TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Actions Are Needed in the Identification, Selection, and Examination of Individual Tax Returns With Rental Real Estate Activity

December 20, 2010

Reference Number: 2011-30-005

<u>Redaction Legend</u>:
2(f) = Risk Circumvention of agency Regulation or Statute

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HIGHLIGHTS

ACTIONS ARE NEEDED IN THE IDENTIFICATION, SELECTION, AND EXAMINATION OF INDIVIDUAL TAX RETURNS WITH RENTAL REAL ESTATE ACTIVITY

Highlights

Final Report issued on December 20, 2010

Highlights of Reference Number: 2011-30-005 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

The Internal Revenue Service's (IRS) Examination function plays a vital role in the IRS mission of promoting voluntary compliance with the tax law. Given the magnitude of underreporting, even small improvements in the IRS's examination of tax returns with rental real estate activity could increase taxpayer compliance and generate substantial revenue to the Federal Government to reduce the tax gap. In addition, increased tax compliance can increase the public confidence in the IRS's ability to enforce tax laws in a fair, equitable, and consistent manner.

WHY TIGTA DID THE AUDIT

This audit was conducted because in August 2008, the Government Accountability Office stated that "at least 53 percent of individual taxpayers with rental real estate activity for Tax Year 2001 misreported their rental real estate activity, resulting in an estimated $12.4 billion of net misreported income." The overall objectives of this review were to evaluate the IRS's coverage of individual tax returns with rental real estate activity and identify changes to aid in the identification, selection, and examination of tax returns with rental real estate activity.

WHAT TIGTA FOUND

The IRS should increase the number of examinations of tax returns with losses from rental real estate activity. During Fiscal Years 2008 and 2009, the IRS's rental real estate Compliance Initiative Programs (CIP) examined **********2(f)*******of the 318,339 examinations conducted by revenue agents and tax compliance officers. TIGTA projected that if the IRS increased rental real estate CIP tax returns examined from***2(f)***********, it could increase the potential tax assessments by $27.3 million over a 5-year period.

TIGTA found that the criteria used to select tax returns included in the CIPs are producing results that are more productive than tax returns selected for examination based on other criteria. TIGTA also found that requiring taxpayers with prior year unallowed passive activity losses to submit Passive Activity Loss Limitations (Form 8582) and increasing the amount of data input from tax returns to the Master File would further improve the efficiency of the programs used to select tax returns with questionable real estate activities for further examination.

WHAT TIGTA RECOMMENDED

TIGTA recommended that 1) the Director, Examination, Small Business/Self-Employed Division, conduct an analysis to determine the population of tax returns with rental real estate activity that meets the criteria for inclusion in the CIPs; 2) the Director, Media and Publications, revise the instructions for Form 8582 to require all taxpayers with prior year unallowed Passive Activity Losses to submit the form with their tax return; and 3) the Director, Customer Account Services, Wage and Investment Division, ensure the information taxpayers provide to report the net amount of income earned, or losses incurred, from being a real estate professional is transcribed.

IRS management agreed with all three recommendations. However, the IRS disagreed with the proposed monetary outcome measures. TIGTA computed the outcomes conservatively using historical data from the Examination program. TIGTA maintains that the potential $27.3 million of increased revenue over a 5-year period is reasonable considering the assumptions used to calculate the estimate.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 20, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Actions Are Needed in the Identification, Selection, and Examination of Individual Tax Returns With Rental Real Estate Activity (Audit # 200930032)

This report presents the results of our review to evaluate the Internal Revenue Service's coverage of individual tax returns with rental real estate activity and identify changes to aid in the identification, selection, and examination of tax returns with rental real estate activity. This audit was initiated as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.

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Abbreviations

AGI	Adjusted Gross Income
AIMS	Audit Information Management System
CIP	Compliance Initiative Program
DIF	Discriminant Function
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
MACS	Midwest Automated Compliance System
PAL	Passive Activity Loss
TY	Tax Year

Background

In August 2008, the Government Accountability Office stated that "at least 53 percent of individual taxpayers with rental real estate activity for Tax Year (TY) 2001 misreported their rental real estate activity, resulting in an estimated $12.4 billion of net misreported income."[1] Internal Revenue Service (IRS) data show that during TY 2001, 8.7 million (6.7 percent) of the 130 million filed individual income tax returns had rental real estate activities. Specifically, taxpayers reported net rental real estate income of approximately $47 billion on 4.2 million tax returns and $31 billion in net rental real estate losses on 4.5 million tax returns.

Prior to 1986, taxpayers were allowed to deduct from their income all of their rental real estate activity losses without any restrictions, regardless of their participation or management of the property owned.[2] This condition raised concerns regarding the significant numbers of tax shelters that allowed taxpayers to lower the amount of their taxable income. On October 22, 1986, Congress enacted The Tax Reform Act of 1986,[3] which added Internal Revenue Code (I.R.C.)[4] Section 469. This provision added Passive Activity Loss (PAL) rules that limit the taxpayer's ability to deduct losses from rental real estate activities. In general, losses generated by passive activities[5] can be deducted only from income generated by passive activities.

Taxpayers report income or losses from Rental Real Estate and Royalties on Page 1 of Supplemental Income and Loss (Schedule E). Page 2 of Schedule E is used to calculate passive and nonpassive income or losses from Partnerships, S Corporations, Estates, Trusts, and Real Estate Mortgage Investment Conduits. Figure 1 shows excerpts of the I.R.C. that describe two of the exceptions to PAL rules that Congress created with regard to rental real estate activities.

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[1] *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance* (GAO-08-956, dated August 2008).
[2] Active participation includes arranging for others to provide services or making significant management decisions. Such management decisions include: approving new tenants, deciding on rental terms, or approving capital or repair expenditures. Active participation does not require regular, continuous, and substantial involvement in real estate activities.
[3] Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 16 U.S.C., 19 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 42 U.S.C., 46 U.S.C., and 49 U.S.C.).
[4] See Appendix V for a glossary of terms.
[5] Passive activities in general are defined in I.R.C. Section 469(c)(1) as any activity - (A) which involves the conduct of any trade or business and (B) in which the taxpayer does not materially participate.

Figure 1: Exceptions to Passive Activity Losses

Exception	Rental Real Estate Activities
1	Permits a taxpayer with modified Adjusted Gross Income (AGI) of $100,000 or less, who owns at least a 10 percent interest in any rental real estate activity and has active participation in that activity, to deduct up to $25,000 of nonpassive income with that portion of the PAL.
2	Taxpayers engaged in a rental real property business may treat rental real estate activities as nonpassive if they materially participate in the rental activity and meet both of the following conditions:
	• More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates.
	• The taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

Source: I.R.C. Section 469 – Passive Activity Rules.

The United States has one of the highest tax compliance rates in the world at 83.7 percent. However, each percentage point of noncompliance costs the Federal Government approximately $21 billion, which equates to more than $345 billion in annual lost revenue. The IRS's Examination function plays a vital role in the IRS mission of promoting voluntary compliance with the tax law. The IRS's Examination policy states:

> *The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers. This requires the exercise of professional judgment in selecting sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration, in utilizing available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources.*[6]

The IRS uses computer programs to screen the more than 130 million tax returns filed each year for questionable issues that should be referred for further review by the Examination function. Tax returns selected for examination are reviewed by examiners who focus their attention on specific or a limited number of issues that the IRS believes to be questionable. There is a large variety of tax returns with rental real estate activity, and the laws pertaining to them are numerous and complex. As such, this condition requires IRS examiners to use their professional

[6] The IRS Internal Revenue Manual Section 1.2.13.1.10 (Aug 31, 2007), Policy Statement 4-21.

judgment when reviewing tax returns to determine the validity of information reported by the taxpayer.

This review was performed at the Small Business/Self-Employed Division Examination function in Lanham, Maryland, during the period February 2009 through June 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

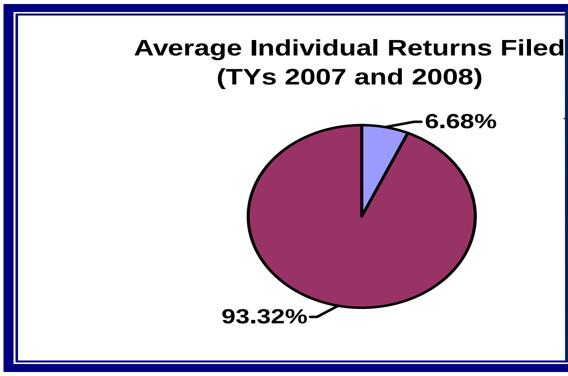
Increased Examination of Rental Real Estate Activities Could Help Reduce the Tax Gap

The IRS should increase the number of Compliance Initiative Programs (CIP) examinations of tax returns with losses from rental real estate activity. During TYs 2007 and 2008, an average of 9.6 million (6.8 percent) taxpayers filed a tax return with rental real estate activity. The IRS has two CIPs that focus on selecting and conducting examinations of tax returns *******2(f)***** *********************************2(f)** *********************************2(f)***************. Our review of the rental real estate CIP results for Fiscal Years (FY) 2008 and 2009 showed the IRS examined 3,016 (0.95 percent) of the 318,339[7] examinations conducted by revenue agents and tax compliance officers.

Individual tax returns with rental real estate activities may be selected for examination from other enforcement programs and functional offices; **************2(f)**************** *************************************2(f)************************************ *****2(f)**********. During FYs 2008 and 2009, the IRS examined ****2(f)*********** *****2(f)****************** with PAL issues. ******************2(f)************** *****2(f)***l *****2(f)***. Consequently, the examination of tax returns with these types of PAL issues could be more complicated and require more time for revenue agents and tax compliance officers to complete. Figure 2 reflects the average number of TYs 2007 and 2008 tax returns filed with rental real estate activity compared to the average number of tax returns examined during FYs 2008 and 2009.[8]

[7] These numbers represent an average of the total number of returns examined in FYs 2008 and 2009.
[8] The fiscal year period is October 1st – September 30th.

Figure 2: Proportion of Individual Income Tax Returns With Rental Real Estate Activities Filed and Examined



****2(f)*****

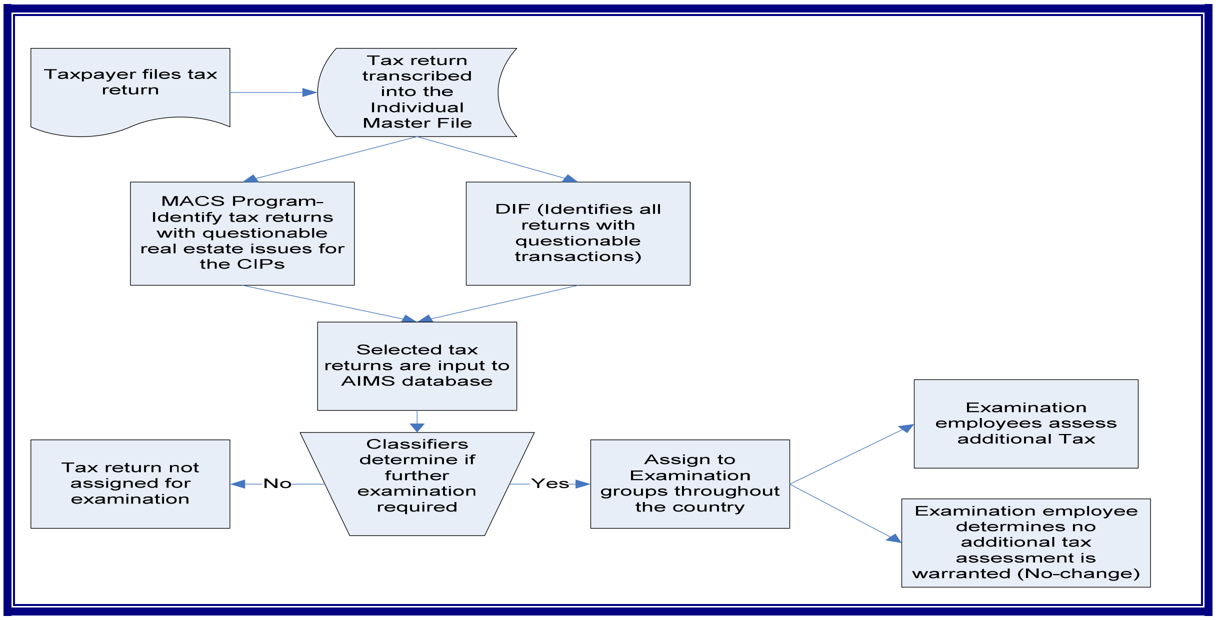
Source: Statistics of Income — TYs 2007and 2008 Individual Income Tax Returns and IRS Data Book, FYs 2008 and 2009.

The IRS generally selects tax returns for examination in the subsequent fiscal year after the tax return has been filed. Because a TY 2007 tax return would be filed in Calendar Year 2008, the first opportunity for the tax return to be examined would be in FY 2008.

The IRS uses the Midwest Automated Compliance System (MACS) to identify tax returns that contain rental real estate activity for inclusion in the CIPs. The identified tax returns are then sent to classifiers who review and select the tax returns that appear to have the most need for further examination of questionable real estate issues. These tax returns are then assigned to examination groups throughout the country to be examined. The objectives of the CIPs are to identify whether noncompliance exists, determine the reasons for noncompliance, reduce noncompliance, and make recommendations for increasing future compliance. The CIPs usually involve a study, survey, or other analysis of a group of individuals such as those involved in a specific economic activity. The IRS also uses other sources, such as the Discriminant Function (DIF) System, to identify tax returns for examination. The DIF-selected tax returns are more random and generally are selected based on historical analyses of high-risk issues on tax returns. Tax returns that are selected for examination are stored on the Audit Information Management System (AIMS) and subsequently are routed to examiners who review the tax returns for specific questionable issues. Figure 3 is a flowchart that shows the general steps the IRS uses for selecting a tax return for examination through the MACS and DIF process.

The IRS uses the CIPs to identify questionable tax returns with rental real estate activity.

Figure 3: Process for Selecting Tax Returns for Examination Through the MACS and DIF Process



Source: Our analysis of Internal Revenue Manual procedures.

During the examination of either a MACS or DIF-selected tax return, taxpayers must provide requested data to support the items in question on their tax return. If the taxpayer provides evidence to support the questionable items, the IRS will not make a change (i.e., defined as a no change to the tax liability). For items that cannot be substantiated or resolved, the examination is closed and the additional assessed tax is posted to the taxpayer's account.

Increasing examinations of tax returns with rental real estate activities could provide more productive work

Our results indicated that the MACS program used for the CIPs is selecting quality tax returns that should be examined for questionable issues. For FYs 2008 and 2009, the 2 CIPs completed **2(f)**examinations and recommended assessments totaling approximately ****2(f)****. In comparison, the IRS examined ***2(f)*** tax returns selected by the DIF and recommended assessments totaling **2(f)*****. However, analyses of the AIMS data showed that the CIP results were more productive than the examination results from the DIF-selected tax returns. For example, the CIP no-change rate was lower and the average amount of time to complete an examination (i.e., hours per tax return) was 11.17 compared to 19.53 for the DIF. The lower the hours per tax return and the higher the dollars per hour, the more efficient IRS employees are performing when conducting examinations. We believe the higher productivity of CIP results could be attributed *********************2(f)**********************.

The Examination function policy states the IRS must make the best use of available resources while, at the same time, treating taxpayers consistently and fairly. ******2(f)***************
2(f)************************
2(f)**********************
**********************2(f)*********************************.

Figure 4: Rental Real Estate Project Results Versus DIF Results

2(f)*

Source: Our analysis of the AIMS for FYs 2008 and 2009.

From our analysis of the IRS's Individual Master File data, we identified 340,558 TYs 2006 and 2007 individual tax returns which may have had questionable rental real estate losses. We selected and reviewed a statistical sample of 500[9] tax returns for questionable issues which we believe could have been considered for further review by IRS examiners. Our results showed that 82 (17 percent) of the tax returns had questionable real estate issues ********2(f)********
*************2(f)********. Specifically:

- In 59 instances, **************************2(f)*************************
  ********************************.
- In the remaining 23 instances, ****************2(f)***************************
  ***.

While the *******2(f)*************** from real estate activity do not directly indicate
************************************2(f)***********************************
************************************2(f)***********************************
************************************2(f)*************************************
[10] ********. ************************2(f)************************************
************************************2(f)*************************************

[9] Our review was limited to 491 because there were 9 tax returns that were unavailable for review.
[10] **********************2(f)***.

2(f)******************************
*******2(f)*************. However, we considered these claims questionable ***2(f)****
2(f)*****************************
2(f)*****************************
***********2(f)**We believe if these tax returns had been selected for examination, the losses claimed by taxpayers may have been disallowed.

The individual income tax is the largest single source of Federal receipts and comprises more than 71 percent of the $345 billion gross tax gap. The examination of tax returns plays a vital role in the IRS's mission of promoting voluntary compliance with the tax law. However, the current allocation of resources ************************2(f)*********************
2(f)*******************
*****************2(f)***************. Based on our results, ***********2(f)*********
***********************************2(f)***********************************
**********2(f)*******************, could be a positive step toward reducing the tax gap.
***********************************2(f)********************************
***********************************2(f)***********************************

Recommendation

Recommendation 1: The Director, Examination, Small Business/Self-Employed Division, should conduct an analysis to determine the population of tax returns with rental real estate activity that meets the criteria of the CIPs. If the results of the analysis identify a population of tax returns with questionable rental real estate activity, the Director should develop and execute a plan for increasing the volume of tax return examinations with rental real estate activity selected through the CIPs.

> ***Management's Response:*** IRS management agreed with this recommendation. In connection with the implementation and development of compliance strategies related to the recently enacted information reporting required for rental real property expense payments after 2010, the IRS will consider whether additional CIP examinations are appropriate. *******************************2(f)**********************
> **2(f)************************
> ***2(f)*************************
> **2(f)************************
> *************2(f)************. The Small Business/Self-Employed Division Field Examination function conducts examinations of rental real estate from various work streams and will continue to emphasize and encourage the National CIP as a productive work stream until the CIP results indicate that noncompliance has been addressed or the project is no longer viable.

IRS management did not agree with the proposed monetary outcome measures. While the data show that FYs 2008 and 2009 examinations of rental real estate activities CIP cases ***********************************2(f)*************************** ***********************************2(f)******************************.
Since the dollars per hour figures were calculated based on actual examinations that were ranked and selected for examination based on their potential yield, the characteristics of these cases are not necessarily an accurate representation of the entire remaining population.

Office of Audit Comment: Our calculation of the outcome measure was based on an analysis of the IRS's AIMS closed case database for FYs 2008 and 2009. We compared the historical data of DIF-selected tax returns to the rental real estate CIP tax returns and our analysis showed that the examination of cases selected through the rental real estate CIPs are more productive. We also reviewed a statistical sample of tax returns selected from the database of U.S. Individual Income Tax Returns (Form 1040) for TYs 2006 and 2007 and concluded that there is a potential universe of tax returns which could be selected for examination under the rental real estate CIPs that were not considered as part of the CIP program. We continue to believe if these unexamined tax returns had been selected for examination, they would result in productive work. We maintain that the CIP examinations are more productive than DIF-related examinations and priority should be given in Examination Policy when selecting returns for examination. Based on our analyses, the financial outcome as shown in Appendix IV is reasonable and appropriate.

Proposed Revisions to Supplemental Income and Loss (Schedule E) Will Improve the Identification of Tax Returns With Questionable Rental Real Estate Activities

The IRS has plans to revise the Schedule E for TY 2011.[11] These changes will increase the amount of information taxpayers are required to report on their tax return related to their rental real estate activities. We reviewed these changes and agree that these revisions will enable the IRS to more effectively identify questionable issues and select tax returns with real estate activity for examination.

The first proposed change will require taxpayers to provide a common description of the rental real estate property (i.e., single-family house, multi-family house, commercial property, personal use, vacation homes, land, royalties, or other). The IRS currently requires taxpayers to describe the type and location of property, but leaves the descriptions entirely up to the taxpayer. This ambiguity can cause challenges for the classifiers when attempting to identify and select tax

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[11] Schedule E is an attachment to U.S. Individual Income Tax Return (Form 1040) and is used to report income or loss from rental real estate, royalties, partnerships, S Corporations, estates, trusts, and residual interests in Real Estate Mortgage Investment Conduit.

returns for examination because taxpayers vary in their descriptions and do not use common definitions. This improvement will benefit classifiers because they will have more descriptive data which can be evaluated to identify questionable items on the tax return. For example, the reasonableness of rental property expenses for a single-family home will be different when compared to multi-family properties.

The second proposed change will require taxpayers to provide the actual number of days the rental property was occupied, and the number of days the property was used for personal purposes. Currently, Schedule E does not require the taxpayer to disclose the number of days the rental property was occupied for personal purposes. Figure 5 is an excerpt of the current Schedule E, Part I, reflecting where taxpayers are to provide this information.

Figure 5: Schedule E Instructions for Rental Use

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type and address of each **rental real estate property:**	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days **or** • 10% of the total days rented at fair rental value? (See page E-3)		Yes	No
A			A		
B			B		
C			C		

Source: IRS Schedule E (2009).

The taxpayer must prorate the total expenses based on the amount of time the property was used for personal purposes. The current "yes/no" question does not provide classifiers with specific information. Capturing the number of days the rental property is used for personal purposes, in comparison to rental use, will enable classifiers to more efficiently identify tax returns that should be examined.

Additional transcription from the forms and changes to the instructions could further enhance the selection process

Further analyses of the **2(f)**tax returns showed that transcription of additional information from Schedule E, as well as changes to Form 8582 instructions, would further improve the process for selecting and reviewing tax returns with questionable rental real estate activities. For all tax returns filed on paper, the information must be manually input into the Master File by IRS data transcribers. However, not all the information included on a tax return is transcribed. The transcribers follow specific guidelines which instruct them as to what lines on the tax return to review and input to the Master File. This information is important because only transcribed information can be utilized by the MACS program. Once these returns are identified by the MACS program, tax examiners do not always have sufficient information to evaluate the reasonableness of the real estate losses claimed by the taxpayer because the Form 8582 may not be attached to the tax return.

A change to the Form 8582 instructions requiring taxpayers with a PAL to file Form 8582 would improve return classification for Examination

For ****2(f)*************** tax returns, taxpayers did not file a Form 8582. Currently, all taxpayers have to use this form when they compute their allowable PAL for the current tax year. However, the Form 8582 instructions do not require all taxpayers to submit the form when they file their tax return. When this form is not filed and is unavailable for classifiers to review, they will be unable to assess the reasonableness of the real estate losses claimed on the tax return. This is particularly true in tax returns where there is lack of information with respect to prior year unallowed PAL carryovers. An unallowed PAL carryover is created when a taxpayer's PAL exceeds passive income in the current year. The excess PAL is unallowed but the taxpayer can carry the loss forward to the following tax year. Unallowed PAL carryovers are normally reported on Form 8582, but the instructions do not require taxpayers to file the Form 8582 with their tax return. As a result, classifiers who select these tax returns for examination are unaware of how much prior year unallowed PAL carryover is being carried forward into the current year which creates the potential for abuse. Having this information would allow classifiers to evaluate the reasonableness of the loss being deducted from current year passive income. We discussed this issue with IRS personnel who agreed that requiring taxpayers to file the Form 8582 could reduce the risk of abuse. Tax examiners would benefit from knowing if a taxpayer had a PAL carryover regardless if they had income to offset the prior year loss. Further, this change could reduce taxpayer burden because taxpayers would not have to research their records and provide the form if their tax return was selected for examination.

The transcription of taxpayers' claims to be real estate professionals would improve the selection of tax returns for examination

For ***********2(f)********** tax returns, taxpayers claimed to be real estate professionals. Taxpayers who claim to be real estate professionals are required to document, on the Schedule E, the amount of income or loss earned from all real estate activity for which the taxpayer materially participates. However, because this amount is not transcribed to the Individual Master File, the MACS program cannot identify taxpayers who have reported to be real estate professionals. Capturing this information would allow the MACS programming to evaluate the reasonableness of a taxpayer's claim of being a real estate professional. For example, our analyses showed taxpayers claimed to be a real estate professional while also reporting on their tax return that they earned significant income from wages. Real estate professionals are allowed to deduct, from their income, all their rental real estate activity losses without any restrictions. For example, our analysis of these tax returns showed 6 taxpayers claimed real estate losses in excess of $100,000. Taxpayers who do not make this designation are limited in the amount of losses that can be deducted from income. We were advised by the IRS that the cost for transcribing this information would be nominal.

When an erroneous claim is made by taxpayers, it can lead to a loss of revenue for the Federal Government. According to a prior Treasury Inspector General for Tax Administration report,[12] the tax gap was estimated at $345 billion for TY 2001. Of this amount, the IRS estimated that individuals underreported their taxes, related to rental real estate, by as much as $13 billion.

Both Congress and the President's Administration agree that a sharper focus on tax evasion is a way to reduce the tax gap. Our sample results showed taxpayers claiming to be real estate professionals deducted approximately $5 million in rental real estate activity losses that were not subject to further examination. The IRS mission is to provide American taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness. As the Government Accountability Office described in its August 2008 report, "Given the magnitude of underreporting, even small improvements in taxpayer compliance could result in substantial revenue." We believe these additional changes will improve the effectiveness of the MACS programming and further improve the efficiency of the CIPs.

The IRS estimates as much as $13 billion of the tax gap can be attributed to underreported taxes related to rental real estate activities.

Recommendations

Recommendation 2: The Director, Media and Publications, should coordinate with the Commissioner, Small Business/Self-Employed Division, to revise the instructions for Form 8582 to require all taxpayers with prior year unallowed PALs to submit the form with their tax return.

> ***Management's Response:*** IRS management agreed with this recommendation. The Media and Publications and the Small Business/Self-Employed Division will work together to revise the 2011 Instructions for Form 8582 to inform all taxpayers with prior year unallowed PAL losses to attach the form to their tax returns.

Recommendation 3: The Director, Customer Account Services, Wage and Investment Division, should ensure the information taxpayers provide to report the net amount of income earned or losses incurred from being a real estate professional is transcribed.

> ***Management's Response:*** IRS management agreed with this recommendation. The Submission Processing function will submit a Unified Work Request by June 15, 2011, with a requested implementation date of January 3, 2012. The IRS will transcribe the information taxpayers provide to report the net amount of income earned, or losses incurred, from being a real estate professional.

[12] *Additional Actions Are Needed to Effectively Address the Tax Gap* (Reference Number 2008-30-094, dated April 23, 2008).

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to evaluate the IRS's coverage of individual tax returns with rental real estate activity and to identify changes to aid in the identification, selection, and examination of tax returns with rental real estate activity. To accomplish our objective, we:

I. Reviewed the Internal Revenue Manual to evaluate how tax returns were processed, reviewed, and selected for examination.

II. Interviewed IRS management to determine what type of oversight, if any, was being performed in the rental real estate PAL area. We also obtained information to see if there were any ongoing CIPs in this area.

III. Selected a statistically valid sample of 500 tax returns from a population of 340,558 TYs 2006 and 2007 individual tax returns with rental real estate activity identified from the IRS's Individual Master File. The sampling was performed with the assistance of a qualified statistician who advised that a precision level, confidence level, and error rate would not be necessary to determine the sample size. As a result, the sample size was determined by taking into consideration the audit resources available to complete the review. We used a random stratified sampling methodology to select tax returns that met the following criteria.

   A. Tax returns with an AGI equal to or less than $100,000, rental real estate loss greater than $25,000, and excluded the filing status "married filing separately."

   B. Tax returns with an AGI greater than $150,000, rental real estate losses greater than zero, and excluded the filing status "married filing separately."

IV. To validate our sample, we compared taxpayer information from 20 tax returns in our sample to data on the Integrated Data Retrieval System and verified that they met the criteria for our sampling methodology.

V. Analyzed the AIMS closed case database for FYs 2005 through 2009. For each year, we compared the CIP selected tax returns to those selected by the DIF for the following workload indicators:

   A. Number of tax returns examined.

   B. Dollars per hour.

   C. Dollars per tax return.

D. Hours per tax return.

E. The no-change rate.

F. Length of Examination.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the Small Business/Self-Employed Division procedures and practices for evaluating individual tax returns with rental real estate activity that were processed, reviewed, and selected for examination. We evaluated these controls by interviewing management and reviewing a statistical sample of tax returns.

We also determined the reliability of the data by relying on Treasury Inspector General for Tax Administration Data Center Warehouse site procedures that ensure data received from the IRS are valid.

Appendix II

Major Contributors to This Report

Margaret Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
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Appendix III

Report Distribution List

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Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $5,454,882.46 per year, or $27,274,412.30 over a 5-year period (see page 4). The increased revenue is related to increasing the percentage of individual tax returns with rental real estate activity selected by the CIP for examination from *******************2(f)******************************. In making the projection, we assumed that the IRS would not reconsider and subsequently reduce any of the tax assessments. We also assumed that the IRS would reallocate resources assigned to complete examinations of DIF-selected tax returns to the examination of tax returns selected by the CIPs.

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with increasing the percentage of individual tax returns with rental real estate activity selected for examination, we analyzed the AIMS closed case database for the two CIPs and DIF-selected tax return examinations for FYs 2008 and 2009. From this analysis, we identified and used the following to calculate our outcome measure:

- Average number of individual tax return examinations conducted by revenue agents and tax compliance officers (FYs 2008 and 2009) = 318,339.

The CIP-selected tax returns for examination with rental real estate activity:

- ************************2(f)**
****************.[1]

- *************************2(f)***
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- ******************2(f)************.

[1] ************************2(f)************************************.

The DIF-selected tax return for examination:

- ********************2(f)***********.
- ********************2(f)***********

The increase in the number of tax returns with rental real estate activity <u>that should be examined</u> was calculated as follows:

- ************************2(f)*************************************.

The number of <u>hours required</u> to examine tax returns with rental real estate was calculated as follows:

- ******************2(f)****************.

Projected <u>yield for examination of tax returns with rental real estate activities</u> was calculated as follows:

- **********************2(f)***********.

Projected lost yield for <u>DIF examinations</u> replaced by examinations of tax returns with rental real estate activities was calculated as follows:

- *************************2(f)***********

<u>Projected net increase</u> in yield for examination of tax returns with rental real estate activities:

- ***********************2(f)*********************.

Projected net increase in yield of examinations with rental real estate activities over a <u>5-year period</u>:

- $5,454,882.46 x 5 years = $27,274,412.30 for the 5-year period.

Appendix V

Glossary of Terms

Adjusted Gross Income – A tax term for an amount used in the calculation of an individual's income tax liability. It is calculated by taking an individual's gross income and subtracting various deductions allowed by the I.R.C.

Assessments – The amount of additional tax the IRS believes the taxpayer should pay based on the results of a completed examination.

Audit Information Management System – A computer system used by the Examination functions in the Large Business and International, Small Business/Self-Employed, and Wage and Investment Divisions to control tax returns, input assessments/adjustments to the Master File, and provide management reports.

Compliance Initiative Program – The IRS defines a CIP as any activity involving contact with specific taxpayers within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance.

Data Center Warehouse – The Data Center Warehouse is a Treasury Inspector General for Tax Administration Office of Information Services function that obtains and stores numerous IRS data files and makes them available to auditors and investigators via the Treasury Inspector General for Tax Administration intranet.

Discriminant Function – A mathematical technique used to score tax returns as to examination potential. These formulas were developed based on available National Research Project data. Each tax return measured under the DIF receives a DIF score. Generally, the higher the DIF score the greater the audit potential.

Gross Tax Gap – An estimated amount determined by the IRS of tax liabilities due in a tax year before enforcement efforts and late payments are considered.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Integrated Data Retrieval System – The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Internal Revenue Code – The main body of domestic tax law of the United States including laws covering the income tax, payroll taxes, gift taxes, and estate taxes.

Master File – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Materially Participates – A taxpayer materially participates in an activity if he or she works on a regular, continuous, and substantial basis in operations. If a taxpayer does not materially participate, then all losses are passive.

Midwest Automated Compliance System – A standalone, automated database that allows immediate access to 3 years of tax return information and is used primarily for identifying and selecting tax returns for examination.

Modified Adjusted Gross Income – In United States tax law, modified AGI is the AGI modified by various adjustments. Certain adjustments allowed in arriving at the AGI are added back to arrive at the modified AGI. The AGI is modified by adding back any deductions for PALs, tuition, fees, student loan interest paid, Individual Retirement Accounts, one-half of self-employment tax, employer-paid adoption expenses, and domestic production activities. In addition, the modified AGI is raised by including interest earned from United States Savings Bonds that were used for higher education expenses, foreign earned income, and foreign housing reimbursements.

Nonpassive Income – Nonpassive income includes salary, wages, net profit from an active trade or business, and income that includes interest, corporate dividends, accumulated earnings and profits, annuities, royalties, net income from publically traded partnerships, income (including dividends) from a regulated investment company, real estate investment trust, cooperative, common trust fund, controlled foreign corporation or qualified electing fund, gain or loss from the disposition of property that produces portfolio income, gain or loss from the disposition of property held for investment, and income, gain, or loss from investment of working capital.

Partnership – The relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor, or skills and expects to share in the profit and losses of the business.

Passive Activity Loss – In general, any loss generated by a passive activity is called a PAL. A passive activity is defined in I.R.C. Section 469(c)(1) as any activity A) which involves the conduct of any trade or business and B) in which the taxpayer does not materially participate.

Real Estate Mortgage Investment Conduit – An entity formed for the purpose of holding a fixed number of mortgages secured by real property. For tax purposes, it is generally treated as a partnership.

Revenue Agent – Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

S Corporation – For United States Federal income tax purposes, an S corporation is a corporation that makes a valid election to be taxed under Subchapter S of Chapter 1 of the I.R.C. In general, S Corporations do not pay any Federal income taxes. Instead, the corporation's income or losses are divided among and passed through to its shareholders.

Tax Compliance Officer – Employees in the Examination function that primarily conduct examinations of individual taxpayers through interviews at IRS field offices.

Tax Gap – The difference between the annual Federal tax obligation and the amount of tax the taxpayer pays voluntarily and timely. The tax gap consists of those who do not file their tax returns, do not make their payments on time, and file tax returns but underreport their income or over report their expenses.

Trust – In general, a trust is a relationship in which the person holds title to property, subject to an obligation to keep or use the property for the benefit of another.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

November 8, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner /s/ Christopher Wagner
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - Actions Are Needed in the Identification, Selection and Examination of Individual Tax Returns With Rental Real Estate Activity (Audit 200930032)

Thank you for the opportunity to review your draft audit report, "Actions Are Needed in the Identification, Selection, and Examination of Individual Tax Returns With Rental Real Estate Activity."

As you reported, our National Compliance Initiative Project (CIP) on Passive Activity Losses (PAL) has been successful in selecting a high rate of noncompliant rental real estate tax returns. The results from these examinations have been more productive than comparable Discriminate Index Function (DIF) returns. However, these examinations were not necessarily more productive than other priority program return audits.

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We agree to revise the instructions for Form 8582, Passive Activity Loss Limitation, to require all taxpayers with prior year unallowed PALs to submit Form 8582 with their tax return. In addition, we will ensure the information taxpayers provide to report the net amount of income earned, or losses incurred, from being a real estate professional is transcribed. These changes will assist in selection of the most high risk returns for audit.

However, we do not agree with the proposed monetary outcome measures in the report:
Increased Revenue - Potential; $5,454,882.46 per year, or $27,274,412.30 over 5-year period.

While data shows that fiscal years 2008 and 2009 examinations of rental real estate activities CIP cases brought in more dollars per hour **2(f)** than DIF examinations **2(f)**, it is not safe to assume that the average additional CIP examination will generate **2(f)**per hour. Since the dollars per hour figures were calculated based on actual examinations that were ranked and selected for examination based on their potential yield, the characteristics of these cases are not necessarily an accurate representation of the entire remaining population. Therefore, because the results of the cases examined do not necessarily represent results from cases not selected, projecting differences in revenues across unexamined cases does not produce accurate revenue estimations.

Attached is a detailed response outlining our corrective actions. If you have questions, please contact me, or a member of your staff may contact Monica Baker, Director, Examination, at (202) 283-2659.

Attachment

Attachment

<u>RECOMMENDATION 1</u>:
The Director, Examination, Small Business/Self-Employed Division, should conduct an analysis to determine the population of tax returns with rental real estate activity that meets the criteria of the CIPs. If the results of the analysis identify a population of tax returns with questionable rental real estate activity, the Director should develop and execute a plan for increasing the volume of tax return examinations with rental real estate activity selected through the CIPs.

<u>CORRECTIVE ACTION</u>:
We agree with this recommendation. In connection with the implementation and development of compliance strategies related to the recently enacted information reporting required for rental real property expense payments after 2010, we will consider whether additional CIP examinations are appropriate. ********************2(f)***************************
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************************2(f)**************************** We will continue to emphasize and encourage the National CIP as a productive work stream until the CIP results indicate that noncompliance has been addressed or the project is no longer viable.

<u>IMPLEMENTATION DATE</u>:
July 15, 2013

<u>RESPONSIBLE OFFICIAL</u>:
Director, Examination, Exam Planning & Delivery, Small Business/Self Employed Division

<u>CORRECTIVE ACTION(S) MONITORING PLAN</u>:
The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
The Director, Media and Publications should coordinate with the Commissioner, Small Business/Self Employed Division, to revise the instructions for Form 8582 to require all taxpayers with prior year unallowed PALs to submit the Form with their tax return.

CORRECTIVE ACTION:
We agree with this recommendation. Media and Publications and Small Business/Self Employed Division will work together to revise the 2011 Instructions for Form 8582, Passive Activity Loss Limitations, to inform all taxpayers with prior year unallowed passive activity losses to attach the form to their tax returns.

IMPLEMENTATION DATE:
February 15, 2012

RESPONSIBLE OFFICIAL:
Director, Customer Assistance, Relationships and Education, Media & Publications, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN:
The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 3:
The Director, Customer Account Services, Wage and Investment Division, should ensure the information taxpayers provide to report the net amount of income earned or losses incurred from being a real estate professional is transcribed.

CORRECTIVE ACTION:
We agree with this recommendation. Submission Processing will submit a Unified Work Request (UWR) by June 15, 2011, with a requested implementation date of January 3, 2012. The IRS will transcribe the information taxpayers provide to report the net amount of income earned, or losses incurred, from being a real estate professional. Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services, submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE:
August 15, 2011

RESPONSIBLE OFFICIAL:
Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN:
The IRS will monitor this corrective action as part of our internal management system of controls.