Improving Tax Basis Reporting For Passthrough Entities

By James Alm and Jay A. Soled

Tax basis reporting is a notoriously complex enterprise, and taxpayer compliance is lackluster at best. One area of the law in which basis reporting remains absent is for passthrough entity investments, such as partnerships and S corporations. As a result, many taxpayers do not know the basis they have in their passthrough investments. These taxpayers must therefore estimate the tax basis they have in those investments, often producing inflated basis figures and, as a byproduct, smaller taxable gains and larger taxable losses. In light of its proven track record in the area of marketable securities (where third-party tax basis reporting has recently become mandatory), Congress should make third-party tax basis reporting for passthrough entities a similar reality. Mandating passthrough entity basis reporting would greatly simplify the compliance process, alleviate the IRS’s burdensome task of trying to detect basis misreporting, and produce billions of dollars in revenue without raising taxes.

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I. Introduction

Several years ago Congress passed legislation that ushered in a new era of tax compliance and simplified the tax administration process for millions of Americans.¹ Since tax year 2011, third-party brokers are required to track the basis taxpayers have in their marketable securities and, on the sale or disposition of those securities, report investment gains and losses on Form 1099.² That information is then readily available to taxpayers to populate their income tax returns and, using a matching oversight program, to the IRS to readily detect noncompliance.

Before that legislation passed, compliance was adrift. Third-party brokers were required only to report on Form 1099 the amount taxpayers realized on a sale or disposition of their marketable securities; taxpayers had the laborious task of tracking the basis they have in their marketable securities and computing for themselves their concomitant investment gains and losses.³ Unfortunately, many taxpayers fell short of the mark, misreporting their basis in a fashion that produced smaller taxable gains and larger taxable losses.⁴ That misreporting

²Section 6045(g).
⁴See, e.g., James M. Bickley, “CRS Updates Report on Basis Reporting in Securities Transactions,” Congressional Research Service report RL34216 (Oct. 8, 2008) (“Basis reporting can help clarify the actual amount of capital gains and thus the tax revenue from such gains may rise if capital gains have been under reported”); Joseph M. Dodge and Jay A. Soled, “Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question,” Tax Notes, Jan. 24, 2005, p. 453; Government Accountability Office, “Capital Gains Tax Gap: Requiring Brokers to Report” (Footnote continued on next page.)
cost the federal government and, by extension, those state governments whose revenue base relied on an income tax.\(^6\)

The introduction of basis reporting in the sphere of marketable securities has been advantageous for taxpayers, the government, and third-party brokers. Taxpayers no longer have to devote time, energy, and resources to track their basis in marketable securities, which alleviates the stress — and the cost — associated with the annual return submission process. The government enjoys two advantages: More accurate basis reporting produces greater revenue, and it enables the IRS — an agency already stretched too thin — to dedicate its limited resources to more productive uses than labor-intensive basis inquiries and audits. Finally, despite the costs third-party brokers must now endure as a result of fulfilling their basis reporting obligations, much of that process is automated, and many individual brokers seem grateful that they no longer have to bear the thankless and time-consuming task of tracking basis on behalf of their clientele.

We contend that the time has come to extend basis reporting beyond marketable securities and to require passthrough entities, such as partnerships and S corporations,\(^8\) to track and report basis on behalf of their investors. We will identify the factors that contribute to noncompliance in this area and will offer revenue projections associated with taxpayers that continue to misreport basis in their passthrough entity investments. Finally, we will propose reform measures modeled after marketable security basis reporting legislation that apply to passthrough entity basis reporting.

II. Factors Causing Taxpayers to Misreport

There is much academic literature that explores the reasons why some taxpayers comply and others do not. There is no one factor that underlies noncompliance, partly because individuals differ in their opportunities and motivations to pay their taxes.\(^9\) Several models attempt to explain noncompliance, namely, the cost benefit model, the expected value model, and the expected utility model.\(^10\) Application of those models suggests that taxpayers may misreport the basis they have in their passthrough entity investments for a variety of reasons, including the lack of useful information returns, the complexity of the basis computation rules, and the absence of IRS oversight.

A. Lack of Useful Tax Information Returns

During much of the code’s history, information returns have proven instrumental to ensuring compliance.\(^11\) Empirical evidence supports that phenomenon: When the code mandates information returns, compliance is ordinarily high; when the code does not mandate information returns, compliance ordinarily suffers.\(^12\)

For marketable securities, that phenomenon has also proved accurate. Before the passage of section 6045(g), the code simply required third-party brokers to report the amount realized on the sale or disposition of a marketable security.\(^13\) However, when basis reporting was concerned, taxpayers were on the honor system. As could be anticipated, compliance suffered because taxpayers misreported the basis they had in their marketable security investments.

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\(^\text{13}\)See, e.g., IR-2012-4 (“Overall, compliance is highest where there is third-party information reporting and/or withholding. For example, most wages and salaries are reported by employers to the IRS on Forms W-2 and are subject to withholding. As a result, a net of only 1 percent of wage and salary income was misreported. But amounts subject to little or no information reporting had a 56 percent net misreporting rate in 2006.”); Karen Setze, “Taxpayers Honest When Someone’s Checking, Say IRS Officials,” Tax Notes, June 12, 2006, p. 1216 (“Results from the recently completed individual reporting compliance study for 2001... showed that only 1.2 percent of wage income was underreported, 57 percent of nonfarm proprietor income was misreported... and 72 percent of farm income was misreported.”). See also H.J. Kleven et al., “Unwilling or Unable to Cheat? Evidence From a Randomized Tax Audit Experiment in Denmark,” 79(3) Econometrica 651 (2010).

\(^\text{10}\)See supra note 3.
Under current law, passthrough entities must annually issue an information return (Schedule K-1) to taxpayers. That information return provides critical information (for example, income and losses) that enables taxpayers to complete their income tax returns. There is, however, one missing critical element: Nowhere on the return is the passthrough entity required to report the basis taxpayers have in their investments. That deficiency opens the door to noncompliance.

It is not that Schedule K-1 entirely ignores basis. Buried in its instructions are detailed worksheets that instruct taxpayers on how to compute the basis they have in their investments. But in the age of electronic return preparation, few taxpayers will turn to those worksheets; fewer still seem likely to learn how to complete them; and even fewer will retain them. Because there is no financial incentive for return preparers to complete them, there is every reason to assume that Schedules K-1 will be ignored.

To paraphrase an observation once made by professor Joseph Bankman of Stanford University Law School, information returns work wonders for compliance, but only if they provide complete information that the IRS can readily cross-check. The existing versions of Schedule K-1 for passthrough entities fall far short of reaching that objective. There is an obvious information gap in basis reporting.

B. Complexity of the Tax Basis Rules

Several years ago, discussion on the hardships taxpayers faced in determining basis for their marketable securities was popular. For example, in arguing for expanded information reporting, National Taxpayer Advocate Nina Olson in her 2005 annual report to Congress pointed out the difficulties taxpayers routinely experienced in computing basis. To illustrate those difficulties, Olson portrayed a taxpayer who had invested in AT&T stock. When the taxpayer sought to sell his stock decades later, he had the Herculean task of determining his basis in that stock and of all of the Baby Bell shares that were spun off from the parent company.

In light of the numerous capital events that market securities commonly endure (for example, stock splits, spinoffs, and reverse stock mergers) and the effect that those events have on basis, Congress found Olson’s report compelling. Grounded in the report and supporting congressional testimony, Congress enacted section 6045(g), which requires expanded information return reporting for marketable securities. By centralizing basis reporting in the hands of third-party brokers, Congress hoped to rely on their expertise and resources to accurately track taxpayers’ basis in their marketable security investments.

Despite the complexity associated with marketable security basis computations, they are relatively easy in comparison to the computations associated with passthrough entity basis determinations. Consider that during the life cycle of most marketable security ownerships, an investor’s basis might endure a capital event once every couple of years. In contrast, passthrough entity basis adjustments must be routinely made throughout the course of every ownership year. The majority of those adjustments require a wealth of tax knowledge and sophistication.

Without going into detail, the basis of passthrough entities must be adjusted annually for the entities’ income and losses. It must also be adjusted for capital contributions (which generally increase tax basis) and distributions (which generally decrease tax basis). Aside from those adjustments, partnerships and S corporations each have their own unique set of rules for basis computations. Those rules — for partnerships, partnership debt, and for S corporations, shareholder debt —

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14Section 6041(a).
16Bankman, “Eight Truths About Collecting Taxes From the Cash Economy,” Tax Notes, Oct. 29, 2007, p. 506 (“It is not so easy to make use of 1099s in business, where 1099s account for only a fraction of gross sales. A simple computer check will not reveal whether income has been underreported.”).
19Id. at 436.
21See supra note 3.
22Sections 705(a), 1367(a).
23Sections 722, 358(a).
24Sections 733, 1368(b).
25Section 752.
26Section 1367(b)(2).
add a disheartening layer of complexity to the already daunting task of determining basis.

With partnerships, debt incurrence triggers intricate basis adjustments. Those rules, encapsulated in section 752 and the accompanying Treasury regulations, are some of the densest ever drafted.27 Those rules require taxpayers to have a thorough mastery of the code, including comprehension of obscure tax jargon such as “minimum gain chargeback,” “partnership minimum gain,” and “excess nonrecourse liabilities,” and leave those who either do not have that mastery or are unwilling or unable to hire tax professionals ill prepared to track and report partnership basis.

A similar indictment can be made against the S corporation basis rules. Aside from the annual adjustments referred to above, if an S corporation shareholder makes a loan to the business enterprise, a set of special basis rules apply.28 Those rules are not easily understood. Admittedly, like their partnership investor counterparts, S corporation shareholders can turn to professionals for advice, but many of them may be reluctant to bear that expense.

C. Absence of IRS Oversight

The IRS has myriad responsibilities, such as facilitating the submission of tax returns, responding to inquiries, and monitoring compliance. Filling those responsibilities has never been easy, but as the number of taxpayers swells and the complexities of the code expand, the IRS faces an increasingly difficult mission.

The IRS has had a particularly challenging time fulfilling its responsibilities because of budgetary constraints.29 Over the last several years, IRS funding has languished,30 despite an increase in the number of annual tax return submissions.31 The implications are serious: The IRS has limited resources to conduct detailed audits and even fewer resources to pursue delinquent taxpayers.

When it comes to passthrough entities, the IRS’s oversight is especially limited. Over the last decade, the number of Forms 1065 and Forms 1120 the IRS audits is miniscule.32 Because audit information is regularly published in the popular press, taxpayers know how many passthrough entities the IRS audits and likely capitalize on the lack of IRS oversight.

When it comes to passthrough entity basis reporting, oversight is particularly scant. Just as was the case with marketable securities, there is little that appears on a taxpayer’s return that indicates whether the basis figure was inflated, excessive, or large.33 (Contrast this with charitable or medical expense deductions, which, if extremely large relative to the amount of the taxpayer’s income, suggest that something may be askew.) The absence of a red flag makes the audit process a truly hit-or-miss proposition.34

Even if the IRS determines that a taxpayer misreported the basis in his passthrough entity investments, the taxpayer still has the upper hand. Under the Cohan doctrine,35 taxpayers are permitted to estimate the basis that they have in their investments. Because taxpayers have the luxury of making those estimations, that ability often safeguards taxpayers from penalties.

Consequently, with little risk of detection and an even smaller risk of additional financial burden, taxpayers can inflate their basis in their passthrough entity investments with few likely consequences. The next section of this analysis highlights the revenue loss associated with that form of noncompliance.

III. Costs of Taxpayer Noncompliance

While there is an unspoken consensus among academics and tax practitioners that taxpayers generally do not have a good command of the basis they have in their passthrough entity investments and that incorrect basis reporting is the norm rather than the exception, to date there has been little direct empirical research that documents the revenue consequences associated with passthrough basis misreporting. This section of the analysis seeks to accomplish that.

Bear in mind that a passthrough entity’s basis can play three critical roles in determining a taxpayer’s tax liabilities,36 including:

- The amount of the taxpayer’s income, suggesting that something may be askew.
- Expense deductions, which, if extremely large relative to the amount of the taxpayer’s income, suggest that something may be askew.
- Basis misreporting. This section of the analysis highlights the revenue loss associated with that form of noncompliance.

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27Reg. section 1.752-1, -2, and -3.
28See supra note 26.

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32IRS 2013 Data Book, at 22 (Mar. 2014) (indicating that the IRS audits 0.5 percent of all partnership and S corporation tax returns).
33See supra note 30.
income and losses.\textsuperscript{39} Those statistics, however, still fail to document taxpayers’ basis reporting practices regarding their passthrough entity investments.

To determine taxpayers’ basis reporting practices, we instead turn to data collected by the Taxpayer Compliance Measurement Program (TCMP) and the National Research Program (NRP).\textsuperscript{40} Data collected by those programs generate a measurement known as the tax gap, defined as the difference between tax revenues actually collected in any given year and the amount that should be collected if taxpayers fully complied with the tax laws.\textsuperscript{41} For tax year 2006 (the last year a detailed examination was conducted), the IRS estimated the federal (gross) tax gap to be $450 billion, for a voluntary compliance rate of 83.1 percent of the total true tax liability.\textsuperscript{42} Although most hard and steadfast conclusions from that tax gap study are difficult to make, one conclusion is not: The so-called net misreporting percentage (NMP)\textsuperscript{43} for

<table>
<thead>
<tr>
<th>Type of Income</th>
<th>Net Misreporting Percentage</th>
<th>Percentage of Tax Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subject to \textit{substantial} information reporting and withholding (wages and salaries)</td>
<td>1</td>
<td>5.3</td>
</tr>
<tr>
<td>Subject to \textit{substantial} information reporting (pensions and annuities, unemployment compensation, dividends, interest, Social Security benefits)</td>
<td>8</td>
<td>5.8</td>
</tr>
<tr>
<td>Subject to \textit{some} information reporting (deductions, exemptions, partnerships and S corporation income, capital gains, alimony income)</td>
<td>11</td>
<td>30.9</td>
</tr>
<tr>
<td>Subject to \textit{little or no} information reporting (non-farm proprietor income, other income, rents and royalties, farmland income, Form 4797 income, adjustments)</td>
<td>56</td>
<td>58.0</td>
</tr>
</tbody>
</table>


\textsuperscript{43}To illustrate, suppose that unreported income equals $20 and reported income equals $80. Then the NMP equals $(20/ (20 + 80))$, or 20 percent.
differently income sources — which measures the unreported (or misreported) income as a fraction of the estimated true income — is appreciably less when subject to third-party reporting and comparably higher when it has “transaction invisibility,” or is largely an absence of third-party information reporting (see Table 1).

To date, the NRP has not attempted to determine the NMP for capital gains. At least four prior studies, however, have attempted to isolate the NMP for capital gains. While each study finds a different NMP for capital gains — namely, 32, 25, 7, and 22.6 — the findings are generally consistent with those of 2006 tax gap estimates in Table 1, in which there was little or no third-party reporting.

Building on the findings of the four foregoing studies, we make three critical assumptions to provide updated overall estimates of the basis misreporting tax gap for capital gains. First, we assume that the NMP has a lower bound of 5 percent and an upper bound of 40 percent, with an intermediate level of 20 percent. Those bounds are based on the previous IRS estimates of NMPs by income category, as well as the estimates of other researchers.

Second, we assume that those NMPs apply to all capital gains reported on Form 1040, line 13. For the years 2001 to 2011, those reported amounts vary considerably, and average (in current dollars) $433.7 billion. Third, to calculate the lost tax revenues because of basis misrepresentation, we use the standard capital gains tax rate of 15 percent that applied over that time period.

Our resulting estimates are in Table 2. The tax gap’s size correlates with increases in the amount of reported capital gains and, especially, with increases in the NMP. For example, in 2007 reported capital gains totaled $895.7 billion. Even with a low NMP (say, 5 percent), the resulting tax gap is $7.1 billion. If a higher NMP of 20 percent is used, as suggested by several previous studies, the tax gap is $33.6 billion. The upper bound estimate (40 percent) generates an even higher tax gap of $89.6 billion.

Which NMP estimate seems most likely to be accurate? It is of course impossible to answer that question definitively. For purposes of that analysis, we assume that the average NMP of the four prior studies (32, 25, 7, and 22.6 percent) or 21.7 percent is accurate, and we use it to determine the capital gains tax gap. We believe that percentage figure is conservative, particularly because third-party tax basis reporting has historically been absent.

### Table 2. Estimates of Tax Basis Misreporting Tax Gap, by Net Misreporting Percentage ($ billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Reported Capital Gains</th>
<th>5%</th>
<th>20%</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>325.2</td>
<td>2.6</td>
<td>12.2</td>
<td>32.5</td>
</tr>
<tr>
<td>2002</td>
<td>238.4</td>
<td>1.9</td>
<td>8.9</td>
<td>23.8</td>
</tr>
<tr>
<td>2003</td>
<td>294.0</td>
<td>2.3</td>
<td>11.0</td>
<td>29.4</td>
</tr>
<tr>
<td>2004</td>
<td>471.7</td>
<td>3.7</td>
<td>17.7</td>
<td>47.2</td>
</tr>
<tr>
<td>2005</td>
<td>663.1</td>
<td>5.2</td>
<td>24.9</td>
<td>66.3</td>
</tr>
<tr>
<td>2006</td>
<td>771.0</td>
<td>6.1</td>
<td>28.9</td>
<td>77.1</td>
</tr>
<tr>
<td>2007</td>
<td>895.7</td>
<td>7.1</td>
<td>33.6</td>
<td>89.6</td>
</tr>
<tr>
<td>2008</td>
<td>466.6</td>
<td>3.7</td>
<td>17.5</td>
<td>46.7</td>
</tr>
<tr>
<td>2009</td>
<td>231.2</td>
<td>1.8</td>
<td>8.7</td>
<td>23.1</td>
</tr>
<tr>
<td>2010</td>
<td>363.8</td>
<td>2.9</td>
<td>13.6</td>
<td>36.4</td>
</tr>
<tr>
<td>2011</td>
<td>375.3</td>
<td>3.0</td>
<td>14.1</td>
<td>37.5</td>
</tr>
<tr>
<td>Average</td>
<td>433.7</td>
<td>3.4</td>
<td>16.3</td>
<td>43.4</td>
</tr>
</tbody>
</table>

Note: The tax basis misreporting tax gap is calculated as: Reported Capital Gains x (NMP/(1-NMP)) x Capital Gains Tax Rate.


estimated amount of annual revenue loss attributable to overall basis misreporting can be solved using the following formula: \[ NMP = \frac{\text{Misreported Income} - \text{Reported Income}}{\text{Misreported Income} + \text{Reported Income}} \]. If we know or assume the values for NMP and Reported Income, we can solve for Misreported Income: \[ \text{Misreported Income} = \frac{\text{Reported Income} \times (NMP/(1 - NMP))}{\text{Reported Income} - NMP} \]. Applying that formula yields the following outcome: \[ \text{Misreported Income} = $433.7 \times (0.2165/1 - 0.2165), \] or $120 billion. As a result of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, the capital gains tax rate depends on a taxpayer’s adjusted gross income and is often 20 percent. Assuming 20 percent is the operative tax rate, the resulting annual tax gap is $24 billion ($120 billion x 0.2), or, for the sake of emphasis, $24,000,000,000.

We must take the projected capital gains tax gap ($24 billion) and isolate the portion attributable to taxpayers misreporting their basis in their passthrough entity investments. Available capital gain and loss data unfortunately fail to make category distinctions between and among capital asset classes (that is, whether they be equity investments like stock versus some other form of capital asset ownership like a personal residence). We therefore make the following critical assumption: Taxpayer gain and loss reporting should generally correlate based on the underlying value of each asset category. By way of example, if partnerships in the United States represent 10 percent of the value of the nation’s overall assets, we would anticipate 10 percent of the reported taxpayer gain and loss to be roughly attributable to the sale or disposition of those partnership interests.

Several studies categorize asset ownership as a percentage of overall asset values in the United States. One recent study (see Table 3) indicates that 18 percent of U.S. wealth in 2010 was owned in the form of unincorporated business equity, defined as “net equity in unincorporated farm and non-farm businesses and closely-held corporations,” or, put in the vernacular of this analysis, passthrough entities. The same study indicates that the value of assets held by those passthrough entities constituted 33 percent of taxpayers’ reportable capital assets — that is, both pension assets, which give rise to ordinary income, and personal residences, which are generally excluded from the income tax base, are appropriately ignored. That being the case, if the overall revenue loss attributable to capital gains misreporting is $24 billion, we would anticipate that portion attributable to passthrough entities misreporting to be one-third of this amount, or $8 billion.

Does $8 billion of annual lost revenue justify Congress imposing an additional administrative burden in the form of information returns that would mandate basis reporting for passthrough entity investments? We think that the answer is yes. Indeed, as the next section of this analysis elaborates, Congress could easily boost compliance at a minimal administration cost to taxpayers. To date, Congress has unfortunately taken no action.

IV. Mandate Basis Information Reporting

Congress continues to put taxpayers on the quixotic mission of determining basis in their passthrough entity investments. That mission entails taxpayers knowing their initial basis, tracking and adjusting it during entity ownership, and properly recording it on its sale or disposition. Those tasks are well beyond the ability of most taxpayers, resulting in large-scale tax basis misreporting, as suggested by the estimates in the previous section. Because the status quo jeopardizes the integrity of the income tax system, this analysis advocates that Congress mandate basis information reporting for all passthrough entity investments.

While there is much speculation concerning those reforms that best increase compliance, one item remains indisputable: the use of information returns, such as the issuance of forms W-2 and 1099, constitutes one of the most effective ways to enhance compliance. When the government uses information returns, compliance rates are ordinarily high; when information returns are absent, taxpayer
compliance rates often plummet.\textsuperscript{55} The reason for increased compliance is simple: Taxpayers are more apt to be forthright if they think the government can readily check the accuracy of their submissions.\textsuperscript{56}

However, there may be limitations associated with mandated information returns. In particular, their administrative costs may significantly outweigh their benefits (that is, the additional revenue generated). The unchecked use of information returns could therefore be counterproductive, particularly in those instances when the administrative costs associated with their issuance is high and taxpayers are already compliant.

Even so, it seems likely that the benefits of mandated information returns (for example, improved compliance, larger revenues, and greater tax simplification) are significantly greater than their costs (for example, more administrative costs, especially on the passthrough entity). Congress knows from experience with the basis reporting requirements for marketable securities that the issuance of

\begin{table}
\centering
\caption{Composition of Total Household Wealth, 1983-2010 (percentage of gross assets)}
\begin{tabular}{lllllllll}
\hline
\hline
Principal residence & 30.1 & 30.2 & 29.8 & 30.4 & 29 & 28.2 & 33.5 & 32.8 & 31.3 \\
Other real estate\textsuperscript{a} & 14.9 & 14 & 14.7 & 11 & 10 & 9.8 & 11.5 & 11.3 & 11.8 \\
Unincorporated business equity\textsuperscript{b} & 18.8 & 17.2 & 17.7 & 17.9 & 17.7 & 17.2 & 17.1 & 20.1 & 18 \\
Liquid assets\textsuperscript{c} & 17.4 & 17.5 & 12.2 & 10 & 9.6 & 8.8 & 7.3 & 6.6 & 6.2 \\
Pension accounts\textsuperscript{d} & 1.5 & 2.9 & 7.2 & 9 & 11.6 & 12.3 & 11.8 & 12.1 & 15.3 \\
Financial securities\textsuperscript{e} & 4.2 & 3.4 & 5.1 & 3.8 & 1.8 & 2.3 & 2.1 & 1.5 & 1.8 \\
Corporate stock and mutual funds & 9 & 6.9 & 8.1 & 11.9 & 14.8 & 14.8 & 11.9 & 11.8 & 11.4 \\
Net equity in personal trusts & 2.6 & 3.1 & 2.7 & 3.2 & 3.8 & 4.8 & 2.9 & 2.3 & 2.4 \\
Miscellaneous assets\textsuperscript{f} & 1.3 & 4.9 & 2.5 & 2.8 & 1.5 & 1.6 & 1.8 & 1.7 & 1.7 \\
Total & 100 & 100 & 100 & 100 & 100 & 100 & 100 & 100 & 100 \\

\hline
Debt on principal residence & 6.3 & 8.6 & 9.8 & 11 & 10.7 & 9.4 & 11.6 & 11.4 & 12.9 \\
All other debt\textsuperscript{g} & 6.8 & 6.4 & 6 & 5.6 & 10.7 & 13.1 & 12.9 & 3.9 & 4.5 \\
Total debt & 13.1 & 15 & 15.7 & 16.3 & 15 & 12.5 & 15.5 & 15.3 & 17.4 \\
\hline
Selected ratios in percentage:

Debt/equity ratio & 15.1 & 17.6 & 18.7 & 19.4 & 17.6 & 14.3 & 18.4 & 18.1 & 21 \\
Debt/income ratio & 68.4 & 87.6 & 88.8 & 91.3 & 90.9 & 81.1 & 115 & 118.7 & 127 \\
Net home equity/total assets \textsuperscript{h} & 23.8 & 21.6 & 20.1 & 19.5 & 18.2 & 18.8 & 21.8 & 18.4 & 18.4 \\
Principal residence debt as a ratio to house value & 20.9 & 28.6 & 32.7 & 36 & 37 & 33.4 & 34.8 & 34.9 & 41.2 \\
Stocks, directly or indirectly owned as a ratio to total assets \textsuperscript{i} & 11.3 & 10.2 & 13.7 & 16.8 & 22.6 & 24.5 & 17.5 & 16.8 & 17.8 \\
\hline
\textsuperscript{a}In 2001, 2004, and 2007, this equals the gross value of other residential real estate plus the net equity in nonresidential real estate.
\textsuperscript{b}Net equity in unincorporated farm and non-farm businesses and closely held corporations.
\textsuperscript{c}Checking accounts, savings accounts, time deposits, money market funds, certificates of deposits, and the cash surrender value of life insurance.
\textsuperscript{d}IRAs, Keogh plans, 401(k) plans, the accumulated value of defined contribution pension plans, and other retirement accounts.
\textsuperscript{e}Corporate bonds, government bonds (including savings bonds), open-market paper, and notes.
\textsuperscript{f}Gold and other precious metals, royalties, jewelry, antiques, furs, loans to friends and relatives, future contracts, and miscellaneous assets.
\textsuperscript{g}Mortgage debt on all real property except principal residence; credit card, installment, and other consumer debt.
\textsuperscript{h}Ratio of gross value of principal residence less mortgage debt on principal residence to total assets.
\textsuperscript{i}Includes direct ownership of stock shares and indirect ownership through mutual funds, trusts, IRAs, Keogh plans, 401(k) plans, and other retirement accounts.
\end{tabular}
\end{table}
information returns that contain basis information is both cost-effective and feasible. Consequently, Congress should take immediate action to make basis reporting for passthrough entities a reality.

In weighing the advantages and disadvantages associated with expanded basis reporting, Professor Leandra Lederman in a published academic essay identifies six factors that she contends favor expanded information reporting. They are (1) arm’s-length parties, (2) bookkeeping infrastructure, (3) centralization, (4) complete reporting, (5) few alternative arrangements, and (6) contributor to the tax gap.

Insofar as passthrough entity basis reporting is concerned, all those factors are present.

Arm’s-Length Parties: While some passthrough entities may be family owned, many have non-family-member owners who are not apt to act collusively.

Bookkeeping Infrastructure: Passthrough entities often have a bookkeeping infrastructure in place (that is, resources to collect, retain, and disseminate information) that would readily facilitate the issuance of information returns.

Centralization: There are economies of scale associated with centralization, given that one party (namely, the passthrough entity) is charged with the responsibility of determining basis rather than individual taxpayers each having to endure the process of computing their basis.

Complete Reporting: Passthrough entities are already responsible for the issuance of information returns (that is, Schedule K-1); however, the reported information on those returns is incomplete, lacking a critical figure, namely, the taxpayer’s basis in the business enterprise.

Few Alternative Arrangements: Taxpayers who invest or who are active participants in passthrough entities cannot readily change their investment portfolio or reorient their activities to other business ventures.

Contributor to the Tax Gap: Existing evidence indicates that basis misreporting is a significant contributor to the nation’s tax gap.

In terms of implementation, the logistics of our proposal are straightforward. The passthrough entity would need to identify the taxpayer’s initial basis. Initial basis determinations are generally made at one of four different time periods, namely, when there is a capital contribution, purchase, gift, or bequest. In the case of capital contributions, the passthrough entity should know the contributor’s basis because it will generally equal the adjusted basis of the contributed assets. In the case of a purchase, the passthrough entity will have no independent knowledge of that information and will ordinarily have to rely on the taxpayer’s bill of sale. In the case of a gift, the basis will generally equal the donor’s basis, which, at least under the proposal, the entity should know. Finally, in the case of death, the basis of the passthrough entity will generally equal fair market value on the date of death, which will require that the passthrough entity and the decedent’s estate work together to determine it. Once the initial basis is determined, over the course of investment ownership, the passthrough entity can make necessary basis adjustments. The adjustments, including those for gains, losses, and distributions, will all be known to the passthrough entity.

In sum, because the additional revenue associated with expanded basis reporting appears to outweigh the administrative costs associated with its implementation, Congress should draft legislation akin to that of section 6045(g). Passthrough entities would then be required to track the basis investors have in their ownership interests and to annually report that information simultaneously to taxpayers and the IRS. Expanded basis information reporting of the sort proposed would prove instrumental in helping to close the nation’s tax gap.

V. Conclusion

On many occasions, Congress has been down the well-traveled compliance path of expanded information reporting — and for good reason: It is one of the few ways that Congress can simplify the administration process and simultaneously collect more revenue without raising rates or expanding the tax base. There are few other reform measures that present such unique opportunities.

If Congress continues to ignore the problem of taxpayers misreporting their basis in their passthrough entities, the problem will worsen. Over the past several decades, the number of partnerships and S corporations has increased rapidly.

58See supra text accompanying notes 4-5.
59Sections 722, 723.
60Section 1015(a). But see section 1015(a) (in the case of gifted property in which the donor’s adjusted basis exceeds the property’s fair market value, if the property is sold at a loss, the FMV of the property is its adjusted basis) and section 1015(d)(6) (requiring basis adjustment for gift tax paid related to the appreciated portion of the property).
61Section 1014(a)(1). But see section 1014(a)(2) (for estate tax purposes, if the estate elects to use the alternate valuation date, that date controls for basis determination purposes).
62See supra note 38.
Indeed, partnerships and S corporations are the choice entities for most entrepreneurs. However, most of those taxpayers do not have the background and skill set necessary to track the basis they have in their passthrough entity investments.

Rather than continue the decentralized process in which each passthrough entity investor computes individual basis, the passthrough entity itself should make those computations on behalf of its investors. The computations should be regularly shared through information returns with the government. Centralizing the basis computation process in the skilled hands of the passthrough entity will create significant economies of scale and will offer the IRS better compliance oversight.

By reducing both taxpayers’ and the IRS’s administrative compliance costs, passthrough entity basis reporting is a reform measure that should be greeted with universal political enthusiasm and graciously welcomed by the general public, if not necessarily by the passthrough entity itself. Put somewhat differently, the orchard has a lot of red apples that are ripe for picking, and there is a tool — basis reporting — that is readily at hand to facilitate their collection. It is now up to Congress to mandate their annual harvest.

### Position Announcement

**Executive Director, National Tax Association**

The Executive Director is responsible for carrying out the policies and procedures established in NTA Bylaws and by the actions of the Board of Directors.

**Duties include:**
- Strategic planning
- Oversight of the NTA office in Washington
- Organization of the annual conference and spring symposium
- Organization of special conferences
- Preparing and monitoring the budget
- General financial oversight and communication with the officers, board, and general membership
- Oversight of the general operations of the *National Tax Journal* in cooperation with the editors

Advanced degree in economics, law, accounting, public policy, or related field and 10 years of professional experience required. Additional requirements include an established record of tax policy research or experience in tax administration, experience with budget management, and excellent communication skills. Desired qualifications include fundraising and development, personnel management, conference planning, website design, and active participation in a membership organization as a board member or officer.

The Executive Director position is part time. An effort designation between 30 to 50 percent will be assigned based on candidate qualifications and interest.

A detailed statement of the position description and the NTA Bylaws are available on request.

This position will remain open until filled.

Please forward a letter of interest and resume or curriculum vitae to nattax@aol.com.