.R.C. § 1022, but only devoting pages 83–89 to nonsubstantive issues, mostly involving procedure rather than compliance issues). More recently, the Senate has voiced its preference to maintain the estate tax, including the basis equals fair market value rule at death. Dustin Stamper, *Baucus, Kyl Agree on Estate Tax Parameters*, 2005 TAX NOTES TODAY 133-1 (2005).

12. There is no legally relevant determination of basis until after gain or loss is reported on a tax return, despite the fact that basis depends on facts that occurred (possibly long) before the sale or disposition that gives rise to the gain or loss. But it would be excessively burdensome to have proceedings contemporaneous with such facts that would legally fix basis for the future because (1) such facts are exceedingly numerous, (2) such basis may turn out to be irrelevant

These systematic problems lead us in Part I to argue that inflated basis reporting is occurring on a massive scale. There we look at record-keeping issues; the plethora of rules affecting basis; the compliance obligations (or lack thereof) of third parties, tax professionals, and taxpayers; the inability of the IRS to monitor compliance; and forces impacting upon voluntary taxpayer compliance. Utilizing this background information, we attempt to quantify the financial magnitude of the problem, estimating the amount of forgone tax revenue resulting from basis overstatements. In Part II we describe our reform proposals. Our principal recommendations are that Congress broaden third-party reporting with respect to basis and taxable dispositions and, where third-party reporting cannot do the job, taxpayers be made subject to a sanctionable duty to establish tax basis. In addition, we argue that to facilitate tax basis reporting, Congress should simplify certain substantive tax basis rules and consider other Code changes that touch upon tax basis compliance issues. Since the suggested reform measures we propose, if enacted, would not operate retroactively, we address the need for transition rules in Part III. We conclude that the reforms we propose offer several mechanisms to help enhance overall tax compliance, invigorating anew the strength of the income tax.

#### I. THE PROBLEM OF UNDERREPORTING NET GAINS

In most transactions, determination of the amount realized is fairly routine: in general, all that taxpayers must do is count the sales proceeds (cash plus the value of any property received and liabilities assumed)<sup>13</sup> and subtract transaction costs, such as selling commissions, if any. These facts are current and memorialized in documents and records, such as closing statements, sales receipts, and broker reports. In the case of marketable security and real estate sales, brokers readily supply this information to the taxpayer on IRS Forms 1099-B and 1099-S, respectively, and simultaneously submit these forms to the IRS.<sup>14</sup> However, sales and dispositions not involving marketable securities and real estate are not subject to third-party reporting.

The situation with basis is markedly worse. In the Code, there is no explicit requirement that a taxpayer keep accurate track of basis or that a third party supply taxpayers or the IRS with such information. In addition, these rules are complex and both compliance and enforcement incentives are weak.

These deficiencies in the tax system, combined with human nature, provide ample occasion for taxpayers to overstate basis and (in some cases) to simply not report gain transactions, whether by inadvertence or design. There is, thus, good reason to hypothesize that compliance in this area is significantly worse than compliance with most tax rules.

In Subpart A, we explore the five reasons taxpayers inadvertently or intentionally inflate the basis they have in their assets. These reasons include (1) lax record-keeping

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(e.g., where a personal-use asset is disposed of at a loss), (3) such basis may be rendered null by a future event (such as death), and (4) the current revenue stake is small or nonexistent in present-value terms.

13. If property other than rights to future cash is received, such property is taken into account at its fair market value (FMV). Treas. Reg. § 1.61-2(d) (as amended in 2003).

14. Rev. Proc. 2004-50, 2004-33 I.R.B. 211 (2004); INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUBLICATION 1220: SPECIFICATIONS FOR FILING FORMS 1098, 1099, 5498 AND W-2G ELECTRONICALLY OR MAGNETICALLY (2004); INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, INSTRUCTIONS TO FORM 1099, at GEN-4-5 (2004).

requirements, (2) complex rules, (3) absence of compliance incentives, (4) IRS disincentives to pursue basis inquiries, and (5) taxpayers' propensity to cheat. In Subpart B, we attempt to quantify the fiscal damage done to the government's coffers as a result of basis overstatements.

### *A. Reasons for Basis and Gain Reporting Noncompliance*

There are two main reasons taxpayers would desire to overstate basis or to fail to report gain transactions: tax savings and opportunity. The first reason is so obvious that lengthy elaboration is unnecessary. The higher an asset's basis, the larger the potential cost recovery associated with its use in a business or investment activity; furthermore, the higher an asset's basis, the smaller the potential gain or the larger the potential loss. Alternatively, failing to report a gain transaction is a form of nonreporting of income, and it avoids even having to go through the motions of attempting to accurately report basis.

The second reason taxpayers inflate basis or omit gain transactions is that they can often do so with ease and impunity, for the reasons discussed below.

#### 1. Lax Record-Keeping Requirements

When basis equals cost (or is derived from cost), its determination requires an exercise of going back in time to ascertain the asset's initial net purchase price. This purchase price is usually memorialized in a broker's statement, a closing statement, a bill of sale, an invoice, or some other document or record (whether in paper or electronic form) that has been preserved by, or is accessible to, the taxpayer.

Taxpayers are notoriously lax in keeping such records. Preservation of records is neither a costless nor an effortless enterprise, as it requires a method of retrieval (a filing system, index, or search mechanism), time, effort, and physical or electronic space. Records can be lost or inadvertently destroyed due to home or office moves, poor retrieval systems, the actions of others, computer malfunctions, and natural causes such as floods. Records may also be destroyed by a taxpayer's conscious decision that it is not worthwhile to keep basis-affecting records beyond the period of time one keeps past tax returns and accompanying matter.<sup>15</sup> Furthermore, the rule currently governing testamentary dispositions of property mandates that, in the hands of the recipient, the basis of such property equals its fair market value (FMV) at the decedent's death,<sup>16</sup> thus, records may not be maintained or may even be destroyed due to the expectation that issues of basis will become moot upon the asset-owner's death.

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15. See, e.g., Mark Schwanhauser, *Your Money: Paper Trail Leads to Peace of Mind*, CHI. TRIB., Feb. 24, 1997, at D3 (giving practical advice on how long to keep tax records).

16. I.R.C. § 1014(a)(1). Technically, the basis is the FMV on the date of death or, if the alternate valuation date is elected for estate tax purposes, on the alternate valuation date. I.R.C. § 1014(a)(2). Even under the so-called carryover basis rule found in I.R.C. § 1022, currently scheduled to take effect for decedents dying after 2009, the basis of property owned by all but the wealthiest decedents will be the date-of-death FMV. More specifically, the decedent's basis in assets (other than rights to "income in respect of a decedent") is adjusted upwards (but not in excess of date-of-death FMV) by (1) \$1.3 million (indexed for inflation) per decedent, (2) \$3 million (indexed for inflation) for assets passing to the decedent's surviving spouse, (3)

Having established that taxpayers may have a natural inclination to be less than diligent when it comes to record keeping, the question is whether there is a countervailing government-mandated duty on taxpayers to keep basis records, the violation of which would be subject to penalties. But it turns out that whatever duty might exist is so weak as to be virtually nonexistent in any practical sense. The Code does impose an obligation on taxpayers to “keep such records . . . as the Secretary [of the Treasury] may from time to time prescribe.”<sup>17</sup> However, the relevant Treasury regulations do not explicitly impose a *specific* duty to keep *basis* records.<sup>18</sup>

The general absence of a basis record-keeping mandate is echoed in the tax return submission process. The Code requires an individual taxpayer to file an income tax return if his or her gross income exceeds a specified threshold amount<sup>19</sup> and further requires taxpayers to “include therein the information required by such forms and regulations.”<sup>20</sup> Schedule D of the Individual Income Tax Return (Form 1040) provides spaces in which the bases of all assets sold or exchanged during the year are supposed to be entered. The taxpayer would thus appear to have a duty to at least enter some dollar figure in the appropriate space.<sup>21</sup>

However, Schedule D hardly gives adequate notice to taxpayers that basis determinations are either important or potentially complex. The column in which the basis figure is to be entered refers to “cost or other basis” and directs perplexed

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unrealized business and investment losses of the decedent, and (4) unused net operating loss (NOL) and capital loss carryovers of the decedent. See I.R.C. § 1022(b), (c), (d)(2), (4). Rights to income in respect of a decedent (IRD), such as annuities and pension rights, obtain a pure carryover basis with no basis adjustments. Thus, for a married decedent, all assets (other than IRD rights) acquire a FMV basis unless aggregate unrealized appreciation exceeds \$4.3 million as indexed by inflation and augmented by NOL and capital loss carryovers.

17. I.R.C. § 6001.

18. See Treas. Reg. § 1.6001-1 (as amended in 1990). The statute, however, does allow the IRS, after notice to the taxpayer in question, to impose “specific” record-keeping requirements upon such taxpayer. *Id.* at § 1.6001-1(d). This requirement would likely come into play only for a business taxpayer keeping sloppy books and records or an investor with a history of poor record keeping. Thus, the IRS, in the course of an audit, may make a written request for taxpayer information (including basis information). In extraordinary circumstances, the willful failure to comply with such a request can give rise to criminal penalties. I.R.C. §§ 7203 (willful failure to supply information), 7210 (failure to obey summons).

19. I.R.C. § 6012(a).

20. I.R.C. § 6011(a).

21. The Code imposes a penalty on a taxpayer’s failure to file a return, I.R.C. § 6651(a)(1), but there is a “reasonable cause and not due to willful neglect” defense to this penalty. *Id.* Moreover, the penalty is for failure to file the whole return, not for a failure to fill in a small portion of a schedule that accompanies a return. Of course, this lesser kind of failure may, on audit, induce the IRS to request such records as the taxpayer has, and the failure to supply the requested information can give rise to the sanctions. The failure to supply information that the taxpayer does not have, however, would not appear to fall under any of these requirements or sanctions. Nevertheless, sanctions would likely apply in the case of a tax protester who has avoided keeping basis records (or has neglected to file returns and schedules or to comply with specific information requests) as a matter of principle. See I.R.C. § 6702 (penalty for frivolous return). A penalty was assessed in *Golub v. Commissioner*, 78 T.C.M. (CCH) 367 (1999), on a tax protester who, inter alia, refused to enter any basis figure on Schedule D or to submit any evidence of basis whatsoever.



taxpayers, confused by the terseness of this reference, to the instructions.<sup>22</sup> The instructions pertaining specifically to Schedule D (Capital Gains and Losses) refer to the concept of income tax basis and to various IRS publications that describe basis rules, principally IRS Publication 551. But there is no requirement (akin to that found under Code section 274(d) requiring all travel and entertainment expenses to be substantiated) that basis be “substantiated” by records or other documents.

The instructions to Form 1040, under the heading “General Information,” have a short section entitled “How Long Should Records Be Kept?,” stating that tax returns, worksheets, and forms should be kept for three years; but records relating to property should be kept longer insofar as they are relevant for determining basis.<sup>23</sup> The operative word here is *should*, not *must*. Another publication, IRS Publication 552 (as revised October 1999), which is entitled “Recordkeeping for Individuals,” is similarly nonassertive. Page two of IRS Publication 552 states that “everybody should keep” basis records for their homes,<sup>24</sup> but the publication says nothing about other property.<sup>25</sup> Under “How Long to Keep Records,” the same IRS publication states that basis records should be kept until the period of limitations expires for the year in which one disposes of the property. In none of these IRS publications or forms is it stated that basis records *must* be kept.

In sum, there appears to be no government-mandated requirement, sanctionable in itself, that taxpayers keep adequate basis records.<sup>26</sup> In general, the IRS urges taxpayers

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22. In the Instructions to Schedule D, the IRS amplifies the meaning of the phrase “other basis.” INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, 2005 INSTRUCTIONS FOR SCHEDULE D, available at <http://www.irs.gov/pub/irs-pdf/i1040sd.pdf> [hereinafter IRS INSTRUCTIONS FOR SCHEDULE D]; see also INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, PUBLICATION 551: BASIS OF ASSETS (May 2002); *Sales and Trades of Investment Property*, in INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, PUBLICATION 550: INVESTMENT INCOME AND EXPENSES (INCLUDING CAPITAL GAINS AND LOSSES) (2003) (offering additional assistance to taxpayers to help them identify their tax basis in marketable securities).

23. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, INSTRUCTIONS FOR FORM 1040, at 63 (2005), available at <http://www.irs.gov/pub/irs-pdf/i1040gi.pdf> [hereinafter IRS INSTRUCTIONS FOR FORM 1040].

24. INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, PUBLICATION 552: RECORDKEEPING FOR INDIVIDUALS (Rev. Oct. 1999) 2 (1999). This reference to the basis of homes is odd because the gains on most sales of principal residences are permanently exempt from tax. See I.R.C. § 121 (excluding the first \$250,000 of gain, or \$500,000 in the case of married taxpayers filing joint tax returns, from income taxation on the sale or exchange of property that the taxpayer has owned and used as the taxpayer’s principal residence for a period of two years or more during the five-year period ending on the date of the sale or exchange).

25. Treas. Reg. § 1.1015-1(g) (as amended in 1971), however, states that donors and donees “should” keep such records as are relevant to figuring the donee’s basis. But most of the relevant information (if accurate) is on Form 709 (the gift tax return), which is not available to the donee as a matter of right! Curiously, the corresponding duty with respect to I.R.C. § 1041 (transfers to a spouse or to an ex-spouse pursuant to a divorce) is couched in mandatory terms. See Treas. Reg. § 1.1041-1T, Q&A (14) (as amended in 2003) (describing transferor’s duty to supply transferee with records in a transfer under I.R.C. § 1041).

26. With respect to property subject to a uniform basis, Treas. Reg. § 1.1014-4(c) (1960) is one of the few places in either the Code or regulations that purport to “require” that basis adjustment records be kept. It would appear, however, that this requirement is satisfied by filing the fiduciary income tax return (Form 1041), which entails the reporting of transactions relating

to keep such records for the taxpayer's self-interest, but this urging is mostly hortatory, not mandatory. Taxpayers have a duty to file returns and accompanying schedules, but the failure to enter basis figures on Schedule D can, at worst, only attract IRS attention and a possible request for specifics.<sup>27</sup>

Where does the absence of a record-keeping mandate lead taxpayers with respect to basis determinations? Ordinarily being unable to rely on their records (due to being incomplete or nonexistent), taxpayers are put in the awkward position of having to make estimates or, worse, uninformed "guesses." And it is plausible to assume that when taxpayers act in this fashion, they would, out of self-interest, give the benefit of their computational doubts to themselves rather than to the government.

## 2. Complex Rules

During the cycle of asset ownership, the Code enlists taxpayers to initially determine and subsequently adjust the basis they have in their assets. These basis rules are often complex, arcane, and obtuse, creating the double effect of clouding basis determinations and providing opportunities for taxpayers to inflate basis.

### a. Initial Basis Determinations

Ascertaining an asset's initial basis is not necessarily an easy task. Even the implementation of the most simple basis rule—that basis equals cost<sup>28</sup>—can pose difficulties, depending on the facts surrounding acquisition and subsequent disposition of the asset.<sup>29</sup>

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to estate or trust property. The term *uniform basis* literally means that the basis of property received by gratuitous transfer is the same whether the property is held by an individual, a trust, or an estate; and, in the context of an estate or trust, it is synonymous with "inside" basis (that is, the basis of estate or trust assets), as distinct from the "outside" basis in trust or estate *interests* held by beneficiaries (such outside basis, where relevant, being subject to actuarial adjustments). Apart from Form 1041, there appears to be no form or schedule for reporting uniform basis adjustments.

27. Analytically, there are three possible scenarios: (1) the taxpayer is clueless and makes a guess as to basis that she thinks is within the realm of possibility (although virtually certain to be incorrect); (2) the taxpayer has some evidence relating to basis, but the figure entered is likely to be incorrect; and, (3) the taxpayer knows the correct basis figure but enters another figure (or a figure outside of the range of possible basis figures). The first two scenarios can lead to negligence and accuracy-related penalties, and the third can lead not only to those penalties but also can rise to the level of civil and criminal fraud. At this point in the discussion, we are focusing only on the first two scenarios, which derive from inadequate records.

28. I.R.C. § 1012.

29. For example, if marketable securities are purchased in a series of transactions, it is necessary to "identify" the basis of such securities when they are subsequently sold (assuming that all of the taxpayer's securities are not sold in the same taxable year). This problem is familiar to business taxpayers who are required to cope with inventories, for which well-known accounting conventions, namely, last-in/first-out (LIFO) and first-in/first-out (FIFO), are available to produce a basis number for sold inventory. Stock of the same class of the same corporation is wholly fungible, regardless of when acquired. Therefore, it would be suitable to subject such stock to either the FIFO or LIFO conventions, or, better yet, a blended-basis (average cost) convention under which the basis for any share would be the aggregate cost of all

Thus, even purchased assets do not necessarily start with an initial basis equal to their cost. Consider, for example, the fact that any cost-derived basis is increased by transaction costs borne by the purchaser,<sup>30</sup> which can sometimes occur in one or more years subsequent to the actual acquisition.<sup>31</sup> Sales taxes, too, are to be added to basis.<sup>32</sup> Finally, assets purchased before March 1, 1913 (i.e., the inception date of the income tax), have an initial basis equal to the greater of adjusted cost basis on that date or the FMV on that date.<sup>33</sup>

Aside from purchases, taxpayers can acquire assets in a myriad of other ways (e.g., as in-kind income or by way of bequest, gift, or interspousal transfer). In these circumstances, assets do not acquire an initial cost basis, and the taxpayer must be aware of the applicable basis rule in addition to having access to relevant records.

Assets received in-kind (e.g., as remuneration for services rendered) that are in fact properly included in the gross income of a taxpayer acquire an initial basis equal to the amount included in income,<sup>34</sup> which is supposed to be the FMV of the asset when acquired.<sup>35</sup>

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shares divided by the number of such shares. But, contrary to logic and practical considerations, the general rule is one of actual identification of the shares sold. *See* Treas. Reg. § 1.1012-1(c)(1) (as amended in 1996). When the specific identification method cannot be followed, the backup rule is FIFO, which (being a technical accounting convention) the typical individual investor may not be either able or willing to grasp. *Id.*

30. *Woodward v. Comm'r*, 397 U.S. 572, 575 (1970); *Spreckels v. Comm'r*, 315 U.S. 626 (1942). *See also* Treas. Reg. § 1.263(a)-2(e) (as amended in 1987) (stating that brokerage commissions must be capitalized in basis); Treas. Reg. § 1.1012-1(b) (as amended in 1996) (stating that real estate taxes paid by purchaser are included in the tax basis of the acquired real estate). The costs of acquiring a gratuitous transfer, however, are not added to basis. Rather, if a transferee incurs costs in acquiring a gratuitous transfer, the Code treats the transaction as a part-sale/part-gift; thus the transferee's basis is the greater of cost (including transaction costs) or gratuitous transferee's basis under any of I.R.C. §§ 1014, 1015, and 1041. Treas. Reg. § 1.1015-4 (as amended in 1972).

31. *See* Treas. Reg. § 1.212-1(k) (as amended in 1975) (stating that the costs of perfecting and defending title must be capitalized).

32. *See* I.R.C. § 164(a) (third sentence). I.R.C. § 164(b)(5) (applicable for taxable years beginning in 2004 and 2005, American Jobs Creation Act of 2004, Pub. L. 108-357, § 501(b), 118 Stat. 1418, 1520-21 (2004)) allows a current deduction for state and local sales taxes (in lieu of income taxes) even if related to personal consumption and personal-use assets. It is not clear if a person deducting sales taxes in lieu of income taxes must still capitalize sales taxes on business and investment assets, but it is clear that the latter must be capitalized if the taxpayer forgoes any deduction of sales taxes. In any event, it seems likely that sales taxes on consumer assets (including artworks and collectibles) that are deducted will often end up being capitalized as well.

33. *See* I.R.C. § 1053. This rule would rarely apply in the case of individual taxpayers, but in the case of corporations, this rule remains relevant.

34. Treas. Reg. § 1.61-2(d)(2)(i) (as amended in 2003) ("In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.").

35. *See* I.R.C. § 83(a) (prescribing inclusion of property transferred to service provider in gross income at FMV); Treas. Reg. § 1.61-2(d)(1) (as amended in 2003). On the other hand, investments that are expensed have an initial basis of zero. Examples of zero basis property include deductible contributions to individual retirement accounts (IRAs) and business and tangible personal property expensed under I.R.C. § 179. It is plausible to assume that taxpayers

Assets acquired by reason of the death of another person (if properly includible in the decedent's gross estate) usually (but not always)<sup>36</sup> acquire a basis equal to their date-of-death value<sup>37</sup> unless the decedent's personal representative makes an alternate valuation date election.<sup>38</sup> The vast majority of estates do not have to file estate tax returns,<sup>39</sup> and bequests do not constitute gross income.<sup>40</sup> Thus, there is no universal

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will sometimes erroneously claim FMV-at-acquisition basis even in cases where the in-kind income was not reported. In this situation, there is old authority that may be (mis)interpreted by a tax adviser to mean that the property's basis in the taxpayer's hands should be its FMV on acquisition even though the receipt of such property was erroneously excluded from gross income. See *Comm'r v. Salvage*, 297 U.S. 106, 109 (1936); *Bennet v. Comm'r*, 137 F.2d 537, 538–39 (2d Cir. 1943); *Countway v. Comm'r*, 127 F.2d 69, 73–76 (1st Cir. 1942). However, these cases merely held (or assumed) that the doctrine of estoppel (an equitable remedy) did not apply in this situation where the erroneous exclusion was not correctable due to the running of the statute of limitations. It is now recognized, as a matter of law, that basis cannot be supported by an erroneous exclusion. See, e.g., *Detroit Edison Co. v. Comm'r*, 319 U.S. 98, 101–03 (1943); *Comm'r v. Gowran*, 302 U.S. 238, 243–45 (1937); *Charley v. Comm'r*, 91 F.3d 72, 74–75 (9th Cir. 1996); *Cont'l Oil v. Jones*, 177 F.2d 508, 512 (10th Cir. 1949); *Comm'r v. Timken*, 141 F.2d 625, 627, 630 (6th Cir. 1944). Cf. *Dobson v. Comm'r*, 320 U.S. 489, 493, 503–04 (1943) (holding that basis determinations are not subject to bar under the statute of limitations). Nevertheless, at least one commentator continues to insist that basis-equals-acquisition-date FMV even when the asset is erroneously excluded, unless the government can successfully apply the so-called mitigation provisions of I.R.C. §§ 1311–1314. See Steven J. Willis, *The Tax Benefit Rule: A Different Rule and a Unified Theory of Error Correction*, 42 FLA. L. REV. 575, 642 (1990).

36. There is one major exception to the basis-equals-FMV rule found under I.R.C. § 1014. Income in respect of a decedent (IRD) rights (these rights refer to income items earned but not received by a decedent prior to death) take a carryover basis that is usually zero. See I.R.C. § 1014(c). Annuities, survivor rights under IRAs, employee retirement plans, and installment obligations are all treated as IRD rights. I.R.C. § 691(d). Note that by definition, IRD has not been included in gross income by the decedent prior to death, and as such these amounts cannot create or support basis. Hence, any carryover basis in an IRD right would derive from the decedent's basis in such right, such as annuity premiums and nondeductible taxpayer contributions (if any) to employee plans and IRAs.

37. I.R.C. § 1014(a). I.R.C. § 1014 is scheduled to yield to a complex carryover basis system with significant FMV-at-death exceptions for decedents dying in 2010 (and possibly thereafter). See I.R.C. § 1022, critiqued in Joseph M. Dodge, *What's Wrong with Carryover Basis, Especially the Carryover Basis Provisions of H.R. 8*, 91 TAX NOTES 961 (2001).

38. See I.R.C. § 2032. This election can only be made if an estate tax return is filed and the alternate valuation would result in a decreased estate tax. Thus, the election cannot properly be made for the purpose of increasing income tax basis. See I.R.C. § 2032(c).

39. Because only roughly 5% of decedents' estates must file an estate tax return, see Charles Davenport & Jay A. Soled, *Enlivening the Death-Tax Death-Talk*, 84 TAX NOTES 591, 594 (1999), the vast majority of other estates have no occasion to record date-of-death values related to the decedent's assets unless there is a duty imposed under a state death tax regime. Due to the scheduled increases in the Applicable Credit Amount, see I.R.C. § 2010(c) (increasing the exclusion amount to \$3.5 million in the year 2009), even fewer estates will likely have occasion to file federal estate tax returns in the future. See Terry Manzi, *Projections of Returns That Will Be Filed in Calendar Years 2004–2010*, SOI BULL. 2003–2004, <http://www.irs.gov/pub/irs-soi/04proj.pdf> (projecting a steep decline in the number of estate tax returns that decedents' estates will file over the next half decade).

40. I.R.C. § 102(a).

mechanism for reporting the facts that establish basis. It follows that even honest taxpayers must resign themselves to estimating (long after the fact) the basis of assets acquired by reason of a decedent's death, and dishonest taxpayers have a wide-open opportunity to "make up" a high basis for such assets.<sup>41</sup>

Assets transferred by inter vivos gift are subject to a carryover basis rule (meaning that the transferor's basis carries over to the transferee),<sup>42</sup> but gifts of property having a date-of-gift FMV below the donor's basis have a "floating" basis that is contingent on the donee's selling price of the asset.<sup>43</sup> Also, gifts of appreciated property for which a gift or generation-skipping transfer tax is paid obtain an upward basis adjustment.<sup>44</sup> It is likely that many donees are not aware of these complicated rules, and, if they are aware, they lack the information (much less the will) to comply with them.<sup>45</sup>

Gifts, sales, and exchanges between a husband and wife while married or pursuant to a divorce are nonrecognition transactions subject to a mandatory carryover basis rule.<sup>46</sup> Even this seemingly straightforward rule, however, might often be misunderstood or ignored, particularly with respect to sales or exchanges between current and former spouses (which can easily be mistaken as being subject to the "cost basis" rule).

Finally, whenever a taxpayer acquires an asset pursuant to a nonrecognition event, the determination of an asset's initial tax basis can present a daunting challenge. Consider, for example, each of the following nonrecognition events: (1) property received in-kind from a trust or estate,<sup>47</sup> (2) securities (and commodity futures) acquired in a "wash sale,"<sup>48</sup> and (3) property acquired in a tax-free, like-kind

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41. The Instructions to Schedule D state that the taxpayer acquiring property from a decedent is to write the word *inherited* in the "acquisition date" column of Schedule D, line 8. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, INSTRUCTIONS TO SCHEDULE D, at D-6 (2004). However, this instruction probably exists because of I.R.C. § 1223(11), which treats all gains and losses on property acquired from a decedent as being long-term, thereby rendering the acquisition date irrelevant for that purpose. But omitting the actual acquisition date for property acquired from a decedent actually renders it more difficult for a return examiner to identify a possible basis overstatement in these cases. A high basis claim for an asset (especially stock) acquired long ago should raise an examiner's suspicions.

42. I.R.C. § 1015(a). For a general overview of this rule, see James B. Lewis, *Exploring Section 1015 and Related Topics*, 43 TAX LAW. 241 (1990).

43. See Treas. Reg. § 1.1015-1(a)(1), (2) (as amended in 1971).

44. The adjustment is equal to the gift and generation-skipping transfer taxes attributable to the unrealized appreciation. See I.R.C. §§ 1015(d)(6), 2654(a).

45. The basis rules described in the previous footnote for gratuitous transfers are further modified in the case of life, term, or remainder interests. If a remainder interest is sold, the seller's basis is the original I.R.C. § 1014 (or I.R.C. § 1015) basis, multiplied by the actuarial factor, *determined at the time of sale*, keyed to the duration or life of the income or term interest. Treas. Reg. § 1.1014-5 (as amended in 1994). Income or term interests received by gratuitous transfer have a basis of zero. I.R.C. §§ 273, 1001(e)(1).

46. I.R.C. § 1041(b)(2).

47. The property is likely to have the same basis in the distributee's hands as it did in the hands of the trust or estate. See I.R.C. § 643(e)(1). If, however, the fiduciary makes a special election, the property could have an FMV-at-distribution basis. I.R.C. § 643(e)(3).

48. A "wash sale" occurs when stock, securities, or commodities are sold by an investor at a loss and substantially identical assets are acquired within thirty days. I.R.C. § 1091(a). Such

exchange.<sup>49</sup> Each one of these nonrecognition events involves very technical tax basis rules that few taxpayers (or their advisers) will have the patience, willpower, or energy to peruse and then apply.<sup>50</sup>

### b. Basis Adjustments and Changes

Once acquired, assets can be subject to several basis adjustments, both upward and downward. It is not always easy to discern when taxpayers are supposed to make these adjustments. Consider the fact that upward basis adjustments are allowed for “improvements,” but not for “repairs.”<sup>51</sup> Yet distinguishing between repairs and improvements is often a difficult task in itself as the tests themselves are imprecise.<sup>52</sup>

The Code does offer several “precise” adjustments that are no less challenging to apply. In general, upward adjustments are required for income and gain inclusions accruing to original issue discount (OID) instruments,<sup>53</sup> interests in pass-through entities,<sup>54</sup> and mark-to-market investments.<sup>55</sup> In addition, interests in entities treated as

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securities are supposed to have a basis determined with reference to the shares disposed of at a loss, I.R.C. § 1091(d), which is supposed to go unrecognized. *See* I.R.C. § 1091(a).

49. Under I.R.C. § 1031, the basis of the acquired property is the same as the transferor’s basis in the transferred property subject to adjustments on account of gain (or loss) recognized, boot received (or given), and changes in mortgage debt. *See* I.R.C. § 1031(b), (d). A similar set of rules applies in the case of involuntary conversions under I.R.C. § 1033. *See generally* I.R.C. § 1033(b).

50. Form 8824 exists for reporting like-kind exchanges. INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, FORM 8824 (2005), available at <http://www.irs.gov/pub/irs-pdf/f8824.pdf>. However, the index to the Instructions to Form 1040 makes no reference to either “exchanges” or “like-kind exchanges”; Form 8824, however, is mentioned in fine print (along with much else in the lengthy Instructions to Schedule D, p. D-1, and on Schedule D itself in lines 4 and 11). IRS INSTRUCTIONS FOR FORM 1040, *supra* note 23; IRS INSTRUCTIONS FOR SCHEDULE D, *supra* note 22; DEP’T OF THE TREASURY, SCHEDULE D (FORM 1040) (2005), available at <http://www.irs.gov/pub/irs-pdf/f1040sd.pdf> [hereinafter IRS SCHEDULE D]. Form 8824 provides for a basis computation of the acquired property. However, since the description of the property can be vague, there is no way for the IRS to use this basis information on its own. The Instructions for Schedule D (2005) state that “you may not be able to use the actual cost as the basis” in the case of property acquired by inheritance, gift, tax-free exchange, involuntary conversion, or wash sale, but there is no explanation of the basis rules for such property in the Form 1040 instructions themselves. Moreover, the instructions state that a separate explanation of the basis figure must be provided if actual cost is *not* used. IRS INSTRUCTIONS FOR SCHEDULE D, *supra*, at D-6. Thus, a conscientious taxpayer is left with the possibility of consulting a Form 8824 filed with a prior return, but this process could entail unappealing complexities. Consequently, the path of least resistance is to enter a basis number without an explanation.

51. *See* I.R.C. § 1016(a).

52. *Compare* Midland Empire Packing Co. v. Comm’r, 14 T.C. 635 (1950) (costs associated with adding a concrete liner to taxpayer’s basement held a deductible repair), *with* Mt. Morris Drive-In Theatre Co. v. Comm’r, 25 T.C. 272 (1955), *aff’d*, 238 F.2d 85 (6th Cir. 1956) (addition of a drainage system held to a nondeductible capital expenditure). *See generally*, Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 47 TAX LAW. 607, 607 (1994) (“One of the recurring problems in tax law is the difficult distinction between expenses that can be deducted when incurred and those that must be capitalized.”).

53. *See* I.R.C. § 1272(d)(2).

54. *See* I.R.C. § 705(a)(1) (partner’s basis in a partnership interest); I.R.C. § 1367(a)(1)

partnerships for tax purposes have an upward basis adjustment on account of an increase in partnership liabilities.<sup>56</sup>

In the Code, there exist many corollaries to these upward basis adjustments in the form of downward basis adjustments. These are required for distributions, losses, and deductions (such as depreciation, amortization, and depletion)<sup>57</sup> accruing to such investments as (1) assets held for use in the taxpayer's trade or business, (2) interests held in pass-through entities,<sup>58</sup> and (3) mark-to-market assets.<sup>59</sup> Also, the "outside" basis in interests in entities treated as partnerships for tax purposes must be correspondingly reduced when there is a decrease in partnership liabilities.<sup>60</sup>

In the case of interests in entities (including publicly traded stock), basis is affected by "capital changes" in the entity.<sup>61</sup> Thus, in the case of a "stock split," the presplit basis is supposed to be reallocated among the new shares on a pro rata basis.<sup>62</sup> A similar rule exists in the case of an excludible stock dividend.<sup>63</sup> In the case of a corporate division (such as a spin-off), recapitalization, merger, or acquisition, the shareholders may end up with stock of one or more corporations other than (or in addition to) the shares of the initial corporation. If the transaction involves a tax-free exchange or distribution of stock,<sup>64</sup> the shareholder's original basis, as adjusted upward

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(shareholder's basis in S-corporation stock).

55. See I.R.C. § 1256(a)(2). There is an obscure but broadly applicable one-time election for appreciated investments held by the taxpayer on January 1, 2001. This election, potentially available for virtually all investments of a noncorporate taxpayer, is contained in section 311(e) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, which is not in the Code but which was brought to the attention of taxpayers by the IRS. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, 2001 INSTRUCTIONS TO FORM 1040 D-2 (2002), available at <http://www.irs.gov/pub/irs-prior/i1040sd--2001.pdf>. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 414, 116 Stat. 21, retroactively amended section 311(e) of the Taxpayer Relief Act of 1997 to clarify that a taxpayer may not use Code section 121 to exclude gain on a principal residence resulting from a mark-to-market election.

56. See I.R.C. § 752(a).

57. See I.R.C. § 1016(a)(2).

58. See I.R.C. § 705(a)(2) (partner's basis in a partnership interest); I.R.C. § 1367(a)(2) (shareholder's basis in S-corporation stock).

59. See I.R.C. § 1256(a)(2).

60. See I.R.C. § 752(b).

61. See Carolyn Hartwell, Russell H. Hereth & John C. Talbott, *Unraveling a Stock's Basis Is Not Necessarily Basic*, 70 PRAC. TAX STRATEGIES 356 (2003) (describing the myriad events that can result in complex tax basis adjustments with no contemporaneous IRS reporting requirement). In contrast, consider the reporting requirements associated with ownership of depreciable assets. Taxpayers must annually adjust their tax bases in these assets, see I.R.C. § 1016(a), and report the sums of these adjustments on Form 4562. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, FORM 4562 (2005), available at <http://www.irs.gov/pub/irs-pdf/f4562.pdf>.

62. See I.R.C. § 358(a)(1).

63. See I.R.C. §§ 305(a), 307(a). In cases when a corporation distributes stock rights that are less than 15% of the FMV of the old stock at the time of distribution, a taxpayer may elect not to reallocate tax basis. I.R.C. § 307(b). However, if the stock dividend is taxable under I.R.C. § 305(b)-(c), the stock received is includible in gross income and acquires a basis equal to its FMV on distribution with no adjustment to the basis in the original shares. See I.R.C. § 301(d).

64. See I.R.C. § 354 (requiring a "reorganization" as defined in I.R.C. § 368); I.R.C. § 355

for any gain recognized and downward for any boot received, is to be reallocated among the "resulting" shares in proportion to their respective FMVs.<sup>65</sup> Stock shares or securities received in a taxable exchange should have a basis equal to their FMVs at the time of the exchange.<sup>66</sup> This rule also applies to in-kind boot, whether received in a taxable or tax-free exchange.<sup>67</sup>

While transactions of the type described in the preceding paragraph may occur fairly often during a sustained period of equity ownership, there are other capital-change transactions that occur less frequently but also implicate basis. A nondividend corporate distribution (i.e., when the corporate enterprise has no earnings and profits)<sup>68</sup> in cash or in-kind reduces basis in the stock to the extent thereof, and any distribution in excess of basis yields capital gain.<sup>69</sup> The liquidation of a corporation is a taxable event to both the corporation and the shareholder,<sup>70</sup> meaning that the basis of any property received by an ex-shareholder is its FMV at the time of liquidation.<sup>71</sup> Finally, the creation of a corporation with in-kind contributions entails the replication of the shareholder's basis at both the shareholder and corporate levels.<sup>72</sup>

Capital changes that cause resulting basis adjustments are not limited to corporate investments. Similar adjustments apply with respect to pass-through entities and interests therein.<sup>73</sup>

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(corporate divisions).

65. See I.R.C. § 358; Treas. Reg. § 1.358-2(a)(2) (as amended in 1995).

66. See *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 166, 172 (1954) (holding that basis in taxable exchange of property received is the FMV of property received, not the FMV of property given).

67. See Treas. Reg. § 1.358-1(a) (as amended in 2002) (last sentence).

68. A nondividend distribution is a distribution by a corporation that has exhausted its post-1913 earnings and profits. See I.R.C. § 316 (defining dividend distribution).

69. I.R.C. § 301(c)(2)-(3). If the distribution is in-kind, the distribution is treated as "at" FMV, which is also the basis of the property in the hands of the distributee. See § 301(b), (c)(2), (d).

70. See I.R.C. §§ 331, 336.

71. I.R.C. § 334(a).

72. Assuming the transfer qualifies (in whole or in part) as a tax-free exchange under I.R.C. § 351, the transferor's basis in the stock and the corporation's basis in the assets are both based on the transferor's basis. See I.R.C. §§ 358(a), 362(a).

73. Application of the basis rules for pass-through entities and interests therein requires constant attention. It has already been noted that the tax basis in interests classified as partnerships for tax purposes is (1) adjusted annually for passed-through profits and losses, (2) reduced by distributions, and (3) altered by changes in partnership liabilities. See *supra* notes 55, 57, 60. Basis is also increased by capital infusions from equity holders. See I.R.C. § 722. In the case of a nonliquidating in-kind distribution, the distributee's basis in the property received is the tax partnership's inside basis (not to exceed the partner's outside basis reduced by any cash received), see I.R.C. § 732(a), and the distributee's outside basis is reduced by the same amount as the partner's basis in the distributed property. See I.R.C. § 733. Outside basis is the equity holder's basis in her tax partnership interest; inside basis is the predistribution basis of an asset, the ownership of which is held by the tax partnership. When a tax partnership is liquidated in-kind, the distributee's basis in the property is the same as her outside basis (rather than inside) basis, reduced by any cash received. See I.R.C. § 732(b). The tax partnership interest no longer exists. Subchapter S corporation stock is subject to basis rules similar to those of tax partnerships, except there is no adjustment with respect to Subchapter S corporation liabilities. In addition, in-kind distributions, whether liquidating or nonliquidating, are treated according to



To illustrate the difficulties the tax basis identification process may engender, consider a case study involving stock ownership in AT&T, once the most widely held stock in the United States.<sup>74</sup> Suppose *A*, in 1982, held 100 shares of common stock in AT&T with a \$1000 aggregate tax basis (or \$10 per share). In the ensuing years, AT&T experienced the following capital-change events: a divestiture, two corporate spin-offs, a stock split, a corporate split-off, a spin-off, and, finally, a reverse stock split. As a result of these events, by the year 2004 *A* would own thirty shares of common stock in AT&T with a tax basis of \$1.89 per share. In addition, she would hold stock in eleven other companies,<sup>75</sup> each of which may have made stock

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the rules applicable for Subchapter C corporations. See I.R.C. §§ 1367(a), 1368.

74. Jill Bettner, *Small Holders Think AT&T Is Still Safe Bet*, WALL ST. J., Jan. 22, 1982, §2, at 33 ("With 3.1 million shareholders, AT&T is the nation's most widely held stock.").

75. On January 1, 1984, AT&T shareholders each received one share in seven regional Bell operating companies for every ten shares of AT&T owned on the record date of December 30, 1983. *A*'s tax basis should have been allocated 28.50% to AT&T (i.e., \$285 or \$2.85 per share) and the remaining 71.50% as follows: Ameritech (10.33%), Bell Atlantic (10.49%), Bell South (13.53%), NYNEX (9.84%), Pacific Telesis Group (8.88%), Southwestern Bell (9.49%), and US West (8.94%). Next, AT&T shareholders of record on September 17, 1996, received a distribution of 0.324084 shares of common stock of Lucent Technologies, Inc., for every share of AT&T stock owned. (AT&T shareholders entitled to a fractional share of Lucent Technologies, Inc., received a cash payment instead.) As a result of this distribution, *A*'s tax basis should have been allocated 72.01% to her AT&T shares (i.e., \$205.23 or \$2.05 per share) and 27.99% to the Lucent Technologies, Inc., shares, including any fractional share ownership. Next, AT&T shareholders of record on December 13, 1996, received a distribution of 0.0625 shares of common stock of NCR Corp. for every share of AT&T stock owned. (AT&T shareholders entitled to a fractional share of NCR Corp. received a cash payment instead.) As a result of this distribution, *A*'s tax basis should have been allocated 95.23% to her AT&T shares (i.e., \$195.44 or \$1.95 per share) and 4.77% to the NCR Corp. shares, including any fractional share ownership. Next, as a result of a three-for-two stock split on April 15, 1999, AT&T shareholders received one additional share of stock for every two shares owned on the record date of March 31, 1999. Cash was received in lieu of any fractional share, unless the shareholders participated in the AT&T Dividend Reinvestment and Stock Purchase Plan (DRSPP) on the record date; in that case, all whole and fractional shares were credited to their DRSPP account. As a result of this stock split, *A*'s \$195.44 tax basis in her AT&T shares would be divided by the total number of her new AT&T shares, resulting in a tax basis of \$1.30 per share (\$195.44/150). Next, AT&T shareholders of record on June 22, 2001, received a distribution of 0.3218 shares of common stock of AT&T Wireless Services, Inc., for every AT&T share owned. (AT&T shareholders entitled to a fractional share of AT&T Wireless Services, Inc., received a cash payment instead.) As a result of this distribution, *A*'s tax basis should have been allocated 77.66% to her AT&T shares (i.e., \$151.78 or \$1.01 per share) and 22.34% to the AT&T Wireless Services, Inc., including any fractional share ownership. Next, AT&T shareholders of record on November 18, 2001, received a distribution of one share of common stock of AT&T Broadband Corp. for every AT&T share owned. (As a result of a merger, all shares of AT&T Broadband Corp. stock were converted into Comcast Corporation.) As a result of this distribution, *A*'s tax basis should have been allocated 37.4% to her AT&T shares (i.e., \$56.77 or 0.38 per share) and 62.6% to the AT&T Broadband Corp. Finally, as a result of a one-to-five reverse stock split on November 18, 2002, AT&T shareholders received one share of AT&T stock in exchange for every five AT&T shares owned on that date. (Cash was received in lieu of any fractional share unless the shareholder participated in the DRSPP; in that case, all fractional shares were credited to her DRSPP account.) As a result of this stock reverse, *A*'s total tax basis in her AT&T shares (i.e., \$56.77) would be divided by the total

distributions and experienced several corporate restructuring events of its own.<sup>76</sup> Although there are websites that deal with these complicated basis issues, a taxpayer must be willing to make the effort, know how to access these sites, and be able to enter the relevant data.<sup>77</sup>

To summarize the foregoing, a good-faith inquiry into basis requires both the finding of accurate historical records and access to advice or information about the legal significance of assorted basis rules pertaining to capital changes and various types of transactions and events. As to historical research, basis might well derive from the acts of another party (such as in the case of gifts and bequests), that may be unavailable, deceased, or, in the case of an estate, trust, or other entity, nonexistent. In many cases, basis records will be lost or inaccessible.

As to the legal significance of basis facts, one must start with the instructions to Schedule D of the individual income tax return (Form 1040). The instructions take up about nine pages of very small print laid out in three columns and cross-referenced to the general discussion of basis rules found in IRS Publication 551, as well as to several more-specialized IRS publications, schedules, and forms (and instructions to such schedules and forms).<sup>78</sup> For a tax-savvy person, an alternative to the IRS publications, forms, schedules, and instructions is the Bureau of National Affairs Tax Management Portfolio describing basis rules.<sup>79</sup>

Having obtained and digested the necessary facts and relevant rules, the civic-minded taxpayer would next need to muster the will, time, and effort to “put it all together” so as to correctly fill out the tax return.<sup>80</sup> The mere mechanics of correctly filling out Schedule D can be extremely onerous, as Schedule D requires that a gain or loss computation be made for *each* asset disposition.<sup>81</sup> First, the matching of purchase and sale information would inevitably be quite time-consuming. Second, if the taxpayer has engaged in dozens, hundreds, or thousands of trades during the year, reams of Schedule D pages would need to be submitted, even though the gains and losses on numerous items might be quite small. Third, gains and losses have to be broken down into numerous specific categories such as capital versus ordinary gains and losses,

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number of her new AT&T shares (i.e., thirty), resulting in a tax basis of \$1.89 per share. See James Schembari, *AT&T x 1.176 - \$15 + Yes, More Questions*, N.Y. TIMES, Feb. 22, 2004 at C9; Jane J. Kim, *AT&T Investors Face Tax Headache*, WALL ST. J., Feb. 3, 2005, at D1. AT&T and other corporations have websites that assist in the computation of basis. See AT&T, Investor Relations: Tax Basis Information, <http://www.att.com/ir/ss/tbi> (last visited Sept. 23, 2005).

76. For example, as a result of holding 100 shares in AT&T, Taxpayer A in the prior example, *supra* note 75, would have received seven shares in BellSouth. Over the next two decades, shareholders in BellSouth experienced four stock splits, each of which resulted in a shareholder tax basis adjustment. To compute these tax basis adjustments, see BELL SOUTH, A GUIDE TO COMPUTING TAX BASIS, [http://www.bellsouth.com/investor/ir\\_shareholder\\_taxbasis.html](http://www.bellsouth.com/investor/ir_shareholder_taxbasis.html) (last visited Sept. 23, 2005).

77. See James Schembari, *The Cost Basis in the Haystack*, N.Y. TIMES, Jan. 25, 2004 at C8.

78. See IRS INSTRUCTIONS FOR SCHEDULE D, *supra* note 22.

79. See Maule, *supra* note 3.

80. See Ken Kies, *Capitol Hill Veteran: 'I Still Hate Doing My Taxes,'* WASH. POST, Mar. 2, 2003, at H11 (former chief of staff of the Joint Committee on Internal Revenue Taxation commenting about his disdain for completing his annual tax return).

81. When there are changes in control or recapitalizations, this requirement is relaxed. In completing Form 1099-B, brokers can aggregate all proceeds (cash, stock, and other property) resulting from these events. See Temp. Treas. Reg. § 1.6045-3T(d) (as corrected in 2004).

long-term versus short-term capital gains, “collectibles” gains and losses, “non-recaptured Code section 1250 gains,” Code section 1231 gains and losses, and so on, some of which are separately reportable on Forms 4684, 4797, 6252, 6781, and 8824. Then all of these results have to be added up, sorted out, and processed. Even though many of the arithmetical operations can be handled by tax return computer programs, simply entering the data correctly is a formidable task in itself.

In sum, it is a truly heroic assumption that taxpayers (and their advisors) can comprehend the basis rules and apply them. In fact, unlike most other rules in the Code, the government essentially leaves to chance the comprehension and application of such rules.

### 3. Absence of Compliance Incentives

For those who lack compliance zeal, there are few incentives (by way of “carrot” or “stick”) to ensure accurate basis and gain reporting. More specifically, third parties are indifferent to tax basis concerns insofar as they have no reporting obligations, the standards of practice established by the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) implicitly discourage basis inquiries, and taxpayers often harbor a nonchalant attitude toward basis in recognition of the fact that their chances of being audited on this issue are virtually nonexistent.

#### a. Third-Party Reporting Obligations

Third-party reporting of basis information is virtually nonexistent.<sup>82</sup> Although Code section 6041(a) requires the issuance of information returns by payors for certain payments, this requirement only applies if the payor is a business and the payment (a) is in the amount of \$600 or more; (b) is made in the course of such business; and (c) constitutes compensation, rent, or other “fixed and determinable profit, gain, or income” of the payee.<sup>83</sup> However, a seller’s amount realized that is attributable to a payment fits into none of these categories,<sup>84</sup> and it is fairly safe to say that asset

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82. One of the few provisions relating to basis reporting is Code section 1060, relating to taxable business acquisitions, where the buyer is supposed to inform the IRS of allocations of the purchase price of intangibles and other assets relevant to Code section 197. I.R.C. § 1060(b). Taxpayers are to enter these allocations on Form 8594. See Treas. Reg. § 1.1060-1(e)(1)(i) (as amended in 2004). This form, however, only requires a breakdown of the aggregate amount of consideration allocated to each asset *category*; thus, the buyer’s asset-by-asset tax basis remains shrouded in mystery. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, FORM 8594 (Rev. Oct. 2002), available at <http://www.irs.gov/pub/irs-pdf/f8594.pdf>. Code section 6043 imposes a reporting obligation on a corporation with regard to liquidations, reorganizations, and other changes in capital structure. Despite this reporting obligation, Form 1099-CAP, which is the vehicle for fulfilling this obligation, makes no reference to shareholder basis, which would not be known by the corporation. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, FORM 1099-CAP (2005), available at <http://www.irs.gov/pub/irs-pdf/f1099cap.pdf>.

83. See I.R.C. § 6041(a).

84. The phrase *fixed and determinable* is lifted from the phrase *fixed or determinable, annual or periodical*, found in I.R.C. §§ 871(a), 881(a), 1441(a). Clearly, the latter phrase was designed to exclude capital gains because the payor/buyer has no means of ascertaining the

purchases are generally excluded under section 6041.<sup>85</sup> Direct third-party basis reporting to the IRS would, if nothing else, put taxpayers on notice that the IRS possesses such information and that filling in the blanks on Schedule D with made-up numbers might be somewhat risky, despite the fact that the IRS at present has no means by which to match basis information with subsequent sale information.<sup>86</sup>

Third-party reporting requirements for sales, exchanges, and other dispositions (all of which would at least posit the existence of a basis issue) are grossly inadequate. Along these lines, Code section 6045 is the most relevant information-reporting provision. It imposes an obligation on a broker<sup>87</sup> to file an information return “with such details regarding gross proceeds and other information as the Secretary by forms and regulations may require.”<sup>88</sup> However, this provision only covers *brokered* sales and is further limited to brokered sales of real estate and securities and other exchange-traded items.<sup>89</sup> Important sectors of the economy thus avoid third-party reporting of

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seller/payee’s basis. See Treas. Reg. § 1.1441-2(b)(1)-(2) (as amended in 2000). There is no other mention of “gain” in the section 6041 regulations and no example involving a scenario in which the payee would have a basis offset.

85. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, INSTRUCTIONS FOR FORM 1099-MISC (2005), available at [http://www.irs.gov/pub/irs-pdf/i1099misc\\_05.pdf](http://www.irs.gov/pub/irs-pdf/i1099misc_05.pdf). This conclusion is reinforced by the fact that there are specific reporting requirements for purchases of goods by “direct sellers” (i.e., not through a permanent retail establishment). See I.R.C. § 6041A. For purchases of fish, see I.R.C. § 6050R.

86. Form 1099-B, see *infra* notes 89–91 and accompanying text, may contain a CUSIP number with respect to each block of stock sold. However, the CUSIP number only identifies the original issue, and it does not serve to identify particular shares. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, FORM 1099-B (2005), available at <http://www.irs.gov/pub/irs-pdf/f1099msc-04.pdf>.

87. A “broker” is one who arranges sales on behalf of another. See Treas. Reg. § 1.6045(c)(1) (as amended in 1997). This definition excludes dealers, traders, and others who sell on their own account.

88. *Id.* § 1.6045(a). There is no de minimis exception, except for real estate brokers in connection with sales of principal residences for \$250,000 or less (or \$500,000 or less in the case of married taxpayers) when the gain is wholly exempt under I.R.C. § 121. I.R.C. § 6045(e)(5).

89. This rule leaves out nonbrokered sales and brokered sales of assets other than real estate, securities, and exchange-traded items. One area not covered by any reporting requirement, therefore, is inventories. Thus, businesses lacking independent accounting oversight can understate inventory profits by such techniques as (a) omitting cash sale proceeds from the computation of gross receipts, (b) overstating inventory costs, and (c) simply not reporting inventory sales. In addition, businesses would be tempted to ignore nonbrokered sales of business-use assets, especially assets that have been fully depreciated. Nonbrokered sales of closely held interests in business and investment entities would also skirt IRS scrutiny due to the absence of third-party reporting requirements. Finally, in the domain of the sale of appreciated artwork and collectibles by individuals and dealers, either directly or through auction houses, there is no third-party reporting except for cash sales in the amount of \$10,000 or more within the United States. The latter rule stems from I.R.C. § 6050I, under which a business taxpayer is required to report the receipt of cash in the amount of \$10,000 or more in any one transaction. This provision, however, does not apply to transactions outside of the United States. See I.R.C. § 6050I(c)(2). Importantly, “cash” under this provision excludes personal checks and credit card transactions. See Treas. Reg. § 1.6050I-1(c)(1)(ii) (as amended in 1991). Hence, this provision is unimportant apart from money-laundering schemes.

sales, and sales not reported to the IRS cannot put the IRS on notice of basis issues. Moreover, for those section 6045 sales that are reported on Forms 1099-B (sales of securities) and 1099-S (sales of real estate), the third-party reporting obligation is expressly limited to the seller's net proceeds of sale.<sup>90</sup> These forms do not identify the buyer (which, in sales over an exchange, would be virtually impossible) and are not sent to the buyer. Finally, the seller's basis (which might be available) is not reportable on these forms.<sup>91</sup> In short, there is no effective basis reporting for two of the most important categories of purchase and sale transactions, marketable securities and real estate, even though the IRS is supposed to be notified that these transactions have occurred.

Gratuitous transfers of property also pose basis-reporting problems. The gift tax return (Form 709) does provide a space for entering the donor's adjusted basis in gifted property.<sup>92</sup> Despite this requirement, such basis has no relevance for the computation of the gift tax itself, and therefore failure to provide an *accurate* basis figure would not expose the *donor* to any gift tax penalty.<sup>93</sup> Moreover, donors need only deliver the gift tax return to the IRS,<sup>94</sup> and there would appear to be no way for the IRS to effectively use these information returns to track basis in the absence of a system of precisely identifying property.<sup>95</sup> Also, there is no concomitant requirement to notify the donee of the gifted asset's adjusted basis. Indeed, such a requirement would violate the existing privacy regulations relating to tax returns.<sup>96</sup> To further complicate matters, the donee's

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90. In the case of closed regulated futures contracts, only profit (net of basis) has to be reported. Treas. Reg. § 1.6045-1(c)(5)(i) (as amended in 1997).

91. Securities brokers, independently of IRS reporting requirements, will probably give their clients confirmation slips as to security purchases, but these will not be identified as "tax documents" and will not be submitted to the IRS. Brokers sometimes, as a service to clients, send year-end statements to clients matching basis with amount realized, but such documents are not submitted to the IRS.

92. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, FORM 709 (2004), available at <http://www.irs.gov/pub/irs-pdf/f709.pdf>.

93. Although the donor is supposed to show the CUSIP number of any gifted securities on the gift tax return, the CUSIP number will not be of any use in determining whether the basis figure entered on the return by the donor is correct. See *supra* note 86.

94. Under circumstances in which the gift qualified for annual exclusion or the marital deduction, see I.R.C. §§ 2503(b), 2523, no gift tax return would have to be filed in the first place. I.R.C. § 6019(a)(1).

95. There is no specific identification system for property listed on Schedule D or other relevant forms and schedules. Various IRS forms, including Schedule D, call for a description of the property, but there is no prescribed form or content for the description, and the space in which it is to be entered is quite small. In the case of real estate, for example, it is not even necessary to list the address of the gifted property. See IRS SCHEDULE D, *supra* note 22.

96. See I.R.C. § 6103(e). Only taxpayers have a right to review copies of their own tax returns. 5 U.S.C. § 552(a) (2000). The regulations implicitly acknowledge this resource limitation, pointing out that "[i]f the facts necessary to determine the basis of property in the hands of the donor . . . are unknown to the donee, the district director shall, if possible, obtain such facts from such donor . . . or any other person cognizant thereof." Treas. Reg. § 1.1015-1(a)(3) (as amended in 1971).

basis is not necessarily the same as the donor's adjusted basis<sup>97</sup> unless the donee is the donor's spouse.<sup>98</sup>

Recipients of gratuitous transfers from decedents (bequests, inheritances, and IRD rights) will often have a difficult time trying to determine the basis of the assets received, even when acting in good faith. The vast majority of estates are exempt from having to file a federal (or state) estate tax return,<sup>99</sup> and in those cases there is no systemic determination of date-of-death asset values by estate transferees, fiduciaries, other third parties, or the government.<sup>100</sup> Thus, unless there is a sale shortly after death, there is no particular reason for anybody to make date-of-death valuations,<sup>101</sup> which (except for IRD rights) fix asset basis.<sup>102</sup> The lack of date-of-death valuations coupled with a possibly long time lag between acquisition and sale operate as an open invitation to inflate the basis of nonpublicly traded assets, especially real estate, artworks, collectibles, and closely held business interests, for which there are no objective indicators of date-of-death value.<sup>103</sup>

For those large estates that are required to file an estate tax return (Form 706), the personal representative must specify date-of-death values and, if relevant, the alternate valuation date values.<sup>104</sup> However, the Code does not mandate (or allow) the distribution of this information to estate recipients.<sup>105</sup> Rather, the heir or legatee must file a request with the IRS to inspect the returns of estates, trusts, and decedents.<sup>106</sup> Finally, there is no rule that the value of an estate asset entered on the estate tax return is per se binding for income tax purposes. Rather, the estate tax return value is only

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97. See *supra* notes 41–44 and accompanying text.

98. I.R.C. § 1041(b)(2). Similar issues arise in other carryover-basis and substituted-basis situations, such as like-kind exchanges. See *supra* note 48 and accompanying text.

99. See *supra* note 39.

100. An exception would occur if, for state death tax purposes, there were appraisals prepared. See Treas. Reg. § 1.1014-3(a) (1957).

101. In the case of publicly traded assets, date-of-death values can be ascertained after the fact by consulting market data for the date of death. However, even here the data may produce an erroneous basis determination if the asset has suffered capital changes.

102. See *supra* note 36.

103. For IRD rights, the decedent's basis carries over, see I.R.C. § 1014(c), but the estate tax return (even if one is due) imposes no obligation to memorialize the decedent's basis in the IRD right. In any event, the tax rules for IRD rights (unlike the basis-equals-estate-tax-value rule) is known only to the tax cognoscenti, and ignorance of the IRD tax rules probably results in erroneous estate-tax-value basis claims.

104. I.R.C. § 6018.

105. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 706 (Rev. Aug. 2005), available at <http://www.irs.gov/pub/irs-pdf/i706.pdf> (estate tax return, with accompanying schedules, submitted only to IRS); INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 1041 AND SCHEDULES A, B, D, G, I, J, AND K-1, 41–44 (2005), available at <http://www.irs.gov/pub/irs-pdf/i1041.pdf>. The instructions for Schedule K-1 of estate or trust income tax returns to be sent to beneficiaries make no mention of basis information.

106. See I.R.C. § 6103(e)(1)(E)–(F), (e)(3) (“material interest” standard); Rev. Rul. 54-379, 1954-2 C.B. 121 (income tax return of year prior to year of decedent's death obtainable by heir of decedent).

presumptively correct; and the decedent's transferee, if not barred by estoppel or similar equitable doctrine,<sup>107</sup> can overcome that presumption.<sup>108</sup>

The bottom line is that when an in-kind estate transferee sells the property years after the decedent's death, the recipient may have a difficult time determining the property's tax basis, and, for that matter, the IRS may have difficulty identifying the accuracy of such a determination.<sup>109</sup> Moreover, since estate tax valuations are not absolutely controlling for income tax purposes, even estate transferees with access to estate tax return information have the opportunity to overstate basis in nonpublicly traded assets without much downside risk.

In sum, from the third-party reporting perspective, it is evident that there is essentially a void where basis is concerned, and there are serious gaps in the reporting of sales and other taxable dispositions.

#### b. Tax Professionals Lack Incentives to Steer Taxpayers Toward Compliance

Many people assume that tax professionals will steer clients toward compliance. While there may be some truth to this assumption regarding issues of law, there is little reason to think that it will extend to issues of fact, such as basis determinations.

A large proportion of taxpayers turn over the task of filling out their income tax returns to professional tax return preparers,<sup>110</sup> and the latter will be familiar with the most commonly applied basis rules and be motivated to ask taxpayers to supply basis information for those sales and exchanges that are reported by the taxpayer to the preparer. However, the preparer can use only the information that the taxpayer communicates.<sup>111</sup> Put differently, a tax return preparer is under no duty to use due diligence to scour records in search of unreported taxable dispositions or to verify the

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107. *See, e.g., Ford v. United States*, 276 F.2d 17, 21 (Ct. Cl. 1960) (estate beneficiary not estopped by estate tax return filed by executor).

108. *See Estate of Cordeiro v. Comm'r*, 51 T.C. 195 (1968), *acq.*, 1969-2 C.B. xxiv; Rev. Rul. 54-97, 1954-1 C.B. 113.

109. The estate (and perhaps trust) representative filing fiduciary income tax returns will often be the same person filing the estate tax return. Hence, the estate or trust as an income tax entity should typically have access to basis information gleaned from the estate tax return with respect to sales and exchanges by the estate or trust. If there is no estate administration, if the asset passes outside of estate administration, or if the estate distributes the asset to the heir or legatee in kind (and there is no I.R.C. § 643(e) election to deem such distribution to be a realization event), there will be no ready access to basis information except by a request to the IRS under I.R.C. § 6103.

110. Approximately 56% of all individual taxpayers utilized the services of a paid preparer in 2002. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, 24 STATISTICS OF INCOME BULLETIN 2, 253 tbl.1, 351 tbl.23 (Fall 2004).

111. The economic incentive for the preparer to do a thorough job depends on whether the preparer is being paid an hourly fee or a flat rate. Since an hourly fee arrangement is somewhat the equivalent of the taxpayer issuing a blank check to the preparer, most individual taxpayers would be expected to opt for a flat fee arrangement; but a flat fee arrangement will create a disincentive on the part of the preparer both to take the time to dig out property transactions not reported by the taxpayer to the preparer and to pursue difficult factual issues such as those pertaining to basis.

facts asserted by the taxpayer that underlie the taxpayer's reported positions.<sup>112</sup> At most, a preparer who is a certified public accountant (CPA) has a duty to ask the taxpayer if the taxpayer is able to support the basis figures entered on Schedule D.<sup>113</sup>

Accurate reporting of basis is as unlikely to occur when a taxpayer engages a lawyer as when a taxpayer engages an accountant or other professional tax return preparer. The taxpayer will probably be as unforthcoming with a lawyer (regarding tax basis issues) as with an accountant or preparer. For income tax penalty purposes, a lawyer giving advice on the contents of a tax return may well be considered a "tax return preparer,"<sup>114</sup> in which case the discussion in the prior paragraph would apply. In

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112. The main tax return preparer penalty provision is I.R.C. § 6694(a). It applies in circumstances when the following threefold conjunctive test is met: (1) a taxpayer's tax liability stems from a nonmeritorious position, (2) that was known to the tax return preparer, and (3) was not disclosed or was frivolous. The term *position* seems to refer to a *legal* position, such as the scope of a Code provision or the import of a court case. A position is sufficiently meritorious if it has at least a one-in-three possibility of being upheld on the merits (i.e., disregarding the chances of being audited). See Treas. Reg. § 1.6694-2(b)(3) (as amended in 1992) (all nine examples referring to legal issues). The amount of this penalty is \$250. I.R.C. § 6694(a).

A larger tax return preparer penalty (i.e., \$1000) applies when the preparer willfully attempts to understate a taxpayer's tax liability or exhibits reckless or intentional disregard of rules or regulations. I.R.C. § 6694(b). The "reckless or willful" conduct penalty is described in terms of applying law to taxpayer-supplied data. Treas. Reg. § 1.6694-3(c) (1991).

Rev. Proc. 80-40, 1980-2 C.B. 774, explicitly states that a tax return preparer has no duty to verify facts but does have a duty to inquire into facts if the taxpayer-supplied information is incomplete or appears on its face to be incorrect. In *Brockhouse v. United States*, 749 F.2d 1248 (7th Cir. 1984), for example, the Seventh Circuit upheld the imposition of a tax-return preparer penalty on the basis of the accountant's failure to inquire about the import of a known fact, relying upon the then-version of I.R.C. § 6694 that encompassed "negligent disregard of rules and regulations." Curiously, the facts of *Brockhouse* are quite similar to those of Rev. Rul. 80-265, 1980-2 C.B. 378, in which the IRS held that I.R.C. § 6694 was not applicable! In Rev. Rul. 80-266, 1980-2 C.B. 378, the IRS distinguished between the situation in which an accountant asked if the taxpayer could substantiate entertainment expense deductions and the taxpayer (falsely) said that he could do so (no penalty imposed) and one in which the accountant failed to ask the taxpayer if such substantiation existed (penalty imposed). However, this ruling can be distinguished from the *Brockhouse* decision on the ground that substantiation is a legal prerequisite for claiming entertainment expense deductions. See I.R.C. § 274(d).

113. See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON STANDARDS FOR TAX SERVICES No. 1.02(a) (rev. ed. 2000) ("A [CPA] should not recommend that a tax return position be taken with respect to any item unless the [CPA] has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged.").

114. See Treas. Reg. § 301.7701-15(b) (as amended in 2002) (an individual is a tax return preparer if he or she prepares all or a substantial portion of a tax return). Some tax practitioners are even themselves not entirely forthcoming with the preparation of their own tax returns. See John Herzfeld, *IRS Looking at Practitioners Who Fail to File Own Returns*, *Official Says*, BNA TAX MANAGEMENT LIBRARY, Nov., 10, 2005 at G3, available at <http://library.bnatax.com/TMD/maillink3.xx3/is/a0b1z3w2v8> (subscription required).

The IRS Office of Professional Responsibility is making it an enforcement priority to gain compliance from tax practitioners who fail to file their own returns, the office's deputy director says. "You would be surprised how many practitioners



addition, a lawyer is subject to certain profession-specific ethical duties, but the thrust of these duties primarily revolves around advising the client on aggressive *legal* (not factual) positions.<sup>115</sup>

Finally, the tax adviser practicing before the IRS (whether that person is a tax return preparer, accountant, or lawyer) must comply with the IRS Rules of Practice (known as Circular 230) or risk losing such right. The relevant portion of Circular 230 states:

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.<sup>116</sup>

Given this standard, a nonconfrontational tax adviser has no desire or interest in knowing about incorrect facts on a tax return and has no duty to inquire about facts unless they appear wrong. A basis entry on Schedule D will practically never appear to be wrong unless the tax adviser has personal knowledge of the property's market history—a very unlikely scenario.<sup>117</sup>

In sum, tax advisors of all types have every incentive neither to inquire into the possible existence of undisclosed transactions implicating basis issues nor to question or investigate the basis figures supplied by taxpayers with respect to disclosed

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view filing a tax return as an optional act," Stephen Whitlock says, adding that in one sample, 11 percent of certified public accountants and 8.5 percent of tax attorneys had not filed. "I don't know where this is going to go, but we're going to get some pressure to do more in this area[.]"

*Id.*

115. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985) (discussing the strength of authority required for a lawyer to advise a particular position on a tax return). Of similar import are the rules of practice before the IRS, compiled as Circular 230, 31 C.F.R. § 10.34(a) (2005). A lawyer has no duty to inquire into facts, and a communication by the client to the lawyer to the effect, say, that the taxpayer's basis figures are wrong may be protected by the lawyer-client confidentiality privilege. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2004). However, the lawyer hearing a client's confession of a material misstatement of fact (such as a basis figure) is supposed to lecture the client on possible civil and criminal penalty exposure. See ABA Comm. on Ethics and Prof'l Responsibility, *supra*. If the client persists, the lawyer has the unappetizing choice of withdrawing from representation, MODEL RULES OF PROF'L CONDUCT R. 1.16(a)(1), (b)(2)-(3), or risking not only ethical sanctions (and possible exposure to tax return preparer sanctions), but also exposure to civil and criminal penalties for aiding and abetting. I.R.C. §§ 6701(a), 7206(2). In any event, the attorney would have a strong reason to avoid knowing about misstatements of fact on a tax return, and that translates into not wanting to know the facts in the first place.

116. Circular 230, 31 C.F.R. § 10.34(c) (2005). The relevant portions of Circular 230 pertaining to compliance (as opposed to opinion letters) were not altered by the highly publicized amendments published in 69 Fed. Reg. 75,841-45 (Dec. 20, 2004).

117. Obvious exceptions to this general rule would be where the taxpayer clearly has not reduced basis to account for depreciation, depletion, and/or loss deductions.

transactions. These incentives are not modified or overcome by any overriding general duty to the tax system.<sup>118</sup>

### c. The Audit Lottery

A basis controversy will arise with the IRS only if the taxpayer is audited. A basis figure entered on Schedule D can neither be incorrect on its face nor (as noted above) can it fail to match an information return submitted to the IRS. Similarly, an unreported taxable disposition for which a Form 1099 is not filed will not attract IRS attention. Neither situation can generate a computer assessment, and even an error in subtracting basis from amount realized would not suggest an error in the basis figure itself.

The possibility of examination and audit is a function of both IRS resources and factors relating to the type of item involved. That audit resources are anemic is well-known in the culture of tax practice and proven by the fact that only about 0.6 percent of individual income tax returns have, in the recent past, been audited<sup>119</sup> and a high percentage of these audits are directed at the earned income tax credit claimed by low-income taxpayers.<sup>120</sup>

For a time, certain returns were randomly selected for the Taxpayer Compliance Measure Program (TCMP), which entailed looking at all aspects of a return, including basis issues, for the principal purpose of generating statistics on taxpayer compliance.<sup>121</sup> However, the TCMP was abandoned in 1995, mainly because it was relatively costly and highly intrusive for the small number of impacted taxpayers.<sup>122</sup> After a period of not collecting random-sampling compliance data at all,<sup>123</sup> a new information-gathering program, known as the National Research Program (NRP), was inaugurated in 2002 that is designed to be less intrusive but far less comprehensive than the TCMP. Unfortunately, the design of the NRP is such that it would be

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118. See Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 U. KAN. L. REV. 847 (1999).

119. See, e.g., INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, DATA BOOK 2002, PUBLICATION 55B tbl.10 (2002) (indicating that for calendar year 2001, only 0.57% of income tax returns filed were audited). In prior tax years, the audit rate has been only marginally better, hovering around 1%. See generally U.S. GOV'T ACCOUNTABILITY OFFICE, IRS AUDIT RATES, GAO-01-484, at 1 (Apr. 25, 2001) (expressing concern that declining audit rates "could lead to a decline in taxpayers accurately reporting their tax liabilities").

120. David Cay Johnston, *I.R.S. Audits of Working Poor Increase*, N.Y. TIMES, Mar. 1, 2002, at C2.

121. See MARVIN GARBIS & STEPHEN STRUNTZ, TAX PROCEDURE AND FRAUD: CASES AND MATERIALS 122 (1982) (referring to comprehensive audits as occurring under the TCMP).

122. See Donald C. Alexander & Edwin P. Geils, *IRS Procedures: Examinations and Appeals*, 465 TAX MGMT. PORTFOLIOS (BNA) A-28 (2003). For a review of current IRS enforcement strategies, see NINA OLSON, TAXPAYER ADVOCATE SERV., INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE 2004 ANNUAL REPORT TO CONGRESS (2004), available at <http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf>.

123. There has been no IRS study on estimates of tax compliance for various categories of income, deduction, and credit items since the April 1996 publication of INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 1415, FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992 (1996), which is based primarily on data obtained under the TCMP.

extremely unlikely to uncover basis overstatements.<sup>124</sup> It is not surprising, therefore, that the problem of basis overstatements is virtually invisible on the IRS radar screen.<sup>125</sup>

Currently, returns (not identified by information-return matching programs) are mainly selected for audit as a result of “suspect” items on a return that are found through computer programs identifying deviations from normal ranges of return entries.<sup>126</sup> The computer merely identifies returns for which there is a probability of error, and not all of these returns are actually selected for audit. Once a return is selected for audit, the examiner will typically focus on only one or a few items on the return that appear to have the greatest potential for generating a meaningful amount of additional revenue.<sup>127</sup>

The IRS does not reveal the contents of the computer programs relating to targeted audits.<sup>128</sup> Writing in 1985, one commentator offered a list of about four dozen scenarios that would have aroused suspicion.<sup>129</sup> Basis, in general, was not on this list, and the only items that implicated basis were the following: (1) “unusual items,”<sup>130</sup> (2) gains on rental property accompanied by a failure to adjust basis for depreciation, and (3) losses on rental property recently converted from personal use.<sup>131</sup>

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124. The new system of collecting compliance information from random audits, the National Research Program (NRP), calls for random audits of about 50,000 individual returns a year, of which 17,000 will involve minimum (or no) taxpayer contact, 30,000 will focus only on selected items, and 2,000 will look at every item but without requiring substantiation of every item. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, IRS MANUAL 4.22 (2004), available at <http://www.irs.gov/irm> [hereinafter IRS MANUAL]; IRA L. SHAFIROFF, INTERNAL REVENUE SERVICE PRACTICE AND PROCEDURE DESKBOOK 3-6 to -8 (3d ed. (updated through Aug. 2004)). For an overview of NRP, see Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255 (2003); George Guttman, *IRS National Research Program on Track Despite Training Delays*, 97 TAX NOTES 331 (2002). For a critique of NRP, see Gordon C. Milbourn, *TIGTA Examines IRS National Research Program*, 2004 TAX NOTES TODAY 28-20 (2004), available at <http://www.treas.gov/tigta/auditreports/2004reports/200430043fr.html>.

125. See STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005), available at <http://www.house.gov/jct/s-2-05.pdf>, reprinted in 2005 TAX NOTES TODAY 18-39 (Jan. 27, 2005) (presenting a long list of tax reform proposals that would improve compliance; the only proposal relating to basis is one that would require estate tax values reported on an estate tax return to be binding for income tax purposes).

126. See IRS MANUAL, *supra* note 124, at 4.1.3 (referring to target audits as occurring under the DIF (discriminant function system)). An audit might also be triggered by outside information, such as media publicity, informers, and public records. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUBLICATION 1: YOUR RIGHTS AS A TAXPAYER 2 (Aug. 2000).

127. See Alexander & Geils, *supra* note 122, at A-27.

128. See IRS MANUAL, *supra* note 124, at 4.1.3.1.

129. MICHAEL MULRONEY, FEDERAL TAX EXAMINATIONS MANUAL 199–202 (1985).

130. This category might conceivably include the claiming of large (in absolute or relative terms) losses or reporting a high basis for stock well known to be highly appreciated (e.g., Dell Corporation stock in the 1990s).

131. The list Professor Mulroney offers, *see supra* note 129, appears to be based on the IRS MANUAL CLASSIFICATION HANDBOOK § 41(12)(0) (1985) as it existed when Professor Mulroney published his treatise on federal tax examinations in 1985. There appears to be no such list in

The current IRS manual refers to LUQs (large, unusual, or questionable items) as items to be examined on returns that the computer has already selected for potential audit. LUQs, however, are defined in terms of a general (and vague) “factor” test rather than in terms of specific types or categories of tax return entries;<sup>132</sup> no specific mention is made of basis and gains.

A final point to keep in mind is that the focal point of IRS examinations is predominately so-called return items (i.e., those items that appear on the face of the tax return itself). Basis, however, is not a return item in itself but only a “sub-item” reflected on a schedule that factors into the computation of gain or loss.

Current IRS research into compliance issues is consequently set up in a way that gain omissions (not reported by brokers) and basis overstatements will not emerge as a significant compliance issue for IRS management,<sup>133</sup> and the examination and audit process itself is structured in a way that is unlikely to uncover basis overstatement cases in the field.

#### 4. IRS Disincentives to Pursue Basis Inquiries

Even if basis overstatements were a compliance issue visible on the IRS radar screen, and even if the IRS generally possessed the resources necessary to conduct thorough audits, there exist various procedural and substantive reasons explaining why the IRS would give basis queries a low priority.

##### a. Procedural Reasons

Some of the procedural reasons relate to points made earlier. For example, the IRS would have little reason to contest a taxpayer- or third-party-provided basis figure at the time of acquisition because the significance of such a figure is contingent on future events,<sup>134</sup> and the IRS has no current system by which it can match such a figure against a future-amount-realized figure. As to current taxable dispositions, there is first the issue of whether the disposition is reported at all, and then, even in cases where a basis-overstatement issue is identified, the IRS might find the task of extracting the relevant records to be excessively costly, time-consuming, and frustrating, especially given the fact that there is no sanctionable duty on taxpayers to keep such records in the first place. And, under those circumstances in which the taxpayer has made a good-faith guess at basis, the IRS may actually lose if the guessing process produced a basis figure lower than that which was permissible.

The consciousness level of both the IRS and of taxpayers regarding basis compliance would certainly be raised if the lack of clear and convincing basis evidence were to result in a basis of zero. However, there is no *statutory* rule (equivalent to the rule of Code section 274(d) totally disallowing unsubstantiated travel and entertainment expenses) that deems an asset’s basis to be zero when there is not adequate substantiation.

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the existing IRS MANUAL.

132. See IRS MANUAL, *supra* note 124, at 4.10.2.3.1.

133. See *supra* notes 124–25 and accompanying text.

134. See *supra* notes 51–81 and accompanying text (discussing basis adjustments and changes).

Nevertheless, some commentators may believe that such a deemed-zero basis rule exists in the common law of the income tax. This misconception probably originates in an often-quoted passage from the well-known case of *Raytheon Production Corp. v. Commissioner*.<sup>135</sup> *Raytheon* involved the income tax treatment of the receipt of civil antitrust damages for injury to goodwill. The First Circuit opinion notes that the record was devoid of evidence as to the amount of the taxpayer's basis in the goodwill and, that being the case, quoted the Tax Court in determining that "in the absence of evidence of the basis of the business and good will of [the taxpayer], the amount of any nontaxable capital recovery cannot be ascertained."<sup>136</sup>

It is easy to read the foregoing sentence as standing for a rule of law to the effect that if the taxpayer fails to prove basis, the basis shall be deemed zero. At least one leading income tax treatise describes this aspect of *Raytheon* in such terms.<sup>137</sup> However, this reading of the quoted passage in *Raytheon* is incorrect for two reasons. First, the taxpayer in *Raytheon* had a zero basis as a matter of law because outlays relating to self-created goodwill are deducted as expenses (or possibly are charged to the basis of identifiable assets other than goodwill).<sup>138</sup> Second, the taxpayer in *Raytheon* adduced absolutely *no* evidence of basis. *No* relevant and credible evidence is qualitatively different from *some* relevant and credible evidence.

During an audit, since the basis-equals-zero rule apparently does not apply, what rule does apply? The answer is that some version of the *Cohan* rule applies.<sup>139</sup> This so-called "rule" (which lacks uniformity or clarity) basically holds that a court will estimate the amount of a deduction (in this case, an asset's basis) if the taxpayer provides some credible evidence to that effect but cannot prove the exact amount.<sup>140</sup> Or, stated somewhat differently, the *Cohan* rule is a device that allows a court to fix the amount of a deduction (or an asset's basis) in cases where the taxpayer has sufficiently established her (perhaps somewhat low) burden of proof regarding an entitlement to some deduction (or some basis offset).<sup>141</sup>

The *Cohan* rule would not come into play if the taxpayer had adequate documentary evidence of net purchase price and relevant basis adjustments, such as would be provided by purchase receipts and invoices, broker-supplied notices of the same, depreciation schedules, and the like. Since most of the reported cases in which basis

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135. 144 F.2d 110 (1st Cir. 1944).

136. *Id.* at 114 (quoting *Raytheon Prod. Corp. v. Comm'r*, 1 T.C. 952, 961 (1943)).

137. DANIEL Q. POSIN & DONALD B. TOBIN, *PRINCIPLES OF FEDERAL INCOME TAXATION* 139 (6th ed. 2003).

138. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 206 (4th ed. 2002).

139. See *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930) (business expenses); *Estate of Goldstein v. Comm'r*, 33 T.C. 1032 (1960) (basis was estimated FMV of property received in corporate liquidation); *McCallson v. Comm'r*, 66 T.C.M. (CCH) 1316 (1993) (applying *Cohan* rule to determine depreciation deduction relating to prior capital expenditure, the amount of which was in doubt).

140. See generally, Jay A. Soled, *Exploring and (Re)Defining the Boundaries of the Cohan Rule*, 79 TEMP. L. REV. (forthcoming 2006) (on file with author).

141. See *Ellis Banking Corp. v. Comm'r*, 688 F.2d 1376 (11th Cir. 1982) (court is at liberty to estimate deductible portion of taxpayer's expense under *Cohan* rule as long as there is some evidence that a portion of accountant's fees was deductible).

was a “fact” issue involved applications of the *Cohan* rule, the obvious implication is that this kind of documentary evidence was lacking in whole or in part, meaning that the court-made determinations were based on such low-grade evidence as oral recollection testimony by the taxpayer and third parties, acquisition-date estimates for marketable securities, diary entries, and bookkeeping entries.<sup>142</sup>

The willingness of the courts to give taxpayers the benefit of the doubt depends on the facts and circumstances. If the relevant events are recent, the basis history is simple, and the taxpayer could have easily kept adequate records, the courts might hew a tougher line,<sup>143</sup> as might also be the case with taxpayers who are uncooperative or hostile.<sup>144</sup> Conversely, if (as is often the case with basis fact questions) the relevant event lies in the more distant past, the asset has a complex history, and/or there are credible reasons for not having the records, the greater the chances of a court applying the *Cohan* rule in a way that benefits the taxpayer.<sup>145</sup> In any event, the bottom line is that only in a handful of cases have courts upheld a zero basis determination by the IRS solely on lack-of-proof grounds.<sup>146</sup>

Although the *Cohan* rule applies in a litigation setting, the same culture exists in the context of IRS audits and appeals.<sup>147</sup> The IRS manual states that, with respect to any

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142. See, e.g., *Caldwell & Co. v. Comm’r*, 234 F.2d 660 (6th Cir. 1956), *rev’g*, 24 T.C. 597, 622–23 (holding that the Tax Court should have accepted the taxpayer’s claimed basis in gifted stock largely based upon the statement of petitioner’s counsel indicating that “the stock was acquired sometime during the 1920s and the testimony of one of petitioner’s officers [that] would indicate that the stock was worth at least \$10 per share throughout”).

143. See, e.g., *Karara v. Comm’r*, 78 T.C.M. (CCH) 197 (1999), *aff’d without opinion*, 214 F.3d 1358 (11th Cir. 2000) (zero basis result for pro se taxpayer selling stock of one company and not filing return, not offering any documentary evidence, and proffering only vague testimony as to cost); *Allnut v. Comm’r*, T.C.M. (RIA) 2004-239 (2004) (IRS position on basis upheld because taxpayer could not produce any written records that contradicted the IRS’s findings).

144. See *Karara*, 78 T.C.M. (CCH) 197; *Allnut*, T.C.M. (RIA) 2004-239; *Golub v. Comm’r*, 78 T.C.M. (CCH) 367 (1999) (zero basis where taxpayer filed return not showing basis and claiming, under “far-out” theory, that sales proceeds were not taxable).

145. See, e.g., *Reynolds v. Comm’r*, T.C.M. 1999-62 (“Although the record does not indicate with mathematical specificity the amount of [the donor’s] basis that passed to petitioner as a result of the gifts, we are satisfied from the facts at hand that her basis equaled or exceeded the amount that she realized on the sale.”); *S. Ry. Co. v. United States*, 585 F.2d 466 (Ct. Cl. 1978) (capitalizable carrying charges incurred prior to 1920).

146. See, e.g., *Karara*, 78 T.C.M. (CCH) 197, *aff’d without opinion*, 214 F.3d 1358 (11th Cir. 2000) (taxpayer had not filed a return and offered no proof of basis, which was held to be zero); *Golub*, 78 T.C.M. (CCH) 367 (same result where taxpayer filed a tax return not showing basis and claiming sales proceeds were not taxable).

147. A *Wall Street Journal* investment columnist gave this advice to a taxpayer who lost his records for a particular security:

Technically, if you can’t show proof of the purchase price, the IRS can make you pay capital gains tax on the entire sale. But the tax cops often will accept a reasonable estimate. For instance, if you’re fairly certain you bought the stock in 1982 or 1983, an average of the high and low price for that two-year period would probably do.

WALL ST. J., Apr. 10, 2003, at D1.

fact issue that does not require documentary evidence as a matter of law, taxpayers are allowed to offer all kinds of evidence, including oral recollections.<sup>148</sup>

The paucity of reported cases dealing with the factual aspect of basis issues is another indicator that basis issues are (1) seldom subject to an in-depth audit, and (2) in case of an audit, routinely compromised.<sup>149</sup> An electronic search of decided court cases that involved tax basis controversies during the ten-year period from 1993 to 2002 turned up only fourteen items relating to basis determinations, and virtually all of these involved questions of law<sup>150</sup> or routine applications of law to facts relating to the basis of business assets (it being taxpayer lore that Schedule C is a frequent audit target).<sup>151</sup> In the most well-known of these cases, *Newark Morning Ledger Co. v. United States*,<sup>152</sup> the government did not even attempt to rebut the taxpayer's asserted cost basis claim for the intangible asset at issue.

### b. Substantive Reasons

The IRS has little incentive to pursue basis fact controversies, even those that it could win, because the benefits may be small relative to effort and expense. Why?

Consider the case of a large (and possibly suspicious-looking) net capital loss amount for the year. The maximum deductible amount for the current year is only \$3000 on account of the capital loss limitation rules,<sup>153</sup> and a \$3000 deduction results

148. IRS MANUAL, *supra* note 124, at 4.10.3.2.5.

149. The Taxpayer Advocate is charged by Congress to outline the most litigated areas of the Code. In the 2003 findings, tax basis controversies did not even appear on the list of tax litigation categories. NINA OLSON, TAXPAYER ADVOCATE SERV., INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE 2003 ANNUAL REPORT TO CONGRESS 312-423 (2003), available at [http://www.irs.gov/pub/irs-utl/nta\\_2003\\_annual\\_report2.pdf](http://www.irs.gov/pub/irs-utl/nta_2003_annual_report2.pdf).

150. *Estate of Bean v. Comm'r*, 268 F.3d 553 (8th Cir. 2001) (shareholder's secondary liability for a loan to an S corporation does not increase shareholder's basis); *Jackson v. Comm'r*, 81 T.C.M. (CCH) 1294 (2001) (same); *Weyerhaeuser Corp. v. United States*, 32 Fed. Cl. 80 (1994) (for purposes of claiming casualty losses, assets acquired before 1913 have cost basis, rather than greater of cost or 1913 value basis).

151. *Merino v. Comm'r*, 196 F.3d 147 (3d Cir. 1999) (no basis because sham transaction entailed no cost); *Hunter Sav. Ass'n v. United States*, 856 F. Supp. 1240 (S.D. Ohio 1994) (composite asset purchase); *Lychuk v. Comm'r*, 116 T.C. 374 (2001) (capital expenditures are added to basis); *Exxon Mobil Corp. v. Comm'r*, 114 T.C. 293 (2000) (same); *Gladden v. Comm'r*, 112 T.C. 209 (1999) (cost of land not allocable in part to water rights); *McFadden v. Comm'r*, 84 T.C.M. (CCH) 6 (2002) (repossessed property has basis equal to FMV, which is not necessarily equal to the secured debt); *Gallagher v. Comm'r*, 81 T.C.M. (CCH) 1149 (2001) (basis in IRA was zero because all contributions were deductible).

152. 507 U.S. 546 (1993). See also *In re Steffen*, 294 B.R. 388, 397 (Bankr. M.D. Fla. 2003) ("[T]he Government . . . never questioned the \$23,366,705 cost basis figure from the beginning of their investigation of the Taxpayers, as far back as 1993 . . .").

153. Noncorporate taxpayers can utilize up to \$3000 of capital losses against ordinary income; in contrast, corporate taxpayers cannot deduct any excess capital losses. See I.R.C. § 1211. Excess capital losses are carried forward indefinitely to future taxable years, except in the case of corporations, which can carry them back up to three years and carry them forward up to five years. I.R.C. § 1212.

in only a modest tax saving.<sup>154</sup> Net capital losses in excess of \$3000 must be carried forward and would, accordingly, bear fruit for the IRS only in reduced deductions for future years. In cases where net capital gain may be understated (or omitted), the government stands to gain—on a taxpayer-by-taxpayer basis—modest tax dollars (currently 15%) for each dollar of basis overstatement.<sup>155</sup>

Arguably, however, the IRS could find the basis area to be a vast reservoir of revenue, particularly if viewed from the vantage points of a longer time horizon and rampant taxpayer noncompliance. These issues will be addressed in Section B below.

### 5. Propensity to Cheat

In terms of accurate basis reporting, the preceding section attempted to show that taxpayers obtain little motivation from the system by way of carrot or stick toward compliant behavior with respect to basis issues or (except for brokered sales of securities and real estate) taxable dispositions in general. In other words, there are vast opportunities to underreport gains and overreport basis. Since the lines among negligent, reckless, and willful noncompliance are hard to draw in practice and irrelevant from the revenue angle, we shall herein treat all varieties of noncompliance as “cheating.”<sup>156</sup> This Part describes behavioral influences that contribute to taxpayer cheating in general and with respect to basis and gain issues.

Although successful cheating clearly advances the taxpayer’s self-interest, cheating can be held somewhat in check by (1) the deterrent effect of legal sanctions and (2) countervailing norms, whether internalized by taxpayers (moral fiber) or exerted externally through social pressures.<sup>157</sup> The question we next address is whether these factors are likely to effectively induce taxpayer compliance in the area of basis and gain reporting.<sup>158</sup>

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154. The tax savings at the maximum marginal rate of 35% would be \$1050 (i.e.,  $0.35 \times \$3000$ ).

155. At the risk of oversimplifying, capital losses taken against capital gains in arriving at net capital gain for the year produce a tax benefit equal to the maximum marginal rate applicable to net capital gains (currently 15% for most net capital gain categories). Thus, the stakes are somewhat less if the overstated basis inheres in a capital gain asset or a capital loss asset. In contrast, an ordinary loss (or a net capital loss not exceeding \$3000) saves taxes equal to such loss times the maximum marginal rate of the taxpayer (currently up to 35%). I.R.C. § 1(i)(2).

156. See I.R.C. §§ 7201–7207 (all tax crimes require specific intent); Walter T. Henderson, Jr., *Criminal Liability Under the Internal Revenue Code: A Proposal to Make the “Voluntary” Compliance System a Little Less “Voluntary,”* 140 U. PA. L. REV. 1429, 1436 (1992) (advocating a “mild expansion of the existing criminal sanctions to reach reckless noncompliance”). See generally Michael W. Spicer, *Civilization at a Discount: The Problem of Tax Evasion*, 39 NAT’L TAX J. 13 (1986) (examining the nature and extent of tax evasion).

157. See generally Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L. J. 1453 (2003) (arguing that increased deterrence mechanisms do not undermine compliance norms).

158. See Curtis J. Berger, *“Voluntary” Self-Assessment? The Unwilling Extraction of Taxpayer Information*, 42 U. PITT. L. REV. 759, 760 (1981) (“One thing is perfectly clear. Congress—whose members understand human nature better than do most of us—recognized long ago that integrity alone would not insure truthful reporting.”).



## a. Sanctions Are Unlikely to Be Effective

Under the “rational-choice model” of adaptive human behavior, people weigh the relative advantages and disadvantages of any action. Without sanctions, virtually no one would pay taxes because the monetary advantages of not paying outweigh the advantages of paying. From the perspective of self-interested taxpayers, paying taxes has the disadvantage of benefiting people other than the taxpayer, and the benefits of taxes are only indirectly advantageous to taxpayers.<sup>159</sup>

Obviously, though, government (and its undeniable benefits) would not exist unless *somebody* pays taxes. In other words, a collective action problem is “solved” by the imposition of a universal tax-paying duty.<sup>160</sup> However, this duty is compromised in the federal income tax area because of the self-assessment paradigm, the lack of universal withholding at the source, the lack of universal third-party reporting, and the likelihood of shirkers and evaders going undetected. Therefore, the opportunity to cheat is vast in areas such as basis and gain reporting, where there is no requirement of withholding<sup>161</sup> and where third-party reporting is of limited scope.<sup>162</sup>

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159. See Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419, 437 (1996) (given that taxes flow into a pot, it is hard to link specific tax dollars to specific benefits). This point echoes criticism of the “benefit principle” of tax fairness. See, e.g., JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* 804–05 (W. J. Ashley ed., Longmans, Green, and Co. 1929) (1848).

160. This is the problem faced by Enlightenment theorists of government. See, e.g., John Locke, *Concerning Civil Government, Second Essay*, in 35 GREAT BOOKS OF THE WESTERN WORLD 58 (Robert Hutchins ed. 1952) (positing duty of citizens to support government that would secure life, liberty, political rights, and property).

161. Of course, withholding from the gross proceeds of sales transactions would be very crude because the withholding agent would have no knowledge of the amount of gain (or loss), which depends on basis information that the withholding agent would typically not know about. However, withholding would be practical when securities and commodities brokers have clients’ basis information. Moreover, withholding from the gross proceeds of sales transactions would be an effective way of “smoking out” the unknown basis information. See I.R.C. § 1445 (withholding of 10% of the sales proceeds required with respect to dispositions of U.S. real property interests by foreign taxpayers unless the taxpayer and IRS agree on correct amount of tax). See also *infra* Part II.B.

162. Those who think that any taxes they pay do not “purchase” personal benefits of equal value will have an economic motive to cheat. A person holding an antigovernment ideology may think that noncompliance by herself and like-minded persons would advance their political agenda. Even those lacking an antigovernment agenda would be subject to certain cognitive biases that would operate to produce a perception that taxes do not yield equal economic value. See SCOTT PLOUS, *THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING* 185–86 (1993) (stating that one such influence is the “self-serving bias,” whereby people attribute market success to themselves and obstacles and failures to others and the environment). It is therefore not surprising that survey data generally show that people in the United States do not like (and are opposed to) taxes. Christopher C. Fennell & Lee Anne Fennell, *Fear and Greed in Tax Policy: A Qualitative Research Agenda*, 13 WASH. U. J.L. & POL’Y 75, 77–79 (2003).

The general antitax attitude derived from calculations of economic self-interest is compounded by the “free-rider” problem, whereby the potential tax cheater would anticipate being able to obtain the benefits of government without paying for them. The free-rider problem is actually exacerbated in a general climate of tax compliance because a potential cheater

At this point in the rational-choice model, deterrence strategies (legal sanctions) to control undesirable behavior are necessary<sup>163</sup> because taxpayers will cheat unless the gains from cheating are outweighed by the expected loss attributable to penalties.<sup>164</sup> Merely being “found out” and then required to pay the correct tax owed (with interest) is not a meaningful sanction since the taxpayer is then no worse off than if compliance had occurred in the first place.<sup>165</sup> The effectiveness of penalties depends on the combination of their severity, contingency (in occurrence and amount), and futurity.<sup>166</sup> Unfortunately, as presently designed and instituted, the tax penalties for basis and gain noncompliance are not up to the task of providing effective deterrence.

On one end of the sanction continuum, there are criminal sanctions for tax fraud that can result in taxpayer imprisonment and fines of a degree that, if credible, would cause a rational actor to hesitate before cheating.<sup>167</sup> However, criminal tax fraud is notoriously hard to prove because of the “specific intent” requirement.<sup>168</sup>

After criminal tax fraud, the next most severe penalty is for civil tax fraud, but here the penalty is drastically less severe than for criminal fraud.<sup>169</sup> Indeed, the penalty currently would amount to only about eleven cents for every dollar of basis

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understands that federal expenditures will not be reduced if only one taxpayer cheats (or if only a limited number of taxpayers cheat).

163. See Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 369 (2002).

164. See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 324–26 (1972). See also generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (discussing the optimal amount of resources and punishments to enforce laws).

165. The taxpayer may (or may not) expend additional time and effort dealing with the IRS, but the taxpayer may actually enjoy the contest.

166. It is a well-known heuristic to discount future occurrences at an excessively high rate. Also, remote contingencies are likely to be undervalued. Pulling in the other direction is the general tendency to risk aversion, so that a small chance of being subjected to a severe penalty (especially a criminal penalty with media publicity) might have a substantial deterrent effect.

167. See I.R.C. § 7201 (willful attempts to evade tax, carrying a maximum penalty of five years imprisonment and/or a \$100,000 fine); I.R.C. § 7203 (willful failure to, inter alia, keep any records or supply any information required by law, carrying a maximum penalty of one year imprisonment and/or a \$25,000 fine).

168. See MARVIN J. GARBIS, RONALD B. RUBIN & PATRICIA T. MORGAN, *TAX PROCEDURE AND TAX FRAUD: CASES AND MATERIALS* ch. 9 (3d ed. 1992). This requirement mandates that the government prove without a reasonable doubt that there was (1) a legal duty imposed on the defendant, (2) actual knowledge by the defendant of such duty, and (3) an intentional violation of such duty. *Cheek v. United States*, 498 U.S. 192, 201 (1991). The authorities are rife with statements to the effect that *criminal* tax fraud is not meant to trap the lazy, the negligent, and the uncomprehending because (1) the tax laws are extremely complex and (2) lesser civil penalties exist for nonfraud offenses. *United States v. Bishop*, 412 U.S. 346, 360 (1973); *United States v. Murdock*, 290 U.S. 389, 396 (1933). In the area of basis overstatements, where the record-keeping duties are vague and the rules often complex, one would expect to find few (if any) examples of successful criminal tax fraud prosecutions. Indeed, we conducted an electronic search of all federal tax cases and did not turn up a single reported example of an attempted (or successful) criminal tax fraud prosecution relating to basis overreporting. It is therefore safe to say that the threat of criminal prosecution is not credible with respect to basis.

169. See I.R.C. § 6663(a) (penalty is 75% of the portion of the underpayment attributable to fraud).

overstatement that reduces capital gains.<sup>170</sup> Reported cases imposing civil fraud penalties on gain understatements attributable to inflated basis reporting are virtually nonexistent.<sup>171</sup> Cases involving nonreporting of taxable sales exist but are still uncommon, and fraud penalties are typically not imposed for such omissions unless the omissions appear to be calculated and systematic.<sup>172</sup>

On a still lower level of severity are the civil “accuracy-related” penalties listed in Code section 6662(b), for which the penalty is 20 percent of the underpayment attributable to any violation of the statutory standards.<sup>173</sup> Thus, the penalty is only three cents for every dollar of understated capital gain or overstated capital loss!<sup>174</sup> In the area of our primary focus (investment gains and losses), this penalty is so feeble as to be laughable, and it renders a discussion of the legal standards essentially academic.

The accuracy-related penalty that is most relevant to our discussion is the one for “negligence or disregard of rules and regulations.”<sup>175</sup> This penalty (especially the aspect of disregard of rules and regulations) encompasses both legal and factual errors.<sup>176</sup> The negligence aspect encompasses “any failure to make a reasonable

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170. See *id.* Multiplying the (usual) maximum capital gains rate of 15% times 75% yields 11.15%.

171. Civil tax fraud also requires the same specific intent as for criminal tax fraud. See, e.g., *Bradford v. Comm’r*, 796 F.2d 303, 307 (9th Cir. 1986). Although the burden of proof remains with the IRS, the standard of proof is reduced to that of “clear and convincing evidence.” In *Groves v. Comm’r*, 78 T.C.M. (CCH) 1201 (1999), the taxpayer—a tax attorney who once worked for the IRS—overstated basis of stock that had a somewhat complex history. The taxpayer pleaded guilty to two criminal counts related to the taxpayer’s failure to supply tax basis information in the audit and examination process, but the Tax Court held that the overstatement of basis itself was negligence, not fraud.

172. See *Marcella v. Comm’r*, 222 F.2d 878, 885 (8th Cir. 1955) (holding that treating outlays on property as “improvements” rather than “repairs,” although erroneous, did not amount to fraud); *LiButti v. Comm’r*, 50 T.C.M. (CCH) 241, 263–64 (1985) (holding that a failure to keep records with respect to some investments does not amount to civil fraud; however, a subsequent pattern of failing to keep records for substantial dealings in tangible personal property is evidence of civil fraud); *Nat’l Land Co. v. Comm’r*, 10 B.T.A. 527 (1928), *acq. in result* 1928-1 C.B. 22 (holding that the omission of land sale is not fraud in the context of a carelessly prepared return). Cf. *Thurston v. Comm’r*, 28 T.C. 350, 356 (1957), *acq. in result*, 1957-2 C.B. 7 (gross negligence in record keeping not fraud). *But cf.* *Scott v. Comm’r*, 15 T.C.M. (CCH) 1156 (1956) (holding that a systematic and consistent lack of adequate business records amounted to civil fraud). Most of the cases noted in the extensive annotations under I.R.C. § 6663, found at 16 CCH FED. TAX REP. ¶ 39,658, involve business taxpayers omitting income and claiming excessive deductions. Practically none involve taxpayers only in their capacity as investors.

173. I.R.C. § 6662(a). The term *underpayment* refers to the tax that would have been paid if the return had been correct minus the tax that was in fact paid on account of the sanctionable violation of one of the standards set forth in I.R.C. § 6662(b). Treas. Reg. § 1.6662-5(g) (as amended in 1992).

174. The product of the 15% net capital gains rate and the 20% penalty rate results in a figure of 3%.

175. I.R.C. § 6662(b)(1).

176. There are two relevant accuracy-related penalties that only rely upon objective criteria. The first applies in instances when taxpayers have “substantially understated” their taxes (in general, more than 10% of the tax required to be shown on the return). I.R.C. §§ 6662(b)(2), (d).

attempt to comply with the provisions of this title.”<sup>177</sup> In the case of (in)accurate reporting of basis and gains, the phrase *provisions of this title* would refer not only to the substantive basis rules, some of which are complex, but also to the imprecise and permissive record-keeping standards described earlier.<sup>178</sup> The notion of “failure to make a reasonable attempt to comply” with such standards raises a question of fact, the resolution of which would be highly contextual, and judges and juries would be expected to be somewhat sympathetic to taxpayers having less than impeccable records and being forced to cope with underpublicized and complex basis rules. There is no way of telling how often negligence penalties for basis overreporting and gain nonreporting are successfully imposed at the administrative level; but it is known that audit activity is low in our areas of concern,<sup>179</sup> and court decisions imposing the

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However, given the fact that capital gains for noncorporate taxpayers are subject to a tax rate of only 15% (currently), the substantial-understatement penalty would rarely come into play for many high-income taxpayers reporting inaccurate basis or gains. Consider an example involving an unmarried taxpayer who had taxable income of \$400,000 and a tax liability of \$121,332 in 2004, but who omitted net capital gains in the amount of \$88,000. If the capital gains had been included, the correct tax amount would have been \$134,532; however, the \$13,200 understatement of tax would be less than 10% of the correct amount, so the penalty would not apply despite the huge understatement.

The second relevant accuracy-related penalty relying on objective criteria applies where taxpayers claim an adjusted basis on a particular property item that is 200% or more of the correct adjusted basis amount. I.R.C. §§ 6662(b)(3), (e)(1)(A). (Note that if the correct basis is zero, the 40% penalty would automatically apply. See Treas. Reg. § 1.6662-5(g).) If the basis overstatement is 400%, the penalty rate is doubled to 40%. See I.R.C. § 6662(h). That, however, still is not severe in the case of understated net capital gains.

Neither of the objective accuracy-related penalties apply, however, unless the resulting understatement of tax exceeds \$5000, I.R.C. §§ 6662(d)(1)(A)(ii), (e)(2), which translates to a net capital gains understatement of more than \$33,333. In addition, there are defenses potentially applicable to some or all of the accuracy-related penalties, although none of them appear to be particularly helpful to taxpayers in this context. For example, the penalty for a “substantial understatement of tax” is waived (except in the case of tax shelters) if there is (a) substantial (legal) authority for the taxpayer’s position or (b) adequate disclosure on the return (coupled with a reasonable basis for the position). See I.R.C. § 6662(d)(2)(B).

Virtually all of the cases that impose the basis overstatement penalty have involved tax shelters purporting to generate substantial current depreciation deductions but having a zero basis on account of “sham debt.” See, e.g., STAND. FED. TAX REP. (CCH) ¶ 39,654.55 (2005) (listing example cases); *Gilman v. Comm’r*, 933 F.2d 143 (2d Cir.1991), *cert. denied*, 502 U.S. 1031 (1992); *Rybak v. Comm’r*, 91 T.C. 524 (1988). In *Visser v. Comm’r*, 65 T.C.M. (CCH) 1734 (1993), the taxpayer was subject to a negligence penalty for failing to produce basis records relating to a purchase of commercial real estate, but he avoided the basis overstatement penalty because the claimed deductions were disallowed on the alternative ground of not having placed the structures in service. The only case noted by CCH not dealing with tax shelters in which the basis overstatement penalty was imposed is *Wyatt v. Comm’r*, 62 T.C.M. (CCH) 1540 (1991), involving the overallocation of property costs to depreciable avocado trees.

Thus, in their present form, neither of the “objective” accuracy-related penalties seem to be a significant “player” in the game of combating abuses of the type discussed herein.

177. I.R.C. § 6662(c).

178. See *supra* notes 19–27 and accompanying text.

179. See *supra* notes 119–33 and accompanying text.

negligence penalty for errors involving investor basis and gain are few and far between.<sup>180</sup>

The civil penalties that can be brought to bear in our area of concern are, on balance, economically very light and appear to be rarely imposed on investors. The criminal fraud penalty appears to exist on paper only. At this point in our analysis, it would be reasonable to hypothesize rampant cheating on basis issues and extensive nonreporting of gains transactions not subject to third-party reporting.<sup>181</sup>

#### b. Compliance Norms Are Too Weak to Constrain Cheating

The rational-choice model can be said to be incomplete insofar as it relies exclusively on deterrence and neglects to factor in the effect of social norms, which might be defined as shared attitudes and understandings relating to social conduct not directly explainable in terms of pecuniary self-interest calculations.<sup>182</sup> Some

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180. *But see* Bothwell v. Comm'r, 77 F.2d 35, 38 (10th Cir. 1935) (imposing negligence penalty where executive failed to report exercise of stock option but claimed basis equal to value of stock at date of exercise); Groves v. Comm'r, 78 T.C.M. 1201 (1999); Bilzerian v. Comm'r, 82 T.C.M. (CCH) 295 (2001) (holding taxpayer negligent for not noting preparer's omission of \$4 million gain transaction); Drummond v. Comm'r, 73 T.C.M. (CCH) 1959 (1997), *aff'd in part, rev'd in part sub nom*, 155 F.3d 558 (4th Cir. 1998) (subjecting taxpayer to negligence penalty for failure to review a return done by a preparer that omitted gain from the sale of artwork); Miller v. Comm'r, 10 T.C.M. (CCH) 210 (1951) (holding that error in reporting gain on sale of orchard was not due to negligence). Golub v. Comm'r, 78 T.C.M. (CCH) 367 (1999) (taxpayer, after (inter alia) failing to offer any proof as to tax basis, had to pay accuracy-related penalties on account of negligence, that is, not acting as a prudent person in good faith); *cf.* Meyers v. Comm'r, 27 T.C.M. (CCH) 1535 (1968) (imposing negligence penalty for overstating cost of goods sold). The extensive annotations in 16 CCH FEDERAL TAX REPORTER ¶ 39,651G with respect to the negligence (etc.) penalty identify no cases on investor basis and gain other than those noted. However, there are dozens of cases imposing the negligence penalty for failure to keep adequate records in general. *See id.* at ¶ 39,651G.63. Undoubtedly some of these involve basis and gain issues, but it appears that these are overshadowed by the commonly-raised issues of gross income omissions and deduction overstatements. *See, e.g.*, Hulbert v. Comm'r, 32 T.C.M. (CCH) 1024 (1973) (holding basis of ranch overstated by unsubstantiated "improvements"; this and numerous other errors due to inadequate record keeping resulted in imposition of negligence penalty).

181. *Cf.* John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, in WHY PEOPLE PAY TAXES 43, 50 (Joel B. Slemrod ed., 1992) (stating that 57% of middle- and upper-income taxpayers in the study reported understating income and overstating deductions).

182. *See* Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 587 (1998) (defining *social norm* as a "consensus in a community concerning what people ought to do . . . [that] affects what people actually do"). Thus, an isolated attitude or opinion is not a norm. However, the notion of a consensus is not very limiting because conflicting social norms may be held by a given individual, and an idiosyncratic attitude may be shared within a subgroup (such as a gang, congregation, or single-issue political aggregation). *See* Lederman, *supra* note 157, at 1507-08 n.281 (reporting studies of tax noncompliance norms among certain subgroups).

We take no position with respect to such theoretical issues as whether the impact of social norms can be incorporated within the rational-choice model. *See* Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 PUB. FIN. PUBLIQUES 70 (1994); James P.F. Gordon, *Individual Morality and Reputation Costs as*

commentators argue that such norms have a greater effect on compliance with the law than deterrence through penalties.<sup>183</sup>

The operation of norms has been advanced as an explanation of why tax compliance in the United States is higher than in most other countries.<sup>184</sup> Honesty, law-abidingness, and cooperativeness are compliance-favorable norms that may well spill over into the tax area.<sup>185</sup> There may even be some who adhere to a specific norm of complying with tax duties, believing that taxes are the price one pays for civilization or for being a citizen of the state.<sup>186</sup>

On the other hand, there may exist countervailing norms of an antigovernment, antitax, and/or tax-evasion character, which can be collectively referred to as libertarian norms. One kind of manifestation of libertarian norms is overtly political

*Deterrents to Tax Evasion*, 33 EUR. ECON. REV. 797, 797–804 (1989) (both positing that compliance with norms plugs into the taxpayer's utility function). We also take no position with respect to the mechanisms by which social norms might influence behavior. See, e.g., Eric Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1787–91 (2000) (advocating “signaling” theory of norms); Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. CHI. L. REV. 607, 608–09 (2000).

183. See Kent W. Smith, *Integrating Key Perspectives on Compliance: A Sequential Decision Model*, 17 CRIM. JUST. & BEHAV. 350, 359 (1990).

Such norms may be internalized, in which case they would constrain or override the economic calculus; or they may be externalized, in which case the norms become integrated into the calculus. For example, an internalized norm of law-abidingness would override a temptation to break the law (as in running a red light), whereas the same norm if viewed as part of the endogenous landscape (social disapproval) would simply be another factor to consider in the economic calculus. See Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1127 (2000) (explaining a view that internalized norms are those that elicit guilt feelings).

184. That social norms influence tax compliance is supported by studies that show different compliance rates for citizens of different countries independent of the country's enforcement apparatus. See Kahan, *supra* note 163; James Alm, Isabel Sanchez & Ana De Juan, *Economic and Noneconomic Factors in Tax Compliance*, 48 KYKLOS 3, 14 (1995). Norms are often said to be embedded in, or produced by, culture. However, culture and norms are separate analytical constructs. Norms are attitudes and patterns relating to social interaction, whereas culture may be said to refer to the content of the symbols and artifacts that identify a people vis-à-vis other peoples. TALCOTT PARSONS, *THE STRUCTURE OF SOCIAL ACTION* 75–77 (1937). In any event, the relationship and degree of separation (if any) between culture and norms is not important for our purposes, except to note that norms are generally more malleable than culture. See Lederman, *supra* note 157, at 1509–10 (noting that compliance attitudes might drastically “tip” with moderate increases or decreases in enforcement).

185. See Wilbur C. Scott & Harold S. Grasmick, *Deterrence and Income Tax Cheating*, 17 J. APPLIED BEHAV. SCI. 395 (1981) (explaining that tax cheating carried a stigma in the United States during the time period studied).

186. This view is expressed by Justice Holmes in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (dissenting opinion). Even more explicit is Holmes's statement, “I pay my tax bills more readily than any others—for whether the money is well or ill spent I get civilized society for it.” Letter to Harold J. Laski (May 12, 1930), in *HOLMES-LASKI LETTERS* 2:1247 (Mark DeWolfe Howe ed., 1953). However, a parallel example of the expression of civic duty and participation, and one that entails minimal cost (if minimal benefits), is voting. The fact that voting turnout even in presidential elections is quite low is indirect evidence that a specific norm of tax compliance is not widely held.

and can take such forms as (1) ideological commitment to libertarian principles,<sup>187</sup> (2) opposition to the U.S. government in all or most of its manifestations, and/or (3) adherence to the tax protestor movement.<sup>188</sup> Another type of libertarian manifestation is the widespread attitude among the economic elite that the government is the adversary in a taxpayer's economic life.<sup>189</sup> A related notion is that the system is too complex and burdensome for an honest person to follow.<sup>190</sup> Another widely held belief is that most taxpayers in a position to cheat do cheat (and most get away with it),<sup>191</sup> so that only fools strictly comply with tax obligations.<sup>192</sup> If the IRS is so lax in enforcement that tax cheaters are willing to go public to boast about "getting away with it,"<sup>193</sup> why should ordinary citizens take their compliance duties seriously?<sup>194</sup> In any event, a system in which there is significant noncompliance not only is unfair to those who do comply, but also does not deserve respect.<sup>195</sup> Several of these attitudes and perceptions (or, if you will, rationalizations) can operate in a way such that even normally law-abiding citizens may feel justification in negligent or intentional noncompliance.<sup>196</sup>

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187. Ideological libertarianism does not necessarily imply defiance of the law or tax evasion, but it implies a disrespect for much government activity financed by taxes and could thereby imply a jaundiced or minimalist view of tax compliance responsibilities.

188. Certain aspects of the tax protestor movement are discussed in DAVID CAY JOHNSTON, *PERFECTLY LEGAL* ch. 14 (2003).

189. This attitude may have roots in the phenomenon of individual psychology known as the self-serving bias, which attributes personal success to the actor and personal failure to outside influences. See PLOUS, *supra* note 162, at 185–86 (reporting studies finding such a self-serving bias and other studies attributing positive behaviors to the person and negative behaviors to the environment). Cf. LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 34–37 (2002) (stating the book's project as being the overthrow of the pervasive "everyday libertarian" norm that pretax market outcomes are just); Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 171 (1996) (stating that taxpayers undervalue the benefits received from government).

190. See Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data*, in *WHY PEOPLE PAY TAXES* 259, 281 (Joel B. Slemrod ed., 1992) (asserting that hearing about unfair treatment of taxpayers by the IRS increases future noncompliance).

191. This belief is not unfounded. See *supra* note 181.

192. See Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333, 340–44 (2001) (linking law compliance to social reciprocity); Richard C. Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, 91 TAX NOTES 115, 123 (2001) (explaining desire to avoid being a chump relative to the free riders); YANKOLOVICH, SKELLY & WHITE, INC., *TAXPAYER ATTITUDES STUDY: FINAL REPORT* 61 (1984) (demonstrating tax compliance affected by perceptions of others' behavior).

193. See JOHNSTON, *supra* note 188, at 196–98.

194. See Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *WHY PEOPLE PAY TAXES*, *supra* note 190, at 223, 244–45 (stating that compliance is linked with perceptions of the state's interest in enforcement). Cf. Jon S. Davis, Gary Hecht & Jon D. Perkins, *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 ACCT. REV. 39, 40 (2003) (suggesting that publicizing the "tax gap" hurts compliance).

195. See Smith, *supra* note 194, at 223 (stating that compliance is linked with perceptions of fairness).

196. On close inspection, this chain of reasoning seems rather circular: the inability or

Clearly, norms in the tax area pull both in the direction of compliance and against it, suggesting that norms do not operate very strongly, overall, to cause taxpayers to comply with tax duties when it is not in their perceived self-interest to do so.<sup>197</sup> Several kinds of evidence support this conclusion. First, studies of the taxpayer population show that cheating is not only extensive<sup>198</sup> but is also increasingly seen as acceptable behavior by the public.<sup>199</sup> Second, it is known that voluntary compliance drastically drops off in the absence of third-party reporting.<sup>200</sup> Third, it appears that compliance norms weaken in a climate of low enforcement.<sup>201</sup>

Norms are evidently somewhat malleable, and there is good reason to think that a prevailing pro-tax-compliance norm could well “flip” to a prevailing noncompliance norm in an environment of antigovernment rhetoric and critically minimized enforcement.<sup>202</sup> Since the mid-1990s, Congress has bashed the IRS, starved it for

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unwillingness of others to comply results in a perception of tax system unfairness, which itself becomes a reason for noncompliance by the observer. At a minimum, this kind of thinking is an easy rationalization for noncompliance or sloppy compliance.

197. See OLSON, *supra* note 122, at 219–21 (recognizing issue of compliance norms and noting the existence of noncompliance norm communities).

198. See *supra* note 181.

199. See George Guttman, *Rossotti's Thoughts on the IRS and the Tax System*, 96 TAX NOTES 1822 (2002) (former IRS Commissioner Rossotti noting “a huge gap between the number of taxpayers whom the IRS knows are not filing, not reporting, or not paying what they owe, and the IRS’s powers of enforcement”); Martha Middleton, *The Tax Gap: Why Don't People Pay Up?*, 69 A.B.A. J. 572, 572 (1983) (“More auditing by IRS agents has been suggested . . . but the plain truth is that there aren't enough agents and resources to do the job.”); Sandra Block, *The Trouble with Taxes*, USA TODAY, April 9, 2004, at 1B (“The number of Americans who believe cheating is acceptable has risen sharply, to 17% last year from 11% in 1999, according to an IRS survey.”); David Cay Johnston, *U.S. Discloses That Use of Tax Evasion Plans Is Extensive*, N.Y. TIMES, May 22, 2002, at C4 (“In several hundred pages of affidavits, tax returns and other documents filed in Federal District Court in Tampa, the Justice Department provided the most extensive picture yet of how much the government knows about the growing business of tax evasion and how little it has done, or even can do, to stop it.”); David Cay Johnston, *A Smaller I.R.S. Gives Up on Billions in Back Taxes*, N.Y. TIMES, April 13, 2001, at A1 (“The Internal Revenue Service, its staff reduced by a sixth since 1992 and its mission shifted to customer service, has virtually stopped pursuing more than one million tax delinquents and has sharply curtailed other kinds of enforcement.”); Janet Novack, *Are You a Chump?*, FORBES 122, 124 (March 5, 2001) (“Americans are becoming ever more shameless about how they dodge the IRS, and ever more confident that the IRS can't keep up with them.”); Amy Hamilton, *GAO Says IRS Compliance Resources Declined over Past Three Years*, 2003 TAX NOTES TODAY 68-5 (April 9, 2003), <http://www.taxanalysts.com> (subscription only) (“The IRS actually experienced an over 7% decline in compliance staff between 2000 and 2002.”).

200. One study showed a 99.5% compliance rate for wages and salaries and a 41.5% compliance rate for self-employment income. See JOEL B. SLEMRD & JON M. BAKIJA, *TAXING OURSELVES* 150 (3d ed. 2004); James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LITERATURE 818, 824 (1998). Accord Lederman, *supra* note 157, at 1503–04; Pirofska Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 116 (1990) (“[S]elf-employed individuals in the United States have a tradition of noncompliance, and studies have consistently shown them to be among the worst tax offenders.”).

201. See Lederman, *supra* note 157, at 1513.

202. See *id.* at 1509–11.



funds, and redirected its mission towards “service” (rather than enforcement), resulting in an individual audit rate below one percent.<sup>203</sup> Thus, compliance norms are likely to be in acute danger of being swamped by a combination of self-interest and anticompliance norms.<sup>204</sup>

In the final tally, taxpayers have the motive, the opportunity, and the means to wantonly inflate basis and omit sales (not reported by third parties), and sanctions and norms do not present a significant obstacle to the accomplishment thereof. In terms of circumstantial evidence, the picture that emerges is that of a “smoking gun” of basis misreporting.

### *B. Revenue Cost to the Government*

Despite the circumstantial evidence that large-scale basis overreporting and gain omissions are commonplace, direct evidence of the revenue loss is hard to pinpoint. This is because the whole aim of noncompliance is to avoid detection. Quantification is, nevertheless, a worthwhile endeavor because it aids in delineating the amount of governmental attention a particular area warrants. Tax compliance data and economic data both aid in determining the scope of noncompliance.

In the tax-compliance data realm, one study estimates the tax gap attributable to underreporting of total taxable income to be \$180 billion (\$150 billion by individual taxpayers and \$30 billion by corporate taxpayers) for 2001.<sup>205</sup> Schedule C (profit and loss from business) filings contributed to about sixty percent of that \$180 billion tax gap, and the earned income credit contributed to another five percent.<sup>206</sup> That leaves a gap of about \$63 billion for everything else. Because compliance with respect to income reported by third parties (wages, interest, dividends, and royalties) is fairly high, a good portion of this gap is therefore probably due to errors in Schedule D (capital gains and losses) and Schedule E (income from rents, royalties, estates, and trusts).<sup>207</sup> Unfortunately, reliance upon the 2001 tax gap estimate proves frustrating because it does not attempt any breakdown by income category.

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203. The story is told by JOHNSTON, *supra* note 188, chs. 10–11. See Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971, 972–74 (2003) (noting a belief in some quarters that a “kindler, gentler” IRS will actually result in increased compliance rates).

204. The IRS appears to have come to a similar conclusion and is planning to step up enforcement. See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, STRATEGIC PLAN 2005–2009, PUBLICATION 3744, 18–24 (2004), available at [http://www.irs.gov/pub/irs-utl/strategic\\_plan\\_05-09.pdf](http://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf).

205. See OLSON, *supra* note 149, at 20 n.3 (citing OFFICE OF RESEARCH, INTERNAL REVENUE SERV., TAX GAP MAP FOR TAX YEAR 2001 (2001)).

206. See *id.* at 21–22.

207. Errors in Schedule A (itemized deductions) would seem to be relatively unimportant because of I.R.C. § 67 (imposing a 2% of adjusted gross income “floor” on “miscellaneous itemized deductions”) and I.R.C. § 68 (phasing out itemized deductions for high-bracket taxpayers), as well as I.R.C. § 56(b)(1) (disallowing many itemized deductions, the standard deduction, and the personal and dependency exemptions for alternative minimum tax purposes). A possible exception might be valuation overstatements under the charitable deduction (I.R.C. § 170); however, such overstatements are subject to a separate civil accuracy-related penalty under I.R.C. § 6662(b)(2), (e).

Another tax compliance study,<sup>208</sup> building upon prior research, shows a correlation between noncompliance and transaction nonvisibility (i.e., situations which involve no third-party reporting).<sup>209</sup> The author of this study calculates a 22.6 percent nonreporting rate for all nonvisible items (including net capital gains).<sup>210</sup> Applying this 22.6 percent noncompliance rate against reported net capital gains (assuming a 15 percent tax rate) would have produced a revenue shortfall of about \$11.5 billion in 2003.<sup>211</sup>

In the 1990s, two studies attempted to identify the noncompliance rate specifically for net capital gains. A 1994 General Accounting Office (GAO) report<sup>212</sup> based its category-by-category breakdown of the tax gap on 1980s data from the now-defunct TCMP.<sup>213</sup> The GAO report recorded an aggregate net capital gains noncompliance rate of about twenty-five percent.<sup>214</sup> Using this rate, the amount of revenue loss associated with capital gains misreporting would have been \$12.9 billion for 2003. However, the 1996 IRS Compliance Report (based on the same data) chronicled a noncompliance rate of only 7.2 percent for net capital gains.<sup>215</sup> Using this rate, the amount of revenue loss due to capital gains misreporting would have been only \$3.7 billion for 2003.

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208. See KIM M. BLOOMQUIST, *TRENDS AS CHANGES IN VARIANCE: THE CASE OF TAX NONCOMPLIANCE* (IRS Research Office 2003).

209. See JEFFREY A. ROTH, JOHN T. SCHOLZ & ANN D. WITTE, *TAXPAYER COMPLIANCE, VOLUME I: AN AGENDA FOR RESEARCH* (1989); Susan Long & Judith Swingen, *Third Party Information Reporting and Compliance*, in RESEARCH CONFERENCE REPORT: HOW DO WE AFFECT TAXPAYER BEHAVIOR? 117 (IRS Doc. 7302) (IRS 3-91).

210. See BLOOMQUIST, *supra* note 208, at 4. The 22.6 % figure was obtained from a 1988 IRS compliance study. See Charles W. Christian, *Voluntary Compliance with the Individual Income Tax: Results from the 1988 TCMP Study*, IRS RESEARCH BULL. (IRS Publ'n 1500) 35-42 (Rev. 9-94).

211. The \$11.5 billion figure for 2003 was obtained by aggregating all gains and losses from the sale of property in 2003 (\$338 billion), see IRS, *STATISTICS OF INCOME 2003* (2-04), available at <http://www.irs.gov/pub/irs-soi/03in01fg.xls>, and multiplying it by 22.6 percent and 15 percent.

212. See *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD 94-123 (May 11, 1994) [hereinafter GAO REPORT], available at <http://archive.gao.gov/t2pbat3/151585.pdf>.

213. See *supra* text accompanying notes 121-25 (discussing TCMP, otherwise known as the "comprehensive audit program"). The 1996 Compliance Study is based on data for the years 1985, 1988, and (by extrapolation from 1988 figures) 1992. For 1988, it found that individual taxpayers had underreported net capital gains income to the tune of \$12.2 billion, which (assuming a tax rate of 15%) would have resulted in a revenue loss of \$1.83 billion at that time. See 1996 COMPLIANCE REPORT, *infra* note 215, at 48. Of the \$12.2 billion, \$6.9 billion was attributed to "overstated basis" and the remaining \$5.3 billion to "other," which presumably means not reporting gain transactions and understating amounts realized.

214. See GAO REPORT, *supra* note 212, at 48.

215. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, *FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992* (PUBLICATION 1415) 8 (Rev. 4-96), available at <http://www.irs.gov/pub/irs-soi/p141596.pdf> [hereinafter 1996 COMPLIANCE REPORT]. Insofar as individual income tax returns are concerned, capital gains underreporting constituted a significant portion of the overall tax gap—in fact, one of the tax gap's largest sources of unreported income. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, *INCOME TAX COMPLIANCE RESEARCH; GROSS TAX GAP ESTIMATES AND PROJECTIONS*

Finally, an earlier study (examining a sample of particular files selected for the TCMP data compilation) that focused exclusively on capital gains noncompliance for the year 1979 discovered an overall net capital gains noncompliance rate of a whopping thirty-two percent.<sup>216</sup> This rate would have produced a revenue shortfall of \$16.4 billion for 2003.

Despite its age, we consider the 1979 study to be the one that is likely to be the most accurate with respect to the specific issue of basis and gain noncompliance.<sup>217</sup> Not only is the study itself more specifically focused on the issue at hand, but there is good reason to believe that the TCMP audits relied on by the other studies would have failed to uncover significant amounts of unreported gains (there would have been no trace of such on the tax returns as filed) and would have failed to pursue basis inquiries to the ultimate degree.<sup>218</sup>

Notwithstanding the undoubted significance of these various tax data studies, we harbor strong doubts as to their accuracy, particularly as they relate to current and future tax years. Since the discontinuance of the TCMP in the late 1980s and early 1990s,<sup>219</sup> there have been no comprehensive income-category studies of the tax gap based on tax return data. Estimates of the overall tax gap in recent years have been based simply upon extrapolations from the data contained in the 1996 Compliance Report, but such extrapolations are based on two flawed assumptions.

The first assumption is that unreported net capital gains have increased at the same rate as the increase in the overall tax gap. A more plausible assumption is that unreported capital gains grew in size at a rate equal to or greater than the increase in the volume and value of property transactions, which happens to have been tenfold.<sup>220</sup> If noncompliance increased only at the same rate as the *reported* underlying economic

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FOR 1973–1992 (PUBLICATION 7285) 3 (1988) (presenting a chart for 1987 indicating that close to 10% of the tax gap was attributable to the misreporting of capital gains income), reproduced in 88 TAX NOTES TODAY 61-35 (1988).

216. See Thomas A. Thompson, 1979 *Individual Income Tax: Capital Gains Income Reporting Noncompliance*, in IRS TREND ANALYSIS AND RELATED STATISTICS 130 (1987) (finding a reporting error of \$8.84 billion against reported net capital gains of \$27.63 billion, a 32% noncompliance rate). This study found that over 50% of the error was attributable to nonreported gains and that one of the most underreported asset categories was personal residences. The personal residence gain reporting issue has been largely (if not completely) swept under the rug by the expansion of I.R.C. § 121 (excluding up to \$250,000 of gains per taxpayer per qualified principal residence sale). Under current law, taxable residence gains include a portion of large gains from principal residence sales and all gains from the sale of vacation homes and rental properties. Even if all residence gains were removed from the 1979 figures, the error rate would still have been 28%, which is the figure we use in the text.

217. There have been no congressional and IRS compliance initiatives in this area since 1979 except for the enactment of the substantial-tax-understatement and substantial-basis-overstatement penalties. See *supra* note 169.

218. See *supra* notes 119–25 and accompanying text.

219. See *supra* note 122 and accompanying text. See also GOV'T ACCOUNTABILITY OFFICE, TAX GAP: MULTIPLE STRATEGIES, BETTER COMPLIANCE DATA, AND LONG-TERM GOALS ARE NEEDED TO IMPROVE TAXPAYER COMPLIANCE, GAO REPORT 06-2087 (2005).

220. See BLOOMQUIST, *supra* note 208, at 4 tbl.1 (showing tenfold increase in reported net capital gains from 1985 to 2000 based on Statistics of Income data); U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2004–2005, at 755 tbl.1201 (2004) (increase of 831% of stock volume activity from 1990 to 2000, but no increase from 2000 to 2003).

activity, the 2003 revenue loss would have been in the range of \$18.3 to \$32.4 billion using the conservative noncompliance rate figure of 7.2 percent.

The second flawed assumption is that of a constant *rate* of noncompliance since the data were collected. Such an assumption is understandable because there is no later noncompliance data from which to ascertain any possible change in noncompliance rates. However, it would seem that noncompliance rates with respect to capital gains and losses in particular are very likely to have increased since 1992 due to lax enforcement by the IRS in general, a relaxation of tax compliance norms,<sup>221</sup> the lowering of tax rates on capital gains,<sup>222</sup> the absence of any meaningful compliance initiatives in this area by Congress or the IRS, and increased opportunities to hide property transactions (and basis information relating thereto).<sup>223</sup> The combination of these factors leads to the conclusion that noncompliance *rates* for capital gain misreporting are likely to have increased by at least fifty percent.

In short, when the raw tax data (which is over fifteen years old) is coupled with consideration of economic and compliance trends—and if extrapolations are adjusted for the volume of property transactions—the annual revenue loss could easily escalate as high as \$60 billion annually.<sup>224</sup>

In addition to examining tax compliance data, economic data could theoretically also be used to determine the amount of capital gains understatement. This approach is currently unavailable, however, because any attempt to convert the available data on aggregate household wealth into realized-gain amounts founders on the problem of identifying taxpayers' asset realizations. Since realization statistics are all based on tax

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221. See *supra* Part I.A.3.

222. For example, the maximum capital gains rate (apart from special categories, such as collectibles and depreciable real estate) was 28% from 1987 to 1996, 20% from 1997 through April 2003, and 15% from May 2003 to the present. Gregg A. Esenwein, *CFR Reports on Capital Gains*, 2005 TAX NOTES TODAY 35-22 (2005). This decline in tax rates (relative to the rates on other income) would likely result in a decrease in enforcement interest by the IRS.

223. For example, the area of like-kind property exchanges, which presents an easy opportunity to overstate basis, has increased dramatically over the last twenty years. Another example would be the increased use of offshore brokerage accounts. See Albert B. Crenshaw, *IRS Leniency to Users of Shelters; Illegal Schemers Targeted*, WASH. POST, Jan. 15, 2003, at A9 (describing that while it is not illegal to have an offshore account, such credit card accounts were often promoted on the basis that the IRS could not find out about them). Offshore bank accounts are effectively immune from the brokered-sales reporting requirements set forth in I.R.C. § 6045. See *supra* notes 87–91 and accompanying text. A third example is stock splits, common in the stock boom of the 1990s, which cause dilution in per-share basis but which can be easily “overlooked.”

224. Our revenue estimates uniformly assume that the tax rate of 15% is applicable to net capital gains. However, some portion of the unreported net gains would have been taxed at ordinary rates on account of being (1) short-term capital gains, (2) ordinary gains due to recapture, (3) gains that otherwise don't qualify for capital gains treatment, (4) excess capital losses deducted against ordinary income, (5) 28%-rate net “collectibles gains,” and (6) 25% “nonrecaptured” section 1250 gain. See I.R.C. §§ 1(h), 1221, 1245, 1250. These higher-rate gains would swamp the lower-rate gains of low-income investors and those of certain small business stock under I.R.C. § 1202. In addition, capital gains earned by corporate taxpayers do not receive preferential tax treatment and are generally taxed at a rate equal to either thirty-four percent or thirty five percent. I.R.C. § 11.

data,<sup>225</sup> it follows that the realization statistics cannot be used to accomplish the goal of gauging the *accuracy* of that tax data. Nevertheless, there is some economic-data-derived evidence<sup>226</sup> supporting the hypothesis of substantial revenue loss due to taxpayers' tendencies either to overstate their basis or to fail entirely to report their transactions.<sup>227</sup>

To sum up, the circumstantial evidence discussed in Part A combined with the tax data discussed above (and perhaps economic data as well) indicates a major annual revenue loss. Over the next ten-year span (assuming constant dollars), at least a half-trillion dollars of revenue are at stake. Even for those operating in and around government who can be relatively numb to figures in the millions, figures in the hundreds of billions are worthy of attention.

## II. PROPOSED REFORM MEASURES

Proposals for improving basis and gain compliance should be nonintrusive, efficient (in the cost-benefit sense), and technologically feasible. We offer several proposals designed to meet these benchmarks. However, we acknowledge that even were

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225. Studies of realization behavior are typically directed toward the issue of whether lowering the capital gains rate will produce a net increase in revenues due to increased realizations. See *THE CAPITAL GAINS CONTROVERSY: A TAX ANALYSTS READER* 71–180 (J. Andrew Hoerner ed., 1992) (excerpting nineteen published items on this issue).

226. A 1990 study that attempts to circumvent the data problems (by using a decision-modeling approach) estimates that the ratio of realized gains to the total market value of corporate equities is around 0.04 under tax rate assumptions that are close to those in the current Internal Revenue Code. See Donald W. Kiefer, *Lock-In Effect Within a Simple Model of Corporate Tax Trading*, 43 *NAT'L TAX J.* 75, 80 tbl.1 (1990). Another source claims that half of all gains are realized (before gift or death). See Jane G. Gravelle, *Commentary on Chapter 11, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 389, 389–90 (Joel B. Slemrod ed., 1992). What is needed, and what is (apparently) not available, is independent (nontax) evidence of realization behavior in particular years. Another problem is that existing studies focus almost exclusively on marketable equities, the most liquid kind of asset and the kind that would be most responsive to changes in tax laws. See *supra* note 222. However, other asset categories held by individuals with significant gain potential, such as real estate and noncorporate equities, have a net value at least twice that of corporate equities. See U.S. CENSUS BUREAU, *supra* note 220, at 458 tbl.695 (giving figures on household and charity assets and liabilities).

227. If the 0.04 assumed annual realization rate offered by Kiefer, see *supra* note 226, is applied only against marketable securities held by individuals (outside of retirement plans), the expected realizations (from 2000 through 2003) from this one source alone would have been close to reported net gains from all sources using IRS statistical (SOI) data. Specifically, such predicted realizations (set against reported realizations in parentheses) are as follows: 2001, \$360 billion (\$326 billion); 2002, \$272 billion (\$292 billion); and 2003, \$327 billion (\$332 billion). (These figures are adjusted to take into account the fact that tax-exempt U.S. taxpayers own about 5% of this kind of wealth; foreign taxpayers and pension-plan assets are initially excluded.) Even allowing for an assumed lower realization rate for real estate and noncorporate business interests (not to mention artwork and collectibles) and taking into account the I.R.C. § 121 exclusion for primary residence gains of \$250,000 per taxpayer, these figures would seem to suggest that a significant percentage of realized net gains are not being accurately reported.

Congress to adopt all of our proposals, the problem of inflated basis would not be entirely eliminated.

Our proposals are of three general types: (1) broadening third-party reporting with respect to basis and taxable dispositions (and improve the ability of the IRS to use basis information), (2) imposing a higher standard of proof upon taxpayers with respect to basis issues while making it easier for taxpayers to produce such information, and (3) changing certain underlying substantive tax rules to make basis computations easier to figure and to track.

#### *A. Broadening Third-Party Reporting Requirements*

Studies uniformly demonstrate that taxpayer compliance levels are vastly higher in areas of third-party reporting than in areas where third-party reporting does not exist.<sup>228</sup> However, as noted earlier, third-party reporting in the areas of basis and taxable dispositions is virtually nonexistent (except for sales proceeds in certain brokered transactions).<sup>229</sup> Therefore, the most obvious type of reform would entail full utilization of third-party reporting.

Not all asset transactions are susceptible to third-party reporting, however; to differentiate those asset transactions that are and those that are not, we categorize investments as follows: (1) intangible financial assets purchased and sold on an exchange,<sup>230</sup> (2) intangible nonpublicly traded financial assets,<sup>231</sup> (3) tangible assets sold through third parties,<sup>232</sup> and (4) tangible assets not sold through third parties.<sup>233</sup> Within each of these asset categories, there are varying degrees of third-party reporting opportunities.

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228. See, e.g., GAO REPORT, *supra* note 212, at 5 (“Information returns are a proven way to promote compliance and help IRS find noncompliance.”); Michael C. Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 TAX LAW. 705, 707 (1989) (“Computer-based enforcement techniques, relying largely on information returns filed by payers of wages, interest, dividends, and other items, have provided valuable benefits by virtually eliminating noncompliance with respect to important categories of income.”); Gene Steuerle, *The Heyday of the Comprehensive Individual Audit Is Over*, 53 TAX NOTES 859, 860 (1991) (advocating further expansion of third-party information reporting).

229. See *supra* notes 85–90 and accompanying text.

230. This category of brokered financial assets includes, besides marketable securities, mutual fund investments and other financial products, commodities futures dealt with on a commodities exchange, and over-the-counter stocks purchased and sold through brokers.

231. This category constitutes mainly equity interests in closely held businesses such as partnerships, limited liability companies, and S corporations. Unique intangibles, such as patents and copyrights, are excluded from our analysis. As taxpayers annually amortize the cost of these assets, taxpayers can fairly easily trace the basis they have in such assets.

232. This category would include most investment real estate plus artwork and collectibles sold at auction houses and possibly over the Internet.

233. This category includes real estate, artwork, and collectibles purchased from dealers and private parties (possibly over the Internet).

### 1. Intangible Financial Assets Purchased and Sold on an Exchange

Financial assets purchased and sold on an exchange offer an excellent opportunity to move to a system of third-party reporting of gains and losses. Under present law, a broker must submit an information return to the IRS reflecting the amount of a taxpayer's net sales proceeds (i.e., Form 1099-B),<sup>234</sup> but this information-reporting requirement does not include tax basis information. Instead, the submission of accurate tax basis information rests entirely with the taxpayer. However, in virtually all cases the assets will have been purchased through the same broker or a predecessor broker. Brokers already record the purchase price of assets, which they report to their customers. Brokers are thus often in the best position to match cost information with amount-realized information. The only new task that brokers would need to perform in order to accurately figure gain and loss would be to keep track of basis through capital changes. Reporting of gains and losses is feasible, as proven by the following: (1) many brokers already perform this service for taxpayers,<sup>235</sup> (2) brokers have the technical wherewithal to perform it,<sup>236</sup> and (3) mutual funds (and certain other investment vehicles) already comply with a system close to that proposed here.<sup>237</sup> A gain and loss reporting system would make things easier for taxpayers, who would not have to keep track of basis at all in the case of financial assets acquired and housed with a broker.<sup>238</sup>

At year's end, the broker would report *aggregate* figures for all relevant tax categories (i.e., long-term capital gains, short-term capital gains, etc.) on a special Form 1099-GL (GL being an acronym for Gain/Loss) to the IRS and to taxpayers. Aggregation by category would save taxpayers the trouble of keeping track of large

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234. I.R.C. § 6045.

235. Many firms provide gain and loss information as a complimentary service to their customers. For a fee, several private companies also offer tax basis identification services over the Internet. *See, e.g.*, CCH - Capital Changes, <http://www.cap.cch.com/> (last visited Sept. 17, 2005).

236. Brokerage firms have computers and access to tax and computer experts to perform the necessary tasks.

237. Mutual funds (regulated investment companies) and their shareholders are taxed according to the rules provided in I.R.C. § 852. Basically, the mutual fund can avoid company-level tax if it distributes all of its net income as dividends. The dividends have the same character (as ordinary income, net capital gain income, tax-exempt income, or nontaxable return of capital) to the shareholders because the net income was composed at the company level. Thus, all of the accounting occurs at the entity level, and the character of the distributions is reported to the shareholders. Similar quasi-pass-through investment vehicles include (1) REITs (real estate investment trusts), governed by I.R.C. §§ 856-859, and (2) REMICs (real estate mortgage investment conduits), governed by §§ 860A-860G. A discussion of these (and other) quasi-pass-through passive investment vehicles is beyond the scope of this Article, except to note that these entities are corporations or trusts subject to reporting requirements applicable to dividends and distributions, as the case may be.

238. Taxpayers often shift investment portfolios from one broker to another. In such a case, Congress would require that tax basis identification information be transferred from the old broker to the new broker and that the new broker henceforth would be responsible for tax basis tracking.

numbers of transactions and having to submit supplemental Schedule D forms.<sup>239</sup> Of course, the raw data that constitutes the components of the aggregate figures should be available to the IRS and taxpayers.

An issue for brokers involves basis adjustments that arise from facts unique to the taxpayer on account of a gratuitous transfer.<sup>240</sup> This problem can be virtually eliminated if substantive tax rules are altered so that all gifts and estate transfers are subject to either a "straight" carryover basis rule (as with property transferred from one spouse to another) or an FMV-basis-at-transfer rule (as is the current rule with respect to testamentary transfers). If either of these changes were instituted, adjustments would have to be made only where an FMV-basis-at-transfer rule applies, and in that case the broker can make the adjustment on being informed of the triggering event and its date. To the extent that these substantive-law changes are not instituted, there are two possible ways to deal with brokered financial assets that are subject to personally unique basis adjustments. One is to treat such assets as having been acquired by the taxpayer outside of the brokered-financial-assets system, which would shift the burden of fixing basis onto the taxpayer. The other would be to leave the assets in the system and require the taxpayer to separately report the basis adjustment on an appropriate line on Schedule D.

Although virtually all marketable financial assets are sold through brokers, some might not have been initially so acquired. That is, the taxpayer may have possession of the actual stock certificates for one reason or another (e.g., shares were owned prior to the company being publicly owned) but needs the services of a broker to effect a sale. This scenario is similar to that of tangible assets sold through a third party and should be governed by the same system, in which the selling broker would continue (as under present law) to report the gross and net proceeds of sale to the taxpayer and the IRS, with the taxpayer being responsible (under rules proposed below) for accurate basis reporting.<sup>241</sup>

## 2. Intangible Nonpublicly Traded Financial Assets

In this subsection, the focus is on issues relating to the basis of equity interests in entities that are not traded on any exchange and that are taxed in whole or in part on a pass-through basis.<sup>242</sup> More specifically, we are dealing with equity interests in S

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239. An issue would be whether the broker could charge the customer for the service. This, presumably, is a matter for the Securities and Exchange Commission. *See generally* I.R.C. § 6045(e)(3) (real estate broker cannot separately charge a customer for filing information returns with the IRS but can take relevant costs into account in setting fees for services).

240. *See supra* notes 39–47 and accompanying text.

241. An alternative approach might be for the broker to ask the taxpayer for basis information and to have the broker report the gain or loss as proposed in the text preceding this text paragraph. However, the broker is not in a position to verify (and would not want to accept the burden of verifying) the basis figure proffered by the taxpayer.

242. Mutual fund shares are usually publicly traded; equity interests in other specialized passive investment quasi-pass-through entities are sometimes publicly traded. *See supra* note 237. Basis adjustments in mutual fund shares can be occasioned by many events, including dividend reinvestments. Basis adjustments in other kinds of interests in passive investment vehicles can be occasioned by the passing through of income, gain, or loss (apart from any



corporations and in entities treated as partnerships for tax purposes, which (along with other entities subject to similar tax rules) are collectively referred to herein as “pass-through entities” on account of the fact that income, deductions, gains, and losses are passed through (in whole or in part) to the equity holders. Here, the third party is the legal entity itself, rather than a broker or “external” third party. The agenda is (1) to make sure that all taxable dispositions not made through brokers are reported to the IRS and (2) to facilitate the record keeping of the basis of interests in such entities.

Under present law, the entity is supposed to issue a Form K-1 on an annual basis to each equity holder.<sup>243</sup> On this form, the reporting entity conveys many pieces of significant tax information (such as the investor’s gains and losses and, if relevant, his capital account). Conspicuously absent, however, from the face of Form K-1 is the basis of the taxpayer in his equity interest (referred to as “outside basis”). Yet, every year, a taxpayer’s basis is likely to fluctuate due to gains, losses, and, in the cases of tax partnerships, liabilities incurred by the entity itself.<sup>244</sup>

Asking equity holders in pass-through entities to keep track of all the relevant basis adjustments (as is currently the case) is a lot to ask both from a legal and mechanical point of view; and from the perspective of the equity holder, who must inevitably hire the services of a tax professional to conduct this tracking, it is an expensive proposition. Moreover, the motivation to keep track of outside basis may be low due to the fact that it would have no year-to-year relevance, except in the case of a tax shelter or failing business.<sup>245</sup>

We propose first that the basis of the equity holder be initially established in the year of acquisition. In the case of an original issue, the entity would report the initial equity outside basis to the holder and the IRS. In the case of a (nonbrokered) sale, the buyer would notify the entity of the purchase price,<sup>246</sup> and the entity would report the gross sale/purchase price to the IRS, the seller, and the buyer. Every year, the entity would be obligated to issue a Form K-1 with adjusted tax basis information.

Obviously, this approach would place some additional administrative burdens on the reporting entity, but the entity would be ideally situated to handle this responsibility since it has all the relevant information readily at hand. (Moreover, similar burdens are already placed on C corporations with respect to liquidations, mergers, and other capital changes.)<sup>247</sup> Since the entity would obtain purchase, basis adjustment, and sales

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distribution). *See* I.R.C. § 857(b)(3)(D) (pass-through of undistributed capital gain of real estate investment trust with concomitant basis increase); I.R.C. § 860C (pass-through taxation of residual interests in real estate mortgage investment conduits). These kinds of investments will not be separately discussed in the text because of their esoteric nature, but the proposals discussed in the text should be considered to apply to these specialized investments as well.

243. I.R.C. §§ 6031(b), 6037(b).

244. I.R.C. §§ 703, 1367.

245. In years a tax partnership or S corporation experiences losses, loss limitation rules that are tied to a taxpayer’s basis in that enterprise may be triggered. I.R.C. §§ 704(d), 1366(d)(1)(A).

246. The entity would need to know about the change in ownership both for internal accounting purposes and to fulfill its reporting obligations to the IRS.

247. *See* I.R.C. § 6043. Section 6043 requires an information return stating the amounts paid to shareholders of C corporations (both in cash and the FMV of securities received) in liquidations, redemptions, and other capital changes. *See* Treas. Reg. § 1.6043-4T (as amended in 2003). Under our recommendations, the effect of such transactions would be factored into basis by brokers in the case of publicly traded securities. In the case of securities that are not publicly traded, the C corporation could be required to inform shareholders of any basis

information for an equity interest held by a particular equity holder, the entity would be in a position to compute the gain or loss on the equity interest when sold and report the same to the IRS and the seller,<sup>248</sup> thereby relieving the selling equity holder of any independent duty to track basis.<sup>249</sup>

### 3. Tangible Assets Sold Through Third Parties

Under current law, third-party reporting requirements for *tangible* assets exist only with respect to real estate,<sup>250</sup> where the broker<sup>251</sup> is only required to report the proceeds of sale.<sup>252</sup> In the case of tangible assets, it would be so rare for the same broker to be involved in buying, holding, and selling the same asset that this category should be deemed to be a separate category apart from that of brokered intangible assets. The selling broker in this category (which would include brokered-sale intangibles acquired individually by the taxpayer) would be assumed to have no direct access to initial basis or to facts causing adjustments to basis, such as losses, depreciation, subdivisions, and improvements. Thus, it is not feasible to impose on brokers the determination and reporting of gains and losses in this category. Nevertheless, a system can be set up to use selling brokers as a means to create strong incentives to report gains and losses more accurately.

Perhaps the best approach would be one modeled on Code sections 897 and 1445, applicable to sales of United States real estate by foreign taxpayers.<sup>253</sup> Based upon this model, what we envision is that the selling broker (in a taxable sale) would be required to withhold an amount equal to fifteen percent of the proceeds of sale (i.e., an amount equal to the “general” capital gains tax that would be imposed if the basis were zero).<sup>254</sup> The withholding tax would be reduced to fifteen percent of any gain (or to

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adjustments that derive from capital changes.

248. The entity would also be in a position to identify any ordinary gain under I.R.C. § 751 in the case of a sale of a partnership interest.

249. Equity holder-specific adjustments to basis on account of gratuitous transfers could be taken into account by informing the entity of the events that give rise to such adjustments. *See supra* note 239.

250. *See* I.R.C. § 6045(e). There is an exception for wholly exempt sales of a seller’s personal residence under I.R.C. § 121.

251. For this purpose (real estate sales), the term *broker* can mean any of the following (in descending order of priority): (1) the closing agent, (2) the mortgage lender, (3) the seller’s broker, (4) the buyer’s broker, and (5) any other person as prescribed by regulations. I.R.C. § 6045(e)(2).

252. *See* I.R.C. § 6045(a) (gross proceeds and other information required by regulations); Treas. Reg. § 1.6045-4(b), (h)–(i) (as amended in 2000) (must report cash and future cash gross proceeds, whether the receipt of property or services is involved, and the portion of any real property tax treated as being imposed on the purchaser). Curiously, the value of property received in an exchange is not reported, although the fact that an exchange has occurred is subject to reporting. *See* Treas. Reg. § 1.6045-4(b) (defining *real estate transaction*).

253. *See also* I.R.C. § 3406 (providing backup withholding at a rate of 31% for any “reportable payment,” which in the case of payments other than dividends and interest is limited to payments to persons with no TIN (taxpayer identification number) or with an incorrect TIN).

254. The capital gains rate for collectibles is actually 28% and that for real estate gains attributable to depreciation is 25%. *See* I.R.C. § 1(h)(1)(C) and (4). The withheld amount under I.R.C. § 1445 is currently 10% of the sales price. I.R.C. § 1445(a). Perhaps the withholding

zero in the case of any loss) calculated using the basis figure supplied by the taxpayer.<sup>255</sup> However, the taxpayer-supplied basis information would be accepted by the broker only if the taxpayer supplied credible documentary evidence of such basis, for example, the closing statement received upon purchase (and, in the case of depreciable property, the aggregate amount of depreciation claimed).<sup>256</sup>

The broker would report the tentative gain and loss, along with the amount (if any) withheld, to both the taxpayer and the IRS. At this point, the final onus of basis reporting would be placed on the taxpayer. (We discuss the obligations of the taxpayer with respect to proving basis in Part B.)

Whether or not a withholding tax is imposed on the proceeds of a brokered sale, brokers can be enlisted on the basis side of the compliance equation. Specifically, in the case of taxpayer-acquired assets that are obtained in taxable brokered transactions, brokers would have a one-time reporting obligation to inform the IRS and the taxpayer of the asset's purchase price. In the case of a brokered asset acquisition that does not yield a cost basis (such as a like-kind exchange under I.R.C. section 1031), the form submitted by the broker would not state a purchase price but would instead indicate that the property had been acquired in a tax-free or partially tax-free transaction.

Broker-supplied basis information, although helpful to taxpayers, would be fairly useless to the IRS unless the IRS could match this information against subsequent sales proceeds. The most plausible solution to this problem would be for the IRS to design an electronic filing system website that would assign an asset (and taxpayer) identification number to an asset adequately described by the broker.<sup>257</sup> Upon sale of the asset, the taxpayer would be required to supply the correct asset ID number. This electronic filing system will be henceforth referred to as the "Asset Identification Number System" (AINS).

A final issue relevant here is whether the concept of *broker* should extend beyond the existing understanding of that term in tax practice (i.e., brokers of financial intangibles and real estate) to include other third-party participants, such as auction

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requirement could be waived for any sale at an amount below some threshold, say, \$20,000. For example, the Code currently provides a withholding exception for residence sales that do not exceed \$300,000. I.R.C. § 1445(b)(5).

255. A problem would arise as to how withholding would operate for installment sales reported under I.R.C. § 453, the whole purpose of which is to postpone the tax on the gain. Here (to prevent avoiding the withholding requirement), the rule should be that the withholding tax should be the greater of 15% of the gain with respect to the first year's payments or 15% of an amount equal to 20% of the total gain. Moreover, the installment method itself should be restricted to assets for which third-party financing is basically unavailable, such as rural acreage and interests in closely held businesses.

256. Under I.R.C. § 1445(b)(4), the buyer is relieved of withholding if the foreign seller proves that such seller has agreed with the IRS to pay the appropriate tax. Such supplied-to-broker basis information would only affect the withholding requirement. It would not be final for purposes of the taxpayer's own tax return.

257. Consider several models for such an ID system: certain law reviews accept article submissions over the Internet upon the submission of an electronic application giving relevant information; the electronic filing system assigns a number that is henceforth used for identification purposes. Airlines, hotel chains, and rental car companies issue similar "confirmation numbers." The information would vary according to asset. Thus, in the case of real estate, the application should show the address, the plat information (if any), and the acreage, as well as relevant information of the purchasing taxpayer.

houses dealing with antiques and collectibles, art and collectibles dealers acting on a consignment basis in the secondary market,<sup>258</sup> and Internet trading sites that intermediate transactions involving art and collectibles. It would appear that the existing statutory definition of *broker* (for the purpose of reporting sales proceeds) could easily be extended by regulation to include auction houses and consignment dealers with respect to art and collectibles in the secondary market.<sup>259</sup> However, any reporting obligations should be limited to those intermediaries that provide significant services (as opposed to facilities), and this limitation rules out Internet trading sites, at least initially.<sup>260</sup> To alleviate administrative burdens, this reporting requirement would encompass only those sales at a price in excess of some threshold number, say, \$10,000.

#### 4. Tangible Assets Not Sold Through Third Parties

What is still on the table is the category of nonbrokered tangible assets. This category would comprise sales with no third-party involvement; that is, dealer (nonconsignment) sales and private sales of nonbusiness real estate,<sup>261</sup> art, and collectibles, including sales made over the Internet.<sup>262</sup> If any reporting is to be done in this type of case, the reporting onus must be on the buyer or the seller.<sup>263</sup>

Consistent with our proposal with respect to tangible assets sold through third parties, the strictest option would be to impose a withholding requirement on the seller. Another (but slightly weaker) option would be to require the seller to report the gross proceeds to the IRS and to the buyer. However, it would be against the self-interest of the seller to do either in the absence of a stiff, no-fault penalty for noncompliance. Therefore, we conclude that seller reporting should be limited to sellers who are dealers, on the theory that business taxpayers are accustomed to some scrutiny by the

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258. Consignment sales on behalf of creating artists (i.e., sales in the primary market) are reportable under I.R.C. § 6041(a) (payments of \$600 or more as compensation, etc.), because the artist will have a zero basis in the work under I.R.C. § 263A(h) and the work would not be a capital asset under I.R.C. § 1221(a)(3). Royalties for authors are required to be reported as compensation under I.R.C. § 6050N.

259. The statutory definition of the term *broker* under I.R.C. § 6045(c)(1) “includes—(A) a dealer . . . and (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services.” The general definition of broker in Treas. Reg. § 1.6045-1(a) (as amended in 2005) is “any person . . . that, in the ordinary course of a trade or business . . . stands ready to effect sales to be made by others.” However, all of the examples refer to securities, commodities, currency, and real estate brokers, and none refers to art dealers, etc.

260. Nevertheless, Internet trading sites operated by auction houses might be included. Dealers are often sellers on Internet trading sites, and in that case imposing requirements on the latter would be redundant.

261. There is no reason to subject I.R.C. § 1231 assets—those assets used in the taxpayer’s trade or business—to additional reporting requirements because they will be reported, reflecting the taxpayer’s depreciation or amortization computation, on the taxpayer’s return in the year of acquisition.

262. There would be no point in imposing reporting requirements for purchases and sales of personal-use assets that ordinarily depreciate greatly in value, such as yachts and private planes, because losses on such items are nondeductible. I.R.C. § 262.

263. In order to eliminate unnecessary administrative burdens, any proposal in this area should probably exempt transactions with a gross proceeds amount below, say, \$100,000.

IRS and can cope with reporting requirements.<sup>264</sup> In private sales, the rule should be that the purchaser has to obtain an asset ID number and report the basis to the IRS or else suffer a zero basis for the purchased asset.

In the end, a system that appropriately mandates the use of information returns that report gains and losses, withholds at the source of payment, and reports basis under an AINS would not be ineffectual or impractical. Armed with information returns and saddled with withholding, taxpayers could readily complete Schedule D of their Form 1040s and would have a major incentive to do so.

### *B. Strengthening Taxpayers' Obligations to Identify Basis*

The previous section offers proposals that would relieve taxpayers of keeping track of basis in the vast majority of cases. In this Part, we consider taxpayer obligations with respect to basis in the remaining cases, which mostly involve tangible assets not sold through a third party.

As noted earlier, current law encourages, rather than mandates, that taxpayers maintain basis records.<sup>265</sup> Taxpayers hear mixed messages, particularly from the mass media, to the effect that record keeping is important but that the IRS will accept taxpayers' best estimates.<sup>266</sup> However, the integrity of the tax system should not rest on mere guesses.

An obvious move to improve taxpayer compliance in a widespread abuse situation is to impose a sanctionable substantiation requirement on taxpayers. For years, taxpayers were able to estimate travel and entertainment expenses.<sup>267</sup> Frustrated by taxpayers who took liberties with their estimates, Congress instituted Code section 274(d), which requires that taxpayers substantiate such expenses before any amount thereof can be deducted.<sup>268</sup> More recently, Congress followed suit in a similar fashion with respect to charitable deductions in excess of \$250: taxpayers must now offer contemporaneous written paperwork authenticating their charitable contributions.<sup>269</sup>

A similar approach should be applied in cases where the taxpayer has the responsibility of establishing basis (or an upwards adjustment to basis of which a third party would not be aware). In order to eliminate taxpayer estimates, we recommend the following simple rule: the tax basis of an asset (that is not subject to the system of third-party responsibility for computing gain and loss) would be deemed to be zero absent (1) a basis supplied under the AINS in appropriate situations,<sup>270</sup> or (2) documentary substantiation of basis in other cases.<sup>271</sup>

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264. Art dealers representing living artists should already be accustomed to filing information returns. *See supra* note 258.

265. *See supra* notes 16–27 and accompanying text.

266. *See supra* note 147.

267. *See, e.g., Kahn v. Comm'r*, 38 B.T.A. 1417, 1420 (1938) (allowing taxpayer entertainment expenses that he could substantiate only by oral testimony).

268. I.R.C. § 274(d).

269. I.R.C. § 170(f)(8)(A).

270. *See supra* text accompanying note 254. To bolster compliance with the rule requiring the obtaining of an asset identification number, Congress could enact a failure-to-identify penalty (akin to the existing penalty for failure to file correct information return, found in I.R.C. § 6721(a)), of, say, \$50 per asset. However, the zero-basis default rule proposed in the text

A zero-basis default rule seems rather harsh, and therefore, it might be tempting to propose a less onerous kind of basis default rule, such as one that would allow taxpayers to use a tax basis that equals the gross sales price discounted by the current interest rate back to the date of initial acquisition (assuming that the latter can be proven by documentary evidence). A discounting-back rule (such as the one just described) might be combined with a “minimum basis rule.”<sup>272</sup> However, any complex rule of this sort—apart from being hard for taxpayers to understand—could encourage opportunistic behavior. (Of course, these rules could be designed to produce a basis on the low side, such as by providing for a very high discount rate and/or by assuming a long-ago acquisition date in case of doubt.)

Whether or not to adopt a set of default rules other than the zero-basis rule is a judgment call, but our view is that the zero-basis rule avoids confusion, complexity, and risks. Moreover, the zero-basis default rule is wholly appropriate in situations where the asset was acquired after the effective date of the proposed reforms because the taxpayer will then have had the opportunity to apply for an asset ID number under the AINS to establish a non-zero basis figure. However, possibly something other than a zero-basis rule should be applicable to assets that can be proven to have been acquired before the effective date of the proposed reforms.

Documentary proof of basis should be obtainable by taxpayers in the situations covered by the zero-basis default rule. The assets for which taxpayers will have to prove basis are mainly real estate, artwork, and collectibles, plus other assets not covered by third-party-reporting-of-gain-and-loss systems. Real estate transactions generate closing statements (issued by third parties); and artwork and collectibles of significant value will not only have generated sales records (that may be traced to an auction house or dealer), but also may have been entered in inventories compiled by the taxpayer for purposes of casualty and theft insurance, in which context the incentive may be (depending on the type of insurance coverage) to state a high cost. In addition, unimproved land, artwork, and collectibles are rarely subject to basis adjustments (other than those attendant upon gifts and bequests).

In many ways, technology enables the adoption of the proposed deemed-zero basis default rule.<sup>273</sup> First, third-party reporting of gains and losses obviates the taxpayer’s

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might well obviate the need for a separate penalty. *See infra* text accompanying notes 272–75.

271. The concept of “documentary” substantiation would exclude self-provided evidence, such as diary entries and contemporaneous estimates. It would include written items provided by or submitted to third parties, such as closing statements, sales invoices, and gift and estate tax returns. *Cf.* I.R.C. § 1059A (providing that the basis of property imported from a related person is not to exceed its customs value). It is conceivable that documentary evidence might itself be “approximate.” An example would be a document revealing that certain shares of stock were acquired from a decedent in the year 1922 but without a cost figure or an exact date. Here, the correct result might be to fix the basis with reference to the lowest market price for that stock in that year (or at the mean price for that year).

272. Thus, in the case of marketable securities for which no acquisition date is provable, the basis could be the greater of (1) the price at original issue, (2) the value at the taxpayer’s fifteenth birthday, or (3) an amount equal to 10% of the gross proceeds of sale.

273. Congress apparently thinks that keeping track of basis is feasible even without reform proposals of the type advanced here. Otherwise, Congress would not have enacted the new carryover basis regime embodied in I.R.C. § 1022, slated to take effect in 2010 and thereafter (assuming the estate tax repeal takes effect). Economic Growth and Tax Relief Reconciliation Act of 2001, I.R.C. § 1014 (Supp. II 2002). To make this rule operative, the decedent’s personal

basis responsibility for a significant number of assets. Second, for the remaining assets, the AINS would allow taxpayers (and others) to establish (and record with the IRS) an initial basis. As for assets that slip through the cracks, computer software programs now allow users to transfer their written records (including third-party invoices) into electronic form, reducing the need to keep bulky paperwork.<sup>274</sup>

Finally, a substantiation requirement would raise the bar for tax return preparers, who would be required, at the risk of sanction, to prod the taxpayer to supply the preparer with whatever documentary evidence the taxpayer has.<sup>275</sup>

### *C. Instituting Legal Changes That Simplify Basis Identifications*

Even if taxpayers and brokers do their part to help identify tax basis, they may find their efforts impeded by the inherent complexity and dubious rationality of many of the substantive rules that impact basis determinations. We offer the following substantive law changes that would greatly facilitate tax basis identifications if adopted.<sup>276</sup>

1. *Move to a mark-to-market system.* Congress could institute a full accrual-based system of taxation that requires the annual recognition of all gains and losses, except those pertaining to consumer durables and collectibles.<sup>277</sup> While such a system would entail annual changes in basis (to equal the FMV at the end of the previous year),<sup>278</sup> it would render the problem of record keeping a relic of the past. A partial accrual-based system that would be limited to the annual recognition of gain and loss on liquid and

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representative will have to supply the IRS and the recipient of the decedent's property with a litany of information, including the following: (1) the name and taxpayer identification number of the recipient of the property, (2) a description of the property, (3) the adjusted basis of the property in the hands of the decedent and its FMV at the time of death, (4) the decedent's holding period in the property, (5) information regarding the character of the property, (6) the amount of basis increase the personal representative allocated to the property under I.R.C. § 1022(b) or (c), and (7) other information that the Treasury may require by regulation. I.R.C. § 6018(c) (effective Jan. 1, 2010). This information, however, will presumably only be available if the decedent, during his or her life, kept accurate and complete books and records. The new modified basis carryover rule thus strongly implies that Congress trusts taxpayers to take tax basis identifications issues seriously and that not doing so will be at the taxpayers' own (or their beneficiaries') peril.

274. See *supra* note 236 (referring to online services for tracking capital changes).

275. See *supra* note 113.

276. We recognize the political controversy that might surround the adoption of the reforms we offer. Substantive tax law changes are more likely to be perceived as "tax increases," attracting political or ideological opposition. Nevertheless, it is worthwhile to at least consider substantive law changes within the income tax, and hopefully, some of these will prove to be relatively noncontroversial.

277. See, e.g., Fred B. Brown, "Complete" Accrual Taxation, 33 SAN DIEGO L. REV. 1559, 1562 (1996) (detailing how an accrual-based tax system would operate); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1119 (1986).

278. To illustrate, suppose on July 1 of Year 1, *A* purchases ten shares of *X* corporation stock for \$100; on December 31, the ten shares of *X* stock are worth \$120. Under a mark-to-market tax system, *A* would be taxed on \$20, raising his year-end adjusted basis in his *X* stock to \$120. Suppose further that at the end of Year 2, *A* sells her ten shares of *X* stock for \$125. Using her Year 1 tax return, *A* could easily discern that her tax basis in her ten shares of *X* stock is \$120.

publicly traded assets would be more within the realm of political possibility.<sup>279</sup> Moving even this far in the direction of a mark-to-market system would be quite controversial,<sup>280</sup> but the extension of mark-to-market taxation is justified by many reasons, not the least of which is the simplification of basis issues.<sup>281</sup>

2. *Abolish the system of separately taxing capital gains and losses.* One of the reasons that the IRS devotes little attention to basis compliance issues is that there is a lower rate on capital gains than on ordinary income.<sup>282</sup> Congress could move to a unitary rate schedule for all income.

3. *Repeal Code section 1031 and certain other tax-free exchange rules.* Tax-free like-kind exchanges under Code section 1031 (which mostly occur with respect to investment real estate) not only pose complex basis rules,<sup>283</sup> but even worse present a major opportunity for overstating basis.<sup>284</sup> Similar issues arise with other tax-free

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279. See, e.g., David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95 (1999) (analyzing the virtues of a partial mark-to-market system); Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 294–372 (1995) (advocating mark-to-market taxation of publicly traded corporate equity and debt).

280. Many persons may still think that realization is inherent in the concept of income, an idea that was long dominant following the Supreme Court decision in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (stating that income is not taxable unless it is “a gain accruing to capital; not a growth or increment of value in the investment.”). See also *Gray v. Darlington*, 82 U.S. (15 Wall.) 63, 66 (1872) (stating that a “[m]ere advance in value in no sense constitutes the gains, profits, or income specified by the statute”), quoted with approval in *Lynch v. Turrish*, 247 U.S. 221, 230 (1918). Attempts to roll back the realization principle, although begun with I.R.C. §§ 475, 1256, would therefore probably be met with strong resistance. Extending the mark-to-market rule beyond highly liquid (and easy-to-value) assets would prompt objections relating to liquidity and valuation. See *Shakow*, *supra* note 277 (offering an exposition of how Congress could overcome the problems of valuation and liquidity). Compare *Weisbach*, *supra* note 279 (offering a partial mark-to-market system of taxation, limited mostly to financial assets, in light of liquidity and valuation concerns).

281. This point has been virtually ignored by advocates of a mark-to-market system. See, e.g., *Brown*, *supra* note 277, at 1564–95 (presenting a detailed list of all the advantages a mark-to-market system offers, but not mentioning how its adoption would affect basis computations).

282. See *supra* note 220 (describing the recent history of capital gains rates). Other arguments in favor of this move include vast simplification of the tax law and reduced distortion of economic behavior. The usual arguments in favor of lower capital gain rates would dissolve in favor of assets marked to market. Presumably, any move of this sort would be coupled with an overall lowering of rates, as occurred under the Tax Reform Act of 1986. See S. REP. NO. 99-313, at 169–70 (1986).

283. The basis in the exchange property is equal to the basis the taxpayer had in the transferred property, increased by the amount of any gain recognized (on account of the receipt of boot) and decreased by (1) the amount of any money received, (2) the FMV of other property received that is not like-kind property, and (3) the amount (if any) of recognized loss with respect to in-kind boot. See I.R.C. § 1031(d). Additional complications arise if either or both of the properties are mortgaged.

284. When the property received in the exchange is sold, it is easier for the taxpayer to claim a basis equal to putative cost (the FMV on acquisition) rather than the (usually lower) basis obtained under the rule described *supra* note 283.



exchanges (such as corporate formations and mergers),<sup>285</sup> but these pose less abuse potential as many of these capital changes can be tracked by brokers. Congress could thus eliminate many tax-free exchange provisions,<sup>286</sup> whose justifications are too tenuous to warrant retaining the provisions.<sup>287</sup>

4. *Replace Subchapter K by a liberalized Subchapter S regime.* Commentators and practitioners alike not only bemoan the complexity of the partnership taxation regime housed in Subchapter K of the Code, but also intimate that compliance is haphazard at best.<sup>288</sup> The basis rules found in Subchapter K, for both inside and outside basis, are especially intricate.<sup>289</sup> We share the opinion of other commentators who argue that Subchapter K should be wholly eliminated or drastically narrowed in its application.<sup>290</sup>

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285. See, e.g., I.R.C. §§ 351(a), 354, 1035(d)(2), 1036(c)(2), 1037(c)(2).

286. See Fred B. Brown, *Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational and More Unified Approach*, 67 MO. L. REV. 705 (2002) (suggesting that the like-kind and involuntary conversion rules are in dire need of significant reform); Marjorie R. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987) (arguing for the elimination of § 1031); Eric M. Jensen, *The Uneasy Justification for Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL'Y 193 (1985) (finding flawed justifications for § 1031 while favoring its retention).

287. The principal justification for many of the Code's nonrecognition provisions is that taxpayers continue to hold onto essentially the same investment before and after the exchange, so tax deferral is appropriate. In most cases, the premise is false, especially in the case of real estate swaps under I.R.C. § 1031. Even granting the premise, the conclusion does not follow since an exchange is no different than a sale followed by a reinvestment (which is taxed). Moreover, these provisions distort behavior and increase transaction costs. Thus, swaps of real estate would be uncommon in the absence of I.R.C. § 1031, and the existence of I.R.C. § 1031 has created an army of real-estate-exchange middlemen having expertise in the intricacies of that section.

We would maintain the tax-free status of certain exchanges whose justifications we do find meritorious, including those related to business formations, see I.R.C. §§ 351, 721; involuntary conversions, see I.R.C. § 1033; exchanges of insurance policies (which are usually involuntary), see I.R.C. § 1035; and interspousal transactions, see I.R.C. § 1041. We do not venture an opinion as to whether corporate mergers and reorganizations should be tax-free at the shareholder level.

288. One commentator states thus:

A large number of partnerships thus seem to be governed by what might be called an "intuitive subchapter K." Taxpayers and tax advisers who want to comply account for partnership transactions in ways that are consistent with their conceptions of the basic aims of subchapter K; others account as adventurously as they believe the IRS is likely to tolerate. IRS auditors challenge partnership accounting only if it seems to be seriously out of whack. No one has the ability, resources, and incentive to figure out exactly what the rules require.

Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 252 (1999).

289. See I.R.C. §§ 722, 723, 731(c)(4), 732, 733, 734, 737(c), 742, 743, 752, 754, 755.

290. See Lokken, *supra* note 288. These reforms are modeled, in part, on reforms offered in Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1998). Other commentators share the perspective that complexities besetting Subchapter K make it administratively untenable. See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 110 (1991) (relying on the "relatively simple foundation of Subchapter S, rather than

We support its replacement by a liberalized version of Subchapter S that posits a simple equity structure and provides relatively straightforward basis rules.<sup>291</sup>

5. *Adopt a deemed-realization system for gratuitous transfers and trust distributions.* If gifts and estate transfers were deemed-realization events, the transferee's basis would be the amount realized by the donor or estate, which is the FMV of the property upon transfer.<sup>292</sup> Adopting a deemed-realization approach to gratuitous transfers would prevent basis issues from lingering for long periods of time, sometimes extending from one generation to another. This extension occurs under the current basis rule for gifts and will occur (with great complexity) under the modified carryover basis rule for estate transfers scheduled to take effect in the year 2010.<sup>293</sup> The same deemed-realization rule can (and should) be made to apply to in-kind trust distributions.<sup>294</sup>

6. *If gratuitous transfers are not treated as deemed-realization events, simplify the carryover basis rule for gifts.* The tax basis a donee has in a gifted asset currently depends upon whether gift and generation-skipping transfer taxes were paid and if there was an embedded loss in the gifted property (i.e., if, on the date of the gift, the basis of the asset was in excess of its FMV).<sup>295</sup> Doing away with these adjustments would produce the simple rule that a donee's asset basis would always be that of the donor. The loss-shifting rule results in there being no basis for gain and loss purposes

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upon the intricately ornate base of Subchapter K [would permit] most of the arcane complexity from this sector of tax law [to disappear.];" Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 TAX L. REV. 665, 669 (1992) ("[O]ne thing that makes subchapter S look really good is [S]ubchapter K, the awesomely complex partnership tax provisions."); Deborah S. Schenk, *Commentary: Complete Integration in a Partial Integration World*, 47 TAX L. REV. 697, 712 (1992) ("[O]ne of the hallmarks of subchapter S is its . . . simplicity [relative to subchapter K]."). Not all commentators, however, share this view. See, e.g., Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591 (1996); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999) (advocating both a reformed Subchapter K and a more liberalized Subchapter S).

291. See I.R.C. § 1367 (distinguishing Subchapter K from Subchapter S by not factoring entity liabilities into outside basis).

292. See, e.g., Joseph M. Dodge, *A Deemed Realization Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001); Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 VA. L. REV. 830 (1973); Zelenak, *supra* note 8. A deemed-realization system was enacted in Canada as a trade-off for repeal of the federal death tax. See R.S.C., ch. 1, s/a 70(5) (5th Supp. 1992) (Can.).

293. This provision, I.R.C. § 1022, is criticized by Dodge, *supra* note 37, and exhaustively analyzed from a technical angle in Dennis L. Belcher & Mary Louise Fellows, *Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes*, 58 TAX LAW. 93, 124–95 (2004).

294. The existing rule is that the trust's basis carries over to the distributee. See I.R.C. § 643(e)(1). An election, however, can be made to recognize gain on such distributions. See I.R.C. § 643(e)(3). However, neither the estate's personal representative nor the trust's trustee has a concomitant reporting requirement under present law to inform either the beneficiary or the IRS what basis the recipient has in the transferred assets. We suspect that many beneficiaries erroneously think that the basis they have in such property is equal to its FMV, based upon the perception that assets received as the result of a death have a basis equal to FMV when acquired, as opposed to the I.R.C. § 1014 rule that basis equals FMV at the date of death.

295. See *supra* notes 42–43.

until the donee sells the asset.<sup>296</sup> This rule is not worth the complexity involved, especially since the shifting of a capital loss will not ordinarily significantly reduce a taxpayer's tax burden, and the anti-loss-shifting rule is inconsistent with the fact that gains are freely allowed to be shifted by way of gift. Congress should also repeal the adjustment for gift taxes paid on unrealized appreciation. This adjustment has a dubious (or at least noncompelling) rationale,<sup>297</sup> is not intuitively obvious,<sup>298</sup> and is too rarely applied to have attracted a meaningful political constituency.<sup>299</sup>

7. *Adopt clear rules on the repairs-versus-improvements issue for real estate not used in a trade or business.* Investors and residence owners have an incentive to claim borderline costs on real estate as improvements (which will increase basis) rather than as repairs, which are either inherently nondeductible or deductible only in varying degrees.<sup>300</sup> Regulations should be issued that treat costs relating to real estate (not used in a trade or business), other than acquisition costs, as repairs in all cases other than

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296. See Treas. Reg. § 1.1015-1(a)(1)–(2) (as amended in 1971).

297. The idea behind the adjustment for gift taxes attributable to unrealized appreciation is that the income tax on the unrealized appreciation (if it had been realized by the donor) would have reduced the estate tax base of the donor (which would have benefited the donee by reducing the estate tax); but since this scenario does not play out, the second-best solution was seen as giving the donee a roughly commensurate income tax benefit. In other words, the theory is similar to that of I.R.C. § 691(c), providing for an income tax deduction equal to the estate tax attributable to estate inclusion of the IRD right. See H. R. REP. NO. 94-1380, at 44 (1976) (stating that the idea is to prevent a tax on a tax).

Upon closer inspection, this rationale fails to pass muster. First, the fact is that the donor avoided income tax by making the gift and could have prevented gain to the donee by holding onto the property until death. Tax rules should be based on what actually happens, not what might have happened under an alternate scenario. Second, the gift tax and the reduced income tax on the gain are paid by different taxpayers. Third, I.R.C. § 275(a)(3) prohibits the deduction of gift taxes, and I.R.C. § 263A(a)(2) prohibits the capitalization of nondeductible items. Thus, § 1015(d)(6) is inconsistent with these provisions. Fourth, there is the overall policy issue of why the gift tax should be so diluted (indirectly), given that the gift tax base already obtains an implicit deduction for the gift tax itself. See Douglas A. Kahn & Jeffrey H. Kahn, "Gifts, Gifts, and Gifts"—*The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441, 484–86 (2003) (stating that adding all or part of gift tax to basis is not logically necessary).

298. The explanation set forth in *supra* note 297 would only occur to a tax specialist seeking perfection. The rationale of the adjustment cannot be that the gift tax is a "cost" of acquiring the gift that should be added to basis. Transaction costs are added to cost basis, but not to "free" basis. Thus, Treas. Reg. § 1.1015-4 (as amended in 1972) states that in the case where a donee incurs a cost in obtaining gift property, the basis of the donee is the greater of such cost or the carryover basis, not the sum of the two.

299. Only a handful of gifts would actually trigger a gift tax that would give rise to this adjustment. In 1976, Congress curtailed this adjustment with no apparent resistance. See I.R.C. § 1015(d)(1).

300. Repairs on a personal-use asset are not deductible at all under I.R.C. § 165(c). Repairs on a vacation home must be prorated between rental and personal use, and the deductions attributable to rental use may be deferred. See I.R.C. § 280A(c). Repairs on rental property may also add to "passive activity losses," which are deferred under I.R.C. § 469. Repairs on (nonrental) investment property are "miscellaneous itemized deductions," subject to disallowance in an amount equal to 2% of adjusted gross income under I.R.C. § 67.

those involving (a) adding square footage or (b) altering the real estate's function or use, regardless of the cost.<sup>301</sup> Such a rule would prevent claimed basis increases for roof and foundation repairs; installation of kitchen, electronic, heating, and air-conditioning equipment and systems; addition of swimming pools, spas, docks, fences, and tennis courts; and other home-remodeling endeavors.<sup>302</sup>

8. *Adopt a blended-basis rule for different lots of the same stock.* Where a person acquires shares of a given stock at various times (and at different per-share costs), the sale of some of such stock raises the issue of figuring out which shares were sold. Present law posits various methods of identification,<sup>303</sup> but their application has proven unwieldy, unnecessary, and confusing. Since shares of the same stock held by the same taxpayer are fungible, a blended-basis rule is not only appropriate in principle but would also be the easiest to administer.

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Listed above are several legislative reform proposals that Congress could institute to greatly facilitate tax basis identifications. By making these changes, taxpayers would have a much easier time computing their gains and losses, and Congress would likely reap the benefit of these simplification changes in the form of enhanced revenue flow.

### III. TRANSITION RULES

Some reform proposals—notwithstanding their theoretical merits—require transition rules that are complex, nonadministrable, and/or inequitable.<sup>304</sup> For example,

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301. Existing Treas. Reg. § 1.162-4 (1963) states that an outlay is a capital expenditure if it “materially add[s] to the value” or “appreciably prolong[s] its life,” but these tests are vague and open-ended because they fail to specify the baseline for comparison. Thus, *any* outlay on property increases its value and prolongs its life relative to the condition that the property would fall into if the outlay were not made. This distinction is frequently litigated. *See* 3 STAND. FED. TAX REP. (CCH) ¶ 8630 (containing twenty-nine pages of short annotations of cases and rulings solely on the issue of business repairs). Moreover, recent regulations in the area of intangibles have tilted the balance toward finding outlays to be expenses rather than capital expenditures. *See* Treas. Reg. § 1.263(a)-4 to -5 (as amended in 2004).

302. If items like those described are added to basis, the basis of the items removed should be subtracted out, but we have never heard of any taxpayer doing this with respect to personal-use property. Thus, it appears that homeowners are routinely guilty of including the cost of both new and removed equipment, etc., as part of the basis in the same building.

303. *See supra* note 29.

304. There are many views on the necessity of transitional rules. Some commentators argue that transitional rules are necessary for reasons of fairness and efficiency. *See generally* DAVID F. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 159–66 (2d ed. 1984). There are others who view tax law changes as being an aspect of market risk and, that being the case, argue that tax law changes do not require transitional relief. Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986). *Cf.* Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996) (positing that some transition rules may be appropriate, depending on the nature of the proposed tax law change); DANIEL SHAVIRO, WHEN RULES CHANGE: AN

as previously described, when Congress adopted a carryover tax basis rule in 1976, a series of intricate transition rules accompanied its adoption.<sup>305</sup> These transition rules were perceived to be so incomprehensible that they, along with other factors,<sup>306</sup> led to the ultimate retroactive repeal of the carryover tax basis rule.<sup>307</sup> The transition rules necessary to implement the changes we propose, however, do not suffer from these problems.

Our proposal that brokers and pass-through entities keep track of basis and calculate gain and loss without taxpayer involvement can be applied retroactively because brokers will (in most cases) have the purchase records and the ability to track basis changes. In the case of pass-through entities, it should be initially presumed that the entity would not know of the equity holder's initial basis. In this type of case and in brokered-asset cases in which the broker cannot determine the date and cost of purchase, there are two options.

The first option would be to require the taxpayer to register problem assets under the AINS, which in this case would require the usual personal information, the date of acquisition, information about the asset acquired (such as, where applicable, the number of shares acquired on that date), and the acquisition date basis, accompanied by a list (and description) of what documents the taxpayer has to support these entries. This information would be submitted to not only the IRS but also the broker or pass-through entity, and thereafter these assets would be subject to the third-party reporting system unless the IRS rejected the application on its face (for vagueness or not listing adequate documentary proof). If no AINS ID number is obtained, the basis would be deemed to be zero.<sup>308</sup> This approach would impose some administrative burdens on the IRS and taxpayers, and it would pose some risk of basis overstatement, but the latter problem can be diluted somewhat by treating the taxpayer-supplied information as nonconclusive when challenged by the IRS.

If a mandatory AINS proves untenable on its own, the other alternative is to couple an elective AINS with an alternative default rule (other than a zero-basis rule). One possible default rule would be to continue the existing status quo under which taxpayers could substantiate the tax basis they had in a particular asset by whatever means possible, and the *Cohan* rule would remain applicable when (and if) controversies arose.<sup>309</sup> Another possible default rule would require the establishment of the asset's FMV as of the effective date, and that FMV would be discounted back (at a high discount rate) to the date of acquisition.<sup>310</sup> Consumer assets (other than those

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ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY 18–19, 27–32, 48–53, 101–02 (2000) (offering a critical analysis of the Graetz/Kaplow viewpoints).

305. See *supra* note 9 and accompanying text.

306. For example, the carryover basis rule established a labyrinth series of instructions that executors were to follow to adjust tax basis between and among the decedents' assets. See Former I.R.C. § 1023(c) (1976) (repealed 1980); Former I.R.C. § 1023(h)(3) (repealed 1980) (providing tax basis adjustments for federal and state estate taxes paid based upon each asset's net appreciation).

307. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299.

308. See *supra* notes 270–71 and accompanying text.

309. See *supra* notes 134–36 and accompanying text.

310. See *supra* notes 271–72 and accompanying text. Application of this transition rule in particular would presuppose adequate evidence that the asset in question was in fact acquired before the effective date, and application of the discounting-back rule would require adequate

having appreciation potential) would be exempt from any strong basis-proof rule<sup>311</sup> unless a casualty loss is claimed.

The proposal relating to the withholding (by third parties) of tax on the proceeds of certain sales should apply to pre-effective date assets because this is only a tax collection device, not a change in substantive or evidentiary law.

Finally, the need for special transition rules for the legislative changes we propose would depend upon the particular reform measure in question. Those changes that modify existing tax basis rules (e.g., a universal gift tax basis rule or the elimination of many tax-free exchanges) could be effective immediately and no transition rules would be necessary. The issue of whether more sweeping changes (such as the elimination of Subchapter K or a shift toward a full or partial mark-to-market tax system) would require transition rules should be addressed on a case-by-case basis.<sup>312</sup>

#### CONCLUSION

For close to one hundred years, the income tax system in the United States has functioned efficiently and has earned worldwide respect. One of its principal premises is that taxpayers can (and do) accurately measure their gains and losses from the sale or disposition of their assets. To do so, taxpayers must be in a position to correctly identify the tax basis of assets sold or disposed of. This Article explores the reasons that taxpayers inadvertently or intentionally misreport the tax basis they have in their assets (and do not report gains) and why external and internal constraints do little to dissuade this behavior. As a result of the breakdown in this process, the government stands to lose billions of dollars of revenue annually.

The reform measures this analysis advocates are administratively feasible and have ample historical precedent. Expanding third-party reporting requirements to include, where appropriate, running basis figures and the calculation of gains and losses is a logical extension of existing requirements of reporting gross sales proceeds. The expansion is close to already being in place for mutual fund shares, and advances and availability of technology make this possible. Technology also allows the creation of an AINS, which would mainly be used for unique assets, such as real estate, artwork, collectibles, and closely held business interests. The zero-basis default rule is simply an extension of the substantiation rule for certain deductions found in I.R.C. section 274(d) (and, to a lesser extent, I.R.C. sections 170(f)(8) and (11)). The withholding-tax proposal is an extension of I.R.C. sections 897 and 1445. Even the discounting-back approach (offered as a possible transition-period default rule) has antecedents.<sup>313</sup> Were Congress to take additional steps to simplify basis rules, even more progress toward accurately reporting tax basis could be achieved. Not only can our proposals be readily

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proof of the year of acquisition.

311. Basis information for consumer durables would not be readily available and there is scant likelihood that such items will be sold at a gain (and losses on these personal-use items are disallowed under I.R.C. § 165(c), except in the case of personal casualty losses). See I.R.C. § 165(h).

312. See, e.g., Shakow, *supra* note 277, at 1178–83.

313. Apart from Former I.R.C. § 1023(h)(3) (repealed 1980), mentioned in *supra* note 306, Treas. Reg. § 1.483-4 (1996) and § 1.1275-4(c) (as amended in 2004) use a discounting-back method to identify the imputed interest component of a payment made pursuant to a contingent-payment sale of property reported under the open-transaction method.

instituted, but they also have (as a package) the virtue of actually lightening the compliance burden on taxpayers to a significant degree.

Unlike many other laudable reform measures (e.g., simplification of the dependent care credit),<sup>314</sup> the proposals we champion (with the exception of certain substantive law changes) are fairly unique in being able to generate significant revenue without being perceived as a politically forbidden “tax increase.”<sup>315</sup> Adoption of our proposals would entail negligible costs to the government and reduced burdens for investors, although third parties would admittedly have slightly higher administrative costs (which could be factored into the fees they charge).

We started this journey with the myth that basis rules are self-actualizing, examining why this myth is contrary to reality. En route, we established that adoption of the proposed reform measures we advocate would tame the basis dragon. Myths, after all, can become reality.

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314. See, e.g., Deborah H. Schenk, *Old Wine in Old Bottles: Simplification of Family Status Tax Issues*, 91 TAX NOTES 1437, 1452 (2001) (proposing that “the credit also could be simplified by eliminating the requirement that a taxpayer must maintain a household in which the qualifying individual lives”).

315. See generally SHELDON D. POLLACK, *REFINANCING AMERICA: THE REPUBLICAN ANTI-TAX AGENDA* (2003); Sheldon D. Pollack, *Republican Antitax Policy*, 91 TAX NOTES 289 (2001). Consider too, that the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, contained numerous revenue-raising provisions, many of them of a procedural or semiprocedural nature. See, e.g., I.R.C. § 72(w) (effectively lowering the basis of annuities of nonresident aliens), 170(f)(11)–(12) (increasing the substantiation requirements for certain charitable contributions), 409A (limiting the ability to defer compensation), 453(f) (restricting the installment method further), 6039G (requiring reporting by expatriates), 6043A (requiring the reporting of boot in mergers and acquisitions to IRS, brokers, and shareholders), 6111–12 (providing for disclosures relating to “reportable transactions” as defined in I.R.C. § 6707A), 6707–08 (creating penalties for failure to comply with I.R.C. § 6111), 7701(n) (requiring that notice be given by expatriates to obtain certain tax benefits). State governments that have seen their revenues recently dwindle have likewise turned increasingly to the institution of compliance measures to maintain their fiscal solvencies. See Timothy Catts, *Prompted by Budget Crises, States Consider ‘Loophole’ Remedy*, 28 ST. TAX NOTES 271 (2003).