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## Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance

James Alm  
Department of Economics  
Tulane University  
jalm@tulane.edu

Jay A. Soled  
Rutgers School of Business  
Rutgers University  
jaysoled@andromeda.rutgers.edu

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### **Abstract**

In the United States, one of the most popular ways to conduct business is to use a pass-through entity such as a partnership, limited liability company, or S corporation. Investor taxpayers in such pass-through entities commonly hold their ownership interest for years or decades. Over this lengthy period of time, a taxpayer's tax basis in the entity is subject to constant annual adjustments, which generally have no immediate tax consequences.

However, when the pass-through entity investment is later sold or liquidated, tax basis determinations are of critical importance, and these determinations enable taxpayers to calculate their concomitant gains or losses. At this pivotal juncture, accurately determining taxpayers' tax bases in these investments is highly unlikely, and the IRS's ability to detect taxpayers' tax basis reporting inaccuracies is virtually nonexistent.

This analysis examines the phenomenon of taxpayers who do not know their tax basis in pass-through entity investments and the consequences associated with such ignorance. Also provided are projected revenue losses associated with taxpayers purposefully or inadvertently inflating the tax basis that they have in their pass-through entity investments.

To curtail the projected revenue losses associated with tax basis misreporting, we propose several reform measures that Congress should adopt. Such measures include simplifying tax basis computations, enhancing information reporting, and limiting the ability of taxpayers to estimate the tax basis of their pass-through investments.

Keywords: tax basis, pass-through entities, information reporting  
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# Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance

JAMES ALM & JAY A. SOLED\*

## ABSTRACT

In the United States, one of the most popular ways to conduct business is to use a pass-through entity such as a partnership, limited liability company, or S corporation. Investor taxpayers in such pass-through entities commonly hold their ownership interest for years or decades. Over this lengthy period of time, a taxpayer's tax basis in the entity is subject to constant annual adjustments, which generally have no immediate tax consequences.

However, when the pass-through entity investment is later sold or liquidated, tax basis determinations are of critical importance, and these determinations enable taxpayers to calculate their concomitant gains or losses. At this pivotal juncture, accurately determining taxpayers' tax bases in these investments is highly unlikely, and the IRS's ability to detect taxpayers' tax basis reporting inaccuracies is virtually nonexistent.

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To curtail the projected revenue losses associated with tax basis misreporting, we propose several reform measures that Congress should adopt. Such measures include simplifying tax basis computations, enhancing information reporting, and limiting the ability of taxpayers to estimate the tax basis of their pass-through investments.

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\* James Alm is the chairman of the Department of Economics at Tulane University, and Jay A. Soled is a tax professor at Rutgers University. Both authors have written and lectured about ways to close the tax gap. The authors thank the participants of the Critical Tax Conference 2014 and the Duke Law School 2014 Tax Symposium for their helpful comments. They are also grateful to Kim Bloomquist and Alan Plumley of the IRS Office of Research for their useful suggestions. Any errors or omissions, however, are the sole responsibility of the authors.

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I. INTRODUCTION

One of the fundamental precepts of tax law is that taxpayers should know the tax basis (i.e., the after-tax investment) that they have in each of the assets that they own. Without such knowledge, the tax system is dysfunctional, taxing too much income in those instances when a taxpayer underestimates an asset’s tax basis and taxing too little income in those instances when a taxpayer overestimates an asset’s tax basis. Accurate tax basis knowledge is thus a linchpin in the nation’s income tax system, making the system both operational and equitable.<sup>1</sup>

However, when it comes to taxpayers’ command of the tax basis they have in their pass-through entity investments, namely, partnerships<sup>2</sup> and S corporations, such knowledge is sometimes scant and often nonexistent.<sup>3</sup> This absence of knowledge weighs heavily on the integrity of the entire income tax system because taxpayers must regularly estimate the tax basis that they have in their pass-through investments and the IRS has limited ability to monitor and assess the accuracy of such estimations. A direct by-product of taxpayers’ estimations and lack of IRS oversight is taxpayer noncompliance, jeopardizing both the functionality and equity of the tax system.

Indeed, in the future, this problem is apt to go from bad to worse. For starters, more taxpayers than ever are utilizing pass-through entities as their choice of entity through which to conduct business.<sup>4</sup> Second, the tax basis computation rules pertaining to these entities are

1. See I.R.C. § 1001(a) (central to the computation of realized gains and losses is an asset’s tax basis).

2. For purposes of this analysis, references to the term *partnership* include domestic general partnerships, domestic limited liability companies, domestic limited partnerships, and domestic limited liability partnerships.

3. See, e.g., U.S. GENERAL ACCOUNTING OFFICE, GAO/GGD-95-151, IRS’ PARTNERSHIP COMPLIANCE ACTIVITIES COULD BE IMPROVED 17 (June 1995), available at <http://www.gao.gov/assets/230/221308.pdf> (“[R]esource constraints have not allowed IRS to place much emphasis on partnership compliance activities.”); U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 16 (Dec. 2009), available at <http://www.gao.gov/new.items/d10195.pdf> (“S corporation stakeholder representatives told us that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules.”).

The complexity that besets this area of the law is compounded by numerous factors. Consider the fact that partners have a unitary basis in their partnership interests; that is, they have a single basis in the business enterprise even if, for example, they purchased their partnership interests for different amounts and at different times. Rev. Rul. 84-53, 1984-1 C.B. 159. This is in stark contrast to basis computations in the sphere of S corporations in which the governing rules require a separate “lot” basis approach for each acquisition. See, e.g., Treas. Reg. § 1.1012-1(c) (in the absence of specific identification, stock lots are generally considered sold on a first-in-first-out basis).

4. See, e.g., Nina Shumofsky, Lauren Lee & Ron DeCarlo, *Partnership Returns, 2010*, 32(2) SOI BULL. 79 (Fall 2012) (“For 2010, the number of partnerships increased 2.5 percent, from 3,168,728 for 2009 to 3,248,481 (Figure B). Since 2001, the number of partnerships has increased at an average annual rate of 4.7 percent.”); Hillary Duffy Parisi, *S Corporation Returns, 2006*, 29 SOI BULL. 92 (Summer 2009) (“Filings of S corporation returns have increased at an average annual rate of 8.2 percent since the enactment of the Tax Reform Act of 1986 (Figure B).”); IRS News Release, IR-2005-76 (July 25, 2005) (“Since the mid-1980s, the number of S corporations has risen rapidly, growing from 724,749 in 1985 to 3,154,377 in 2002.”). This trend of increasing pass-through entity usage is expected to continue. Brett Collins, *Projections of Federal Tax Return Filings 2011–2016*, 32 SOI BULL. 182 fig.A (Winter 2012).

becoming increasingly complex.<sup>5</sup> Third, the IRS lacks the resources to oversee taxpayer compliance.<sup>6</sup> Finally, due to a recent Supreme Court case, the statute of limitations has effectively been shortened with respect to the IRS's ability to challenge taxpayers' misreporting of the tax basis of their assets.<sup>7</sup>

There are significant implications associated with taxpayers misreporting the tax basis that they have in their pass-through entity investments. Most importantly, when taxpayers make tax basis estimations, such estimations are apt to be inflated (i.e., made in the taxpayer's favor),<sup>8</sup> resulting in significant revenue losses to the government as taxpayers report smaller gains and larger losses. Another problem is that pass-through entity investments attract taxpayers whose income is subject to higher marginal tax rates relative to the general public;<sup>9</sup> thus, noncompliance inures to those taxpayers in upper socioeconomic classes, thereby fostering economic inequity. Tax basis misreporting also undermines attempts to introduce important tax reforms such as a carryover tax basis regime or a deemed realization rule at death.<sup>10</sup> The institution of either such reform would facilitate the elimination of the current rule, which, at a taxpayer's demise, makes the tax basis of assets equal to their fair market value,<sup>11</sup> generally minimizing future taxable gains and augmenting losses associated with the disposition of inherited assets.

In the analysis below, we highlight the need for accurate tax basis reporting in taxpayers' pass-through entity investments. We proceed as follows: Part II provides background, detailing the underlying nature of the problem and its consequences.<sup>12</sup> Part III presents a series of potential legislative reforms designed to simplify the operative rules, enhance tax information returns, and curtail estimations, the institution of which would lead to greater taxpayer compliance.<sup>13</sup> Part IV explores the practical implications associated with instituting these reforms from a taxpayer's perspective, as well as that of the IRS.<sup>14</sup> Finally, Part V concludes.<sup>15</sup>

## II. BACKGROUND

While making the claim that there is a crisis in taxpayer compliance from tax basis reporting of pass-through entities is easy, proving such noncompliance is far more challenging. In order to substantiate the claim that taxpayer compliance is lackluster at best and abysmal at worse, we examine the following: (A) the complexity of the existing tax basis rules as applied to pass-through entities; (B) the lack of existing reporting standards; (C) the IRS's inability to monitor

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5. See, e.g., Howard E. Abrams, *Long Awaited Regulations Under Section 752 Provide Wrong Answers*, 44 TAX L. REV. 627 (1989) (detailing how the existing Internal Revenue Code (Code) § 752 regulations are much more complex than the predecessor regulations).

6. See INTERNAL REVENUE SERV. OVERSIGHT BD., FY2013 IRS BUDGET RECOMMENDATION SPECIAL REPORT (2011), available at <http://www.treasury.gov/irsob/reports/2012/IRSOB%20FY13%20BUDGET%20REPORT.pdf> (expressing the need for greater resources to ensure taxpayer compliance).

7. See *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1838 (2012) (holding that an overstatement of tax basis in an investment did not produce a substantial omission from gross income, and, accordingly, the applicable statute of limitations remained three years rather than being extended to six years).

8. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-603, CAPITAL GAINS TAX GAP (2006), available at <http://www.gao.gov/new.items/d06603.pdf> (in the absence of tax information returns, indicating that roughly two-thirds of taxpayers underreported their capital gains and one-third overreported).

9. See, e.g., Justin Bryan, *Individual Income Tax Returns, 2010*, 32 SOI BULL. 30 tbl.1 (Fall 2012), available at <http://www.irs.gov/PUP/taxstats/productsandpubs/12infallbulincome.pdf> (portraying the correlation between taxpayers' adjusted gross incomes and net long-term partnership and S corporation gains).

10. Several theorists support a carryover tax basis regime. See, e.g., Edward J. McCaffery, *A Progressive's Silver Linings Playbook: Repeal Stepped-Up Basis*, TAX NOTES TODAY 39-11 (2013); Calvin H. Johnson, *The Elephant in the Parlor: Repeal of the Step-Up in Basis at Death*, 121 TAX NOTES 1187 (2008). In contrast, several theorists support a deemed-at-death realization rule. See, e.g., Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993); Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of Current Proposals*, 59 VA. L. REV. 830 (1973); Thomas L. Waterbury, *A Case for Realizing Gains at Death in Terms of Family Interests*, 52 MINN. L. REV. 1 (1967).

11. I.R.C. § 1014(a).

12. See *infra* Part II.

13. See *infra* Part III.

14. See *infra* Part IV.

15. See *infra* Part V.

compliance; and (D) the projected revenue losses associated with such mischaracterizations. Together, these background items paint a bleak compliance picture in which taxpayers and their advisers frequently do not know the tax basis of their pass-through entity investments; taxpayers and their advisers deliberately misrepresent (to their advantage) the tax basis; and the IRS lacks the ability to monitor such misreporting, resulting in significant Treasury losses.

#### A. Complexity of Tax Basis Rules

Ascertaining an asset's tax basis is rarely an easy exercise.<sup>16</sup> It necessitates opening a window back in time to the exact point of acquisition, which may span months, years, or even decades. In the simplest case, in which the tax basis of an asset remains constant, say, the purchase of raw land, tax basis determinations require recording and documenting this information. However, as we and the technology we use are fallible, this information may be forgotten, lost, or accidentally destroyed, confirming that even in the simplest cases tax basis determinations predicated on psychological recollections, paper documents, and electronic hard drives are all susceptible to shortcomings, destruction, and malfunctions.

An asset's tax basis seldom remains constant, though. To the contrary, over time, an asset's tax basis regularly fluctuates, presaging additional challenges.<sup>17</sup> Consider, for example, the acquisition of a commercial building. When a taxpayer places it into service, depreciation deductions are allowed, which reduce the building's tax basis;<sup>18</sup> conversely, as improvements are made, upward tax basis adjustments are allowed.<sup>19</sup> These tax basis adjustments are among many other tax basis adjustments found in the Internal Revenue Code (Code). In order to ensure that tax basis adjustments are properly made, not only is document retention necessary, but also taxpayer knowledge of the tax law intricacies is required.

Several years ago, Congress recognized that taxpayers were regularly misreporting the tax basis that they had in their marketable securities.<sup>20</sup> This misreporting came at a steep price, likely costing the government billions of dollars of lost revenue.<sup>21</sup> Aside from the revenue loss, trying to ascertain accurate tax basis information made the annual tax-filing ritual for many ordinary taxpayers an anguishing experience.<sup>22</sup> More specifically, every April 15, taxpayers who had sold marketable securities had to reconstruct years of marketable security ownership that often included multiple capital events (e.g., stock splits, corporate spin-offs, and mergers) upon which tax basis determinations hinged.

In 2008, Congress took decisive action to help preserve the integrity of the income tax base and to simplify the tax-filing process: it mandated that third-party brokers record and maintain the tax basis that investors have in their marketable securities, including mutual funds.<sup>23</sup> On a going-forward basis, those best positioned to track and maintain tax basis information, namely, third-party brokers, would be charged with this responsibility and required to make it accessible to taxpayers and the IRS alike.<sup>24</sup>

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16. David J. Herzig, *Something from Nothing: Taxing Assets Accurately*, 2011 MICH. ST. L. REV. 1057 (2011); Joseph Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539 (2006).

17. Dodge & Soled, *supra* note 16, at 551–56.

18. I.R.C. § 1016(a)(2).

19. *Id.* § 1016(a)(1).

20. *See, e.g., JCT Sends Tax Gap Recommendations to Grassley*, TAX NOTES TODAY 203-13 (2006) (presenting an overview of taxpayer noncompliance with respect to tax basis reporting).

21. *See, e.g., Joseph M. Dodge & Jay A. Soled, Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question*, 106 TAX NOTES 453 (2005).

22. *See Frequently Asked Question: How Do I Figure the Cost Basis on a Stock Investment*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/05/costbasis.asp> (last visited Feb. 23, 2014) (“The calculation of cost basis can be complicated, however, due to the many changes that will occur in the financial markets such as splits and takeovers.”).

23. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854–55 (requiring tax basis reporting beginning in the 2011 tax year).

24. *See id.*

But on the issue of tax basis misreporting for pass-through entities, Congress has remained silent. This silence continues to plague the Code, as determining tax basis in pass-through entity investments constitutes one of the greatest challenges present in the Code. In the sections below, we outline the unique difficulties associated with tax basis determinations for the two most utilized pass-through entities, namely, (1) partnerships<sup>25</sup> and (2) S corporations.<sup>26</sup>

### 1. *Ascertaining the Tax Basis in a Partnership Interest*

In the area of tax law, courts, academicians, practitioners, and students generally agree that Subchapter K (the subchapter that details partnership taxation) and the Treasury regulations promulgated thereunder are extraordinarily complex.<sup>27</sup> Consistent with this characterization, the tax basis computation rules are described below.

There are several Code sections that play a pivotal role in determining a partner's tax basis in a partnership. At the inception of partnership ownership, two potentially relevant Code sections are 722 and 742. Code section 722 applies in those instances when a partner contributes property into a partnership in return for partnership interest.<sup>28</sup> The general rule is that a partner will obtain a tax basis equal to the adjusted tax basis of the assets contributed to the partnership.<sup>29</sup> In those instances, when a partner purchases a partnership interest, Code section 742 dictates that a partner's tax basis will generally equal the purchase price of such interest.<sup>30</sup>

Such initial tax basis determinations are the relatively easy part. Once partnership operations commence, however, two dynamic tax basis rules—one pertaining to partnership operations and the other to partnership debt—often come into play. The first is found in Code section 705. As a result of partnership operations, this section requires regular partnership upward and downward tax basis adjustments, depending upon whether the entity experiences gains or losses and/or makes distributions.<sup>31</sup> Each of these tax basis adjustments themselves is also subject to specialized rules.<sup>32</sup>

As if these tax basis adjustments specified in Code section 705 were not enough, the existence of partnership debt compounds the problem of tax basis determinations for partnership interests. The starting point for comprehending these complex rules commences with the proposition that taxpayers are accorded tax basis in assets even if they use borrowed funds to

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25. See *infra* Subpart II.A.1.

26. See *infra* Subpart II.A.2.

27. See, e.g., *Foxman v. Comm'r*, 41 T.C. 535, 551 n.9 (1964):

The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. . . . Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.

Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 108 (1991) ("In order to keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury [fashioned] a statutory and regulatory apparatus which [is] one of the most inaccessible and burdensome features of the entire tax system."); Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 452 (2001):

However, having studied closely the ALI's eulogy for Subchapter K and the accompanying literature, one detects a growing chorus: "Down with Subchapter K! Long live Subchapter S." The soundness of such proposals casts a siren-like spell on those of us drawn uncontrollably into the stormy debate. Alas, given this mounting evidence of a fatally flawed Subchapter K, I too come to bury Subchapter K.

28. I.R.C. § 722.

29. *Id.*

30. *Id.* § 742.

31. Upward basis adjustments are supposed to be made for (a) the taxable income of the partnership, (b) income of the partnership exempt from tax, and (c) the excess of depletion deductions over the basis of the property subject to depletion. *Id.* § 705(a)(1). Downward basis adjustments (but not below zero) are supposed to be made for (a) partnership distributions; (b) partnership losses; (c) partnership expenditures not deductible in computing its taxable income and not properly chargeable to the taxpayer's capital account; and (d) any partnership oil and gas property, by the amount of the partner's deduction for depletion, to the extent that such deduction does not exceed the proportionate share of the adjust basis of such property allocated to such partner. *Id.* §§ 705(a)(2), (3).

32. For example, consider the fact that when a partnership distributes partnership assets, partners must reduce their partnership tax basis by the adjusted basis of the distributed property, not by the fair market value of such property. *Id.* § 733(2).

make an acquisition.<sup>33</sup> Therefore, a taxpayer who acquires a new building using \$1 million of borrowed funds will have a tax basis in the building equal to \$1 million.<sup>34</sup> When it comes to partnership taxation, the Code attempts to replicate this outcome: if A and B form a partnership and the partnership acquires a \$1 million building using only borrowed funds, the aggregate tax basis of A's and B's partnership interests will similarly be \$1 million.<sup>35</sup>

On the surface, the introduction of partnership debt does not seem to obfuscate tax basis determinations. In practice, however, this is not the case.<sup>36</sup> Two opposing, yet parallel, rules establish the tax basis framework associated with partnership debt:

- (1) Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of partnership liabilities, shall be considered a contribution of money by the partner to the partnership.<sup>37</sup>
- (2) Any decrease in a partner's share of partnership's liabilities, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money to the partner by the partnership.<sup>38</sup>

While the foregoing two rules present their own challenges, the classification of debt as recourse or nonrecourse engenders a whole additional layer of complexity. Indeed, applicable Treasury regulations, spanning over ten single-spaced pages, spell out in minute detail the implications associated with this distinction. In the case of recourse liabilities, a constructive liquidation of the business enterprise must be imagined in which projected losses are allocated between and among the partners; the recourse liabilities are then shared in the same way that economic risk of loss would be borne, and each partner's tax basis is adjusted accordingly.<sup>39</sup> In the case of nonrecourse liabilities, a number of technical rules apply, allocating nonrecourse liabilities based upon each partner's share of (a) partnership minimum gain, (b) Code section 704(c) minimum gain, and (c) "excess nonrecourse liabilities" (i.e., not allocated under (a) or (b)). A taxpayer's partnership tax basis is correspondingly adjusted in accordance with these allocations of nonrecourse liabilities.<sup>40</sup> These computations—constituting some of the most intricate mandated under the Code—are strictly for seasoned tax practitioners to endeavor, and even these practitioners are likely to meet with mixed computational success.

To demonstrate the complexity associated with tax basis determinations, consider the following "simple" example. Assume that taxpayers Jay and Kay each contribute appreciated real estate (i.e., raw land) to a newly formed equal partnership, that the real estate Jay contributes has a \$40,000 cost basis and \$100,000 fair market value, and that the real estate Kay contributes has a \$40,000 cost basis and \$50,000 fair market value. Assume further that Jay's contributed real estate is subject to a \$50,000 nonrecourse liability that was incurred more than two years ago (thereby avoiding the possible application of the disguised sale rules under Code section 707(a)(2)(B)). Once the partnership commences operations, assume finally that the following series of events occur in the same calendar year: (a) the partnership experiences \$30,000 of losses (which, when evaluated from each partner's individual perspective, are passive in nature); (b) it obtains the sum of \$80,000 cash by obtaining additional financing on each piece of real estate

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33. *Id.* § 1012.

34. *See Crane v. Comm'r*, 331 U.S. 1, 11 (1947) ("We conclude that the proper basis . . . is the value of the property, undiminished by mortgages thereon. . .").

35. I.R.C. § 752.

36. *See, e.g.,* Philip F. Postlewaite & Tammy Jo Bialosky, *Liabilities in the Partnership Context: Policy Concerns and the Forthcoming Regulations*, 33 UCLA L. REV. 733 (1986) (discussing the complexity of taxpayers determining the tax basis that they have in their partnership interests once partnership debt is incurred).

37. I.R.C. § 752(a).

38. *Id.* § 752(b).

39. Treas. Reg. § 1.752-2(a).

40. *Id.* § 1.752-3(a).

(i.e., \$40,000 per property), and each financing is secured by a nonrecourse mortgage; and (c) the partnership distributes the proceeds from the financing proportionately to each partner.

Under these assumptions, several tax basis rules come into play. Jay's initial tax basis would start at \$40,000<sup>41</sup> and undergo the following series of adjustments: reduced by \$20,000 (net decrease in Jay's share of liabilities),<sup>42</sup> reduced by \$15,000 (proportionate share of passive losses), increased by \$60,000 (increase in Jay's share of liabilities attributable to the financing),<sup>43</sup> and reduced by \$40,000 (decrease associated with the cash distribution).<sup>44</sup> Kay's initial tax basis would likewise start at \$40,000<sup>45</sup> and undergo the following series of adjustments: increased by \$20,000 (net increase in Kay's share of liabilities),<sup>46</sup> reduced by \$15,000 (proportionate share of passive losses), increased by \$20,000 (increase in Kay's share of liabilities attributable to the financing),<sup>47</sup> and reduced by \$40,000 (decrease associated with the cash distribution).<sup>48</sup>

This "simple" example demonstrates only a small fraction of the difficulties associated with tax basis determinations of partnership interests. Indeed, partnership tax basis determinations are far more challenging when one or more of the following commonplace events occur: a partnership obtains title to multiple pieces of properties upon which liabilities rest, there is admission of new partners who contribute properties that are subject to liabilities, or there are partnership distributions of properties that are subject to liabilities.

Aside from the partnership tax basis computations themselves, there is another major source of confusion that dominates this area of the law. A central feature of partnership taxation is that taxpayers are simultaneously supposed to maintain what are known as *capital accounts*.<sup>49</sup> Capital accounts are numeric computations that are designed to represent a partner's economic stake in a partnership (i.e., the hypothetical dollar amount that a partner would be entitled to receive were the partnership to be liquidated).<sup>50</sup> Proper capital account maintenance is crucial in demonstrating whether particular partnership allocations have what is known in partnership parlance as *substantial economic effect*.<sup>51</sup> Throughout a partnership's life cycle, each partner's capital account is supposed to be regularly adjusted in a manner that, in many ways, parallels tax basis adjustments.<sup>52</sup> Due to these computational similarities, what commonly happens is that taxpayers confuse concepts of tax basis with capital accounts, mistakenly thinking that the two phrases—namely, *tax basis* and *capital account*—can be used interchangeably.<sup>53</sup> Misunderstandings of this nature contribute to taxpayers misreporting the tax basis that they have in their partnership interests.

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41. I.R.C. § 722.

42. When Jay contributes his property, he "sheds" \$20,000 of liability because the difference between the amount of the liability (\$50,000) and Jay's adjusted basis in the real estate (\$40,000) constitutes the so-called 704(c) gain under Treasury Regulation § 1.752-3(a)(2). The balance of the liability remaining (\$40,000) may be shared by the partners in accordance with their profit interests. Treas. Reg. § 1.752-3(a)(3).

43. Jay's share of Code section 704(c) gain would thereby increase from \$10,000 (see *supra* note 34) to \$50,000 (i.e., the difference between the \$90,000 overall liability on the property and its \$40,000 adjusted basis). The balance of the liability remaining (\$130,000 - \$50,000 or \$80,000) may be shared by the partners in accordance with their profit interests. Treas. Reg. § 1.752-3(a)(3).

44. I.R.C. §§ 705, 752.

45. *Id.* § 722.

46. When Kay contributes her property, under the terms of the partnership agreement, she may "absorb" her 50 percent proportionate share of the nonrecourse liability that does not constitute either so-called *minimum gain* or *Code section 704(c) gain* (i.e., .5 x \$40,000, or \$20,000). See Treas. Reg. § 1.752-3(a)(3).

47. Under the terms of the partnership agreement, Kay's adjusted basis may increase by her proportionate share of the liability that does not constitute either so-called *minimum gain* or *Code section 704(c) gain* (which, in this case, is \$20,000). See *id.*

48. I.R.C. §§ 705, 752.

49. Treas. Reg. § 1.704-1(b)(2)(iv).

50. See David Hasen, *Partnership Special Allocations Revisited*, 13 FLA. TAX REV. 349, 361 ("The idea is to ensure that capital accounts reflect the economic stakes of the partners.").

51. Treas. Reg. § 1.704-1(b)(2)(i)-(iii).

52. *Id.* § 1.704-1(b)(2)(iv)(b).

53. See ROBERT RICKETTS & LARRY TUNNELL, PRACTICAL GUIDE TO PARTNERSHIPS AND LLCs ¶ 902.06 (3d ed. 2007) ("The lesson here, however, is that because of this long history of confusion, practitioners need to be careful in relying on the Schedule K-1 information concerning the 'capital accounts' to be either tax basis or capital account information.").



## 2. *Ascertaining the Tax Basis in an S Corporation Interest*

Akin to its partnership counterpart, making S corporation tax basis determinations is a complex enterprise. Once again, the process starts off simply enough, and then complexity often besets the computational enterprise.

The initial stock basis in an S corporation is computed much the same way as the tax basis in a partnership interest, but different Code sections govern. At inception, a taxpayer's initial tax basis in an S corporation investment is typically controlled by either Code section 358 or 1012.<sup>54</sup> More specifically, taxpayers who acquire their S corporation investment by means of a capital contribution are generally accorded a tax basis in their S corporation stock equal to the adjusted bases of the contributed assets;<sup>55</sup> alternatively, taxpayers who acquire their S corporation investment by means of purchase are generally accorded a tax basis in their S corporation shares equal to the purchase price.<sup>56</sup>

Once the initial S corporation stock basis has been computed, this basis undergoes a series of annual adjustments during the S corporation's life cycle that are similar in nature to a partnership's life cycle adjustments. In particular, the Code provides a series of detailed upward tax basis adjustments<sup>57</sup> and downward tax basis adjustments.<sup>58</sup>

S corporation entity indebtedness is treated in a wholly different fashion than that applicable to partnerships. If an S corporation incurs debt, whether recourse or nonrecourse, then no tax basis adjustments are made to a taxpayer's ownership interests. But if a shareholder taxpayer lends funds to an S corporation, then the lending taxpayer's tax basis in the loan will equal the loan's face amount;<sup>59</sup> and if and when the lending taxpayer's tax basis in his S corporation stock has been reduced to zero, then his tax basis in the indebtedness may be reduced, but not below zero, by loss and deduction items that flow through the S corporation.<sup>60</sup> At a subsequent point of time, if and when the S corporation activities subsequently trigger tax basis increases, then the taxpayer's tax basis in the corporation's indebtedness owed to him will increase to its face amount before increasing his tax basis in the S corporation stock.<sup>61</sup>

Consider the same facts of the earlier problem in which Jay and Kay formed a partnership, but this time they form and operate an S corporation. Assume that they each contribute the same property (namely, Jay contributes real estate that has a \$40,000 adjusted basis and \$100,000 fair market value subject to a \$50,000 liability, and Kay contributes real estate that has an adjusted basis of \$40,000 and a \$50,000 fair market value). Once the S corporation commences operations, the S corporation experiences the following series of events: (a) it has \$30,000 of passive losses; (b) it borrows \$80,000 cash by refinancing each piece of real estate (\$40,000 per property), with each refinancing secured by a nonrecourse mortgage; and (c) it distributes the proceeds from the refinancing proportionately to each shareholder. In addition, Jay and Kay each lend the S corporation \$70,000.

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54. See I.R.C. § 358, 1012.

55. This presumes that Code § 351 applies (i.e., Code § 368(c) "control" requirements have been met) and that Code § 362(e) does not apply (i.e., the aggregate adjusted bases of the contributed assets do not exceed the aggregate fair market value of such assets).

56. I.R.C. § 1012(a).

57. Shareholders' tax basis in their ownership interests are upwardly adjusted for the following series of events: separately stated items of income, nonseparately computed income, and the excess of the deductions for depletion over the basis of the property subject to depletion. *Id.* § 1367(a)(1).

58. Shareholders' tax basis in their ownership interests are downwardly adjusted for the following series of events: distributions by the corporation (other than those treated as dividends under Code § 1368), separately stated loss and deduction items, nonseparately computed losses, expenses of the corporation that are not deductible in computing taxable income and not properly chargeable to capital account, and the amount of a shareholder's depletion deduction with respect to oil and gas wells to the extent that the deduction does not exceed the shareholder's proportionate share of the property's adjusted basis allocable to the shareholder under Code § 613. *Id.* § 1367(a)(2).

59. *Id.* § 1366(d)(1)(B).

60. *Id.* § 1367(b)(2)(A).

61. *Id.* § 1367(b)(2)(B).

Several tax basis rules accordingly come into play. Jay's tax basis would start at \$0 because the contributed real estate is subject to a liability in excess of Jay's basis (thereby triggering a \$10,000 recognition event to Jay (i.e., \$50,000 liability less the \$40,000 adjusted basis in the real estate)).<sup>62</sup> Jay's \$0 tax basis would remain constant, and his \$70,000 tax basis in his debt instrument would then endure the following series of adjustments: reduced by \$15,000 (proportionate share of passive losses) and reduced by \$40,000 (decrease associated with the cash distribution). Kay's tax basis would start at \$40,000 and experience the following two adjustments: reduced by \$15,000 (proportionate share of passive losses) and reduced by \$25,000 (decrease associated with the cash distribution), resulting in a \$0 tax basis; Kay's \$70,000 tax basis in her debt instrument would then be reduced by \$15,000 (the balance of the cash distribution).

This example, like the prior partnership example, demonstrates both the complexity and difficulties associated with S corporation tax basis determinations. Admittedly, the absence of specialized rules pertaining to recourse versus nonrecourse liabilities applicable to partnerships alleviates some of the underlying computational complexity associated with S corporation tax basis determinations.<sup>63</sup> Even so, many taxpayers still find the existing S corporation tax basis rules confusing and hard to apply.<sup>64</sup>

The foregoing partnership and S corporation examples both illustrate that tax basis determinations can be realistically handled only by a seasoned tax specialist.<sup>65</sup> No ordinary taxpayer has the time, energy, and resources to master the intricacies of tax law inherent in pass-through tax basis determinations. Note that during the course of taxpayer ownership, regular tax basis computations are not ordinarily conducted.<sup>66</sup> Years or decades may pass before tax basis determinations become vitally important (e.g., at the point of sale or liquidation). To then ascertain the taxpayer's tax basis in the pass-through entity requires an in-depth knowledge of prior and existing tax law, a good calculator, and recovering not only age-old records pertaining to capital contributions or purchases but also years of prior tax returns. The combination of all of these items falling perfectly into place is highly unlikely, suggesting that tax basis determinations are virtually impossible to reconstruct with any degree of meaningful accuracy.<sup>67</sup>

## B. Lack of Existing Reporting Standards

Empirical evidence indicates that the issuance of information returns, such as Form 1099s and W-2s, greatly enhances taxpayer compliance.<sup>68</sup> Conversely, empirical evidence demonstrates

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62. *Id.* § 357(c)(1).

63. *See, e.g.*, 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 subchapter K, the awesomely complex partnership tax provisions.”); Joseph A. Snoe, *Economic Reality or Regulatory Game Playing?: The Too Many Fictions of the § 752 Liability Allocation Regulations*, 24 SETON HALL L. REV. 1887, 1929 (1994) (“[T]he § 752 regulations, even as shortened in the final regulations, rely on too many fictions and are too difficult to understand and apply.”).

64. *See, e.g.*, Burgess J. W. Raby & William L. Raby, *S Corporation AAA and OAA—Alphabet Soup or Taxpayer Stew?*, 78 TAX NOTES 1013, 1013 (1998) (describing Subchapter S as “remarkably complicated”).

65. *See, e.g.*, Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Taxation*, 64 ALA. L. REV. 289, 316 (2012) (“Congress’s desire to provide partnerships with flexible allocation provisions, coupled with the line drawing that such an approach requires, has burdened partnerships with enormous complexity. Under the substantial economic effect safe harbor, a partnership must apply multiple layers of intricate, mathematical provisions to every allocation it makes, every year.”).

66. Prior to sale or liquidation and during the life cycle of a pass-through entity, tax basis determinations may, of course, prove critically important. This occurs if the entity experiences losses or makes distributions; in those cases, taxpayers will want to carefully monitor the tax basis of their pass-through entity investments to ensure that the losses are allowable (I.R.C. § 704(c) and I.R.C. § 1366(d)) and that the distributions do not give rise to a taxable event (I.R.C. § 731(a) and I.R.C. § 1368(b)(2)).

67. *See, e.g.*, Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL’Y, 13, 57 (1995) (“It is already widely perceived that many small (and even some large) partnerships fail to comply strictly with the detailed requirements of Subchapter K.”).

68. *See* Press Release, Internal Revenue Serv., IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study (Jan. 6, 2012) (IR-2012-4), available at <http://www.irs.gov/pub/irs-news/ir-12-004.pdf>.

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

that the absence of information returns results in lackluster taxpayer compliance.<sup>69</sup> The Code requires pass-through entities to issue tax information returns, namely, Form K-1s.<sup>70</sup> However, these tax information returns lack critical tax basis data, which raises doubts about overall taxpayer compliance in computing gains and losses.<sup>71</sup>

The two subparts below detail the information return submission processes associated with partnerships and S corporations and their respective shortcomings. More specifically, the analysis explores the following: (1) partnership Schedule K-1<sup>72</sup> and (2) S corporation Schedule K-1.<sup>73</sup>

### 1. Partnership Schedule K-1

Every year the Code obligates partnerships to make several critical tax return submissions. First, the partnership must file a Form 1065 (U.S. Return of Partnership Income), which details the income and deductions that the partnership has experienced.<sup>74</sup> Second, the partnership must issue a Schedule K-1 to each partner (and simultaneously submit each such Schedule K-1 along with the Form 1065 to the IRS).<sup>75</sup>

The Schedule K-1 is supposed to enable partners to fulfill their individual tax-filing obligations and to enable the IRS to monitor compliance. The Schedule K-1 contains the following three parts: Part I (Information About the Partnership); Part II (Information About the Partner), and Part III (Partner's Share of Current Year Income, Deductions, Credits, and Other Items).<sup>76</sup> Aside from enabling partners to populate their tax returns with income and loss figures, the information that this schedule provides is critical in enabling partners to properly adjust their tax basis in their ownership interests.

The instructions for Schedule K-1 contain a short section entitled "Basis Rules."<sup>77</sup> In this section, the instructions make the following declaration: "The Partnership is not responsible for keeping the information needed to figure the basis of your partnership interest."<sup>78</sup> Taxpayers are then informed that they "can"—not that they "must"—figure the adjusted basis of [their] partnership interest by adding items that increase [their] basis and then subtracting items that decrease [their] basis."<sup>79</sup> To assist taxpayers performing these tax basis computations, the

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wage and salary income was misreported. But amounts subject to little or no information reporting had a 56 percent net misreporting rate in 2006.

*Id.*; Karen Setze, *Taxpayers Honest When Someone's Checking, Say IRS Officials*, 111 TAX NOTES 1216, 1216 (2006) ("[R]esults 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."); INTERNAL REVENUE SERV., TAX GAP FOR THE TAX YEAR 2006 OVERVIEW, at chart 1 (2012) [hereinafter TAX YEAR 2006 OVERVIEW] available at [http://www.irs.gov/pub/newsroom/overview\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf) (estimating 1% noncompliance rate when income is subject to substantial information reporting and withholding, and 8% noncompliance rate when income is subject to substantial information reporting but not withholding); see also Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 511 (2007) ("By now almost everyone knows the tremendous bang for the buck we get with third-party reporting. Current rules impose relatively minor compliance costs and effectively capture most income.").

69. TAX YEAR 2006 OVERVIEW, *supra* note 68 (estimating 56% noncompliance rate when income is not subject to information reporting or withholding).

70. I.R.C. §§ 6031(b), 6037(b).

71. See TAX YEAR 2006 OVERVIEW, *supra* note 68.

72. See *infra* Subpart II.B.1.

73. See *infra* Subpart II.B.2.

74. I.R.C. § 6031(a).

75. *Id.* § 6031(b).

76. Part I supplies background partnership information (e.g., the partnership's employer identification number, name, and address). Part II supplies background partner information (e.g., the partner's identifying number, name, and address); this part also delineates each partner's share of nonrecourse, qualified nonrecourse financing, and recourse liabilities, information that is salient for tax basis computation purposes. Part III summarizes each partner's share of income, deductions, credits, and other items (including distributions). See INTERNAL REVENUE SERV., PARTNERSHIP SCHEDULE K-1 (2013), available at <http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf>.

77. See INTERNAL REVENUE SERV., PARTNER'S INSTRUCTIONS FOR SCHEDULE K-1 (FORM 1065), available at <http://www.irs.gov/instructions/i1065sk1/ch01.html#d0e155> (last visited Feb. 23, 2014).

78. *Id.*

79. *Id.*

instructions provide a long, detailed, twelve-step worksheet entitled “Worksheet for Adjusting the Basis of a Partner’s Interest in the Partnership.”<sup>80</sup>

## 2. S Corporation Schedule K-1

Akin to partnerships, the Code obligates S corporations to make two critical annual tax return submissions. First, S corporations must file a Form 1120S (U.S. Income Tax Return for an S Corporation), which details the income and deductions that the corporation has experienced.<sup>81</sup> Second, S corporations must issue a Schedule K-1 to each shareholder (and simultaneously submit each Schedule K-1 along with the Form 1120S to the IRS).<sup>82</sup>

In the S corporation context, Schedule K-1s are supposed to enable shareholders to fulfill their individual tax-filing obligations and to enable the IRS to monitor compliance. Paralleling a partnership Schedule K-1, the S corporation Schedule K-1 contains the following three parts:<sup>83</sup> Part I (Information About the Corporation); Part II (Information About the Shareholder), and Part III (Shareholder’s Share of Current Year Income, Deductions, Credits, and Other Items).<sup>84</sup> Aside from enabling shareholders to populate their tax returns with income and loss figures, this information is critical to enabling shareholders to properly adjust their tax basis in their stock.

The instructions for the Schedule K-1 also contain a fairly lengthy section entitled “Basis Rules.”<sup>85</sup> Within this section, the instructions make the following declaration: “You are responsible for keeping the information needed to figure the basis of your stock in the corporation.”<sup>86</sup> Taxpayers are then informed that “Schedule K-1 provides information to help you figure your stock basis at the end of each corporate tax year.”<sup>87</sup> Along with some additional instructions on how they are to compute the tax basis in their shares, shareholders are then directed to a long, detailed worksheet entitled “Worksheet for Figuring a Shareholder’s Stock Basis.”<sup>88</sup>

This subpart reveals that Schedule K-1s constitute an efficient mechanism for providing taxpayers with important, yet incomplete, annual information that enables partners and shareholders to populate their individual tax returns. However, neither the partnership Schedule K-1 nor the S corporation Schedule K-1 supplies taxpayers (or, for that matter, the IRS) with a tax basis dollar figure for their pass-through entity investments. The instructions for both schedules provide a pertinent worksheet for tax basis computations, but, as a practical matter, many taxpayers either retain tax professionals or use computer software to prepare their tax returns;<sup>89</sup> that being the case, many taxpayers do not actually take the necessary time to complete the proffered tax basis worksheets. Even if taxpayers did have the time to complete the tax basis

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80. *Id.*

81. I.R.C. § 6037(a); Treas. Reg. § 1.6012-2(h).

82. I.R.C. § 6037(b).

83. See INTERNAL REVENUE SERV., SHAREHOLDER’S SCHEDULE K-1 (2013), available at <http://www.irs.gov/pub/irs-pdf/f1120ssk.pdf>.

84. Part I supplies background corporation information (e.g., the corporation’s employer identification number, name, and address). Part II supplies background shareholder information (e.g., the shareholder’s identifying number, name, and address); this part also delineates each shareholder’s percentage ownership interest. Part III summarizes each shareholder’s share of income, deductions, credits, and other items (including amounts distributed); a great deal of this information has important tax basis implications.

85. See INTERNAL REVENUE SERV., SHAREHOLDER’S INSTRUCTIONS FOR SCHEDULE K-1 (FORM 1120S) (2013), available at <http://www.irs.gov/pub/irs-pdf/i1120ssk.pdf>.

86. *Id.*

87. *Id.*

88. *Id.*

89. INTERNAL REVENUE SERV., IRS PROPOSES NEW REGISTRATION, TESTING AND CONTINUING EDUCATION REQUIREMENTS FOR TAX RETURN PREPARERS NOT ALREADY SUBJECT TO OVERSIGHT (Jan. 4, 2010) (IR-2010-1), available at <http://www.irs.gov/uac/IRS-Proposes-New-Registration,-Testing-and-Continuing-Education-Requirements-for-Tax-Return-Preparers-Not-Already-Subject-to-Oversight> (estimating that over 80% of taxpayers use tax preparers or tax return software to prepare and submit their tax returns).

worksheets, few taxpayers or, for that matter, tax practitioners would comprehend the highly technical challenges associated with their completion.<sup>90</sup>

The salient point is that Schedule K-1s for both partnerships and S corporations lack a bottom-line tax basis dollar figure. Taxpayers are thus essentially left to their own devices to determine their tax basis for their pass-through entity investments. As the next subpart explores, taxpayer latitude of the sort just described does not portend well for the IRS in terms of monitoring compliance.<sup>91</sup>

### C. *The IRS's Inability to Monitor Taxpayer Compliance*

When it comes to tax basis determinations, there are several reasons that the IRS endures significant challenges in determining the accuracy of taxpayers' tax basis reporting positions. We categorize these reasons into two baskets: (1) the IRS is at a strategic disadvantage in monitoring taxpayer compliance; and (2) taxpayers are at a strategic advantage in obfuscating their noncompliance.

#### 1. *IRS: Strategic Disadvantage in Monitoring Taxpayer Compliance*

By way of background, one of the Code's bulwarks for ensuring taxpayer compliance is purposefully recruiting disinterested third parties, such as financial institutions and employers, to issue a set of information returns on an annual basis (e.g., Form 1099s and W-2s) to both taxpayers and the government.<sup>92</sup> Receipt of this information facilitates taxpayer compliance by providing taxpayers with information that they need to fulfill their tax return submission obligations; simultaneously, this information enables the IRS to monitor taxpayer compliance.<sup>93</sup> This cross-checking system greatly enhances overall tax compliance.<sup>94</sup>

As a result of a plethora of information returns required by the Code, the vast majority of tax audits can be conducted automatically. For example, if a taxpayer accidentally or intentionally fails to report the receipt of interest income, the IRS can readily discover this error through its matching program, send a proposed assessment via the mail to the taxpayer, and, in the large majority of cases, anticipate collection soon thereafter. This can all be handled expeditiously with minimal cost to the IRS or to the taxpayer.

But when it comes to tax basis reporting for pass-through entities, there is no disinterested third-party reporting. As previously discussed,<sup>95</sup> Schedule K-1s do not supply taxpayers and the IRS with a tax basis figure. Thus, misreported tax basis cannot be picked up automatically.

Instead, such audits are likely to be a labor-intensive endeavor<sup>96</sup> in which the IRS must examine the taxpayer's individual books and records along with years of prior individual and partnership tax returns and attempt to determine their overall accuracy.<sup>97</sup> Apart from being labor

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90. See *supra* Subpart II.A.

91. See *infra* Subpart II.C.

92. I.R.C. § 6041(a).

93. See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 697 (2007):

This "information reporting," like red light cameras, provides information to the government, and it is information that the taxpayer knows the government is receiving. Moreover, in some situations, the payor, such as an employer, must also withhold taxes from the payment and remit those taxes to the government. Withholding taxes, like speed bumps, constrain compliance with the law.

94. See TAX YEAR 2006 OVERVIEW, *supra* note 68.

95. See *supra* Subpart II.B.

96. See, e.g., Richard Lavoie, *Deputizing the Gunslingers: Co-Opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 65 (2001) ("[C]onducting audits is expensive and time consuming.").

97. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-620T, INTERNAL REVENUE SERVICE: ASSESSMENT OF THE 2009 BUDGET REQUEST, at n.14 (2008), available at <http://www.gao.gov/new.items/d08620t.pdf> ("In FY 2007 correspondence audits took, on average, 1.4 hours to conduct compared to the 30.8-hour average for field audits done at taxpayers' locations and the 7.8-hour average for field audits done at IRS offices."); see also Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 252 (1999).

Moreover, many tax practitioners believe that very few IRS auditors of partnership returns understand enough of subchapter K to challenge partnership accounting for items subject to the more complicated aspects of subchapter K and that the few auditors with deep understanding of subchapter K are assigned to very large transactions where their skills will likely produce

intensive, the revenue associated with the IRS's audit efforts will often likely be small relative to other audit exercises.<sup>98</sup>

Another problem associated with tax basis misreporting is that detection is difficult. Unlike, for example, charitable deductions or automobile expenses that may appear disproportionately large relative to a taxpayer's overall income and thereby trigger further examination,<sup>99</sup> reported tax basis dollar figures will rarely appear "wrong" or "aggressive" on their face. This failure to stand out often enables misreported tax basis figures to slip under the tax detection radar system.

Aside from the problem of detection, the complex nature of pass-through entity taxation requires a great deal of technical expertise. Although the IRS attracts many talented and capable auditors, it is unclear whether public sector remuneration attracts sufficient IRS staff with the necessary technical skills to go head-to-head with those in the well-compensated private sector.

Finally, the IRS lacks the financial resources to conduct wide-scale tax audits, a problem that puts the IRS at a strategic disadvantage relative to taxpayers. Over the last several years, the percentage of tax returns annually audited by the IRS has been low and declining;<sup>100</sup> with respect to pass-through entities, the audit rate is anemic.<sup>101</sup> As this audit rate is regularly published in the press,<sup>102</sup> taxpayers recognize that they are essentially on an honor system of sorts. Combine this with the fact that most taxpayers truly do not know the tax basis that they have in their pass-through entity investments, and a situation exists that is ripe for abuse.

## 2. Taxpayers: Strategic Advantage in Obfuscating Noncompliance

When taxpayers realize that taking an aggressive tax return position engenders little or no audit risk, they are more prone to taking such a position.<sup>103</sup> The reason is simple: the financial upside associated with taking such a position will produce tax savings, and the financial downside (e.g., payment of taxes due plus interest and penalties) is highly unlikely.<sup>104</sup> When it comes to tax basis reporting for pass-through entity investments, heads-the-taxpayer-wins-and-tails-the-government-loses outcomes predominate, casting accurate taxpayer basis reporting into deep doubt.

This implicit invitation to take aggressive tax positions is due in large part to the application of the so-called Cohan doctrine to tax basis determinations. The Cohan doctrine's genesis is found in the eponymously named *Cohan v. Commissioner* case.<sup>105</sup> In *Cohan*, taxpayer George M. Cohan, a well-known entertainer of his time and composer of such classics as "Give My Regards to Broadway," "Over There," "You're A Grand Old Flag," and "Yankee Doodle Dandy,"

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the greatest revenue yield for the government. This perception diminishes taxpayers' incentives to try their best to comply in any but the largest transactions.

98. See, e.g., Press Release, Internal Revenue Serv., IRS Offshore Programs Produce \$4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens (updated Jan. 9, 2012), available at [http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-\\$4.4-Billion-To-Date-for-Nation%E2%80%99s-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens](http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-$4.4-Billion-To-Date-for-Nation%E2%80%99s-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens) (estimating that the Voluntary Disclosure Program will produce a lot of tax revenue).

99. INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL: AUDIT ¶ 4.10.2.3 (2000) (instructing IRS auditors to identify large, unusual, or questionable items).

100. See, e.g., TIGTA, TIGTA 2013-30-078, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2012 (Aug. 23, 2013), available at <http://www.treasury.gov/tigta/auditreports/2013reports/201330078fr.pdf> (demonstrating the low number of returns audited); U.S. GEN. ACCOUNTING OFFICE, GAO 01-484, IRS AUDIT RATES: RATE FOR INDIVIDUAL TAXPAYERS HAS DECLINED BUT EFFECT ON COMPLIANCE IS UNKNOWN (Apr. 1, 2001), available at <http://www.gao.gov/new.items/d01484.pdf> (for fiscal years 1996 to 2000, depicting an average audit rate in the 1% range). See also INTERNAL REVENUE SERV., INTERNAL REVENUE SERVICE DATA BOOK 2011, at 26 tbl.9b (2012) (Publication 55B), available at <http://www.irs.gov/pub/irs-soi/11databk.pdf> (stating that the overall audit rate for 2011 was 1.11%).

101. See, e.g., INTERNAL REVENUE SERVICE, FISCAL YEAR 2011 ENFORCEMENT AND SERVICE RESULTS (2011), [http://www.irs.gov/pub/newsroom/fy\\_2011\\_enforcement\\_results\\_table.pdf](http://www.irs.gov/pub/newsroom/fy_2011_enforcement_results_table.pdf) (presenting tables indicating that over the last ten years, the audit rates for both partnerships and S corporations are well below 1%).

102. See, e.g., Robert W. Wood, *What's Your IRS Audit Risk*, FORBES (2011), available at <http://www.forbes.com/sites/robertwood/2011/03/17/whats-your-irs-audit-risk/#> (revealing the low IRS audit rate).

103. See generally Sarah B. Lawskey, *Modeling Uncertainty in Tax Law*, 65 STAN. L. REV. 241 (2013) (illustrating how taxpayers weigh their risks of noncompliance against their chances of being subject to a tax audit).

104. *Id.*

105. 39 F.2d 540 (2d Cir. 1930).

incurred a whole host of business expenses associated with his traveling around the country. Cohan deducted these business expenses, but when audited, he lacked documentation to substantiate these deductions. As a result, the IRS sought to disallow all of his putative business expenses.

The Board of Tax Appeals (now the Tax Court) sided with the IRS and disallowed all of the taxpayer's expenses.<sup>106</sup> Upon review, the Second Circuit reversed, declaring that the IRS's all-or-nothing approach was flawed. Instead, it struck a middle ground, stating thus: "[T]he Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."<sup>107</sup> In making this declaration, the Second Circuit sanctioned the use of taxpayers' estimations.

Over the ensuing years, Congress has narrowed the scope of the Cohan doctrine. For example, in cases of business travel and entertainment expenses, Congress has declared that detailed substantiation of such expenses is required and that estimations will not suffice.<sup>108</sup> Tax basis determinations, however, have not met with this fate. As a result, when completing their tax returns, taxpayers are still at liberty to use the Cohan doctrine to their strategic benefit.<sup>109</sup>

And use it to their strategic advantage they have. When it comes to tax basis determinations, there are numerous cases in which taxpayers have invoked the Cohan doctrine<sup>110</sup> and, at least in a few cases, have avoided penalty imposition.<sup>111</sup> What this means is that taxpayers are at liberty to make good faith estimates of the tax bases they have in their pass-through entity investments; and even if they estimate in their favor, there is little downside risk of penalties being imposed. At the very least, this is the public's perception of the existing state of affairs.

#### *D. Projected Revenue Losses Associated with Taxpayer Noncompliance*

Insofar as tax basis reporting is concerned, the IRS is obviously at a strategic disadvantage relative to that of taxpayers. Revenue projections confirm this point.

Generating revenue loss estimates associated with tax basis misreporting is a difficult exercise. After all, taxpayers have strong incentives to conceal inflated tax basis reporting given its associated tax savings and the legal consequences associated with detection. Indeed, estimating noncompliance of any form involves tremendous hurdles.

There have been many approaches to measuring taxpayer evasion that are subject to various and serious criticisms.<sup>112</sup> Resulting estimates from these approaches are undoubtedly imprecise. Even so, researchers have been inventive in developing accurate approaches to ascertain taxpayer evasion.

The most common of these approaches attempts to measure 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.<sup>113</sup> The tax gap is generally comprised

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106. 11 B.T.A. 743 (1928).

107. *Cohan*, 39 F.2d at 544.

108. I.R.C. § 274(d).

109. Jay A. Soled, *Exploring and (Re)defining the Boundaries of the Cohan Doctrine*, 79 TEMP. L. REV. 939 (2006).

110. *See, e.g., S. Ry. Co. v. United States*, 585 F.2d 466, 470 (Cl. Ct. 1978) ("Manifestly, the estimates made by the [the taxpayer] provide the best, and in fact the only, available source for determining the tax bases of the taxpayers' properties. Accordingly, we hold that the Cohan rule [cite omitted] should be applied in these cases. . . ."); *Zeidler v. Comm'r*, T.C. Memo. 1996-157 ("The Court, accordingly, estimates that petitioners paid \$8,250 for the house and improvements and, assuming a useful life of 27.5 years (which respondent does not dispute), allows petitioners a depreciation deduction of \$300 for each of the years at issue."); *Kerr, Jr. v. Comm'r*, T.C. Memo. 1990-155 ("Under the circumstances here, we find it appropriate to apply the Cohan rule of approximation and find petitioner has a \$1,000.00 basis.").

111. *See, e.g., William A. Powe, Trust*, T.C. Memo. 1982-488 (the Tax Court allowed the taxpayer to estimate the tax basis he had in his stock and imposed no penalties).

112. James Alm, *Measuring, Explaining, and Controlling Tax Evasion: Lessons from Theory, Experiments, and Field Studies*, 19(1) INT'L TAX & PUB. FIN. 54 (2012).

113. *See generally* Eric Toder, *What Is the Tax Gap?*, 117 TAX NOTES 367 (2007); Mark J. Mazur & Alan H. Plumley, *Understanding the Tax Gap*, 60 NAT'L TAX J. 569 (2007); Robert E. Brown & Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement*, 56 NAT'L TAX J. 689 (2003).

of three separate components: (a) the “nonfiling gap” (taxes not paid by taxpayers who do not file a return at all or who file after the due date), (b) the “underreporting gap” (taxes not paid by taxpayers who file a return and who misreport their true tax liability), and (c) the “underpayment gap” (taxes reported on filed tax returns that are not timely paid by taxpayers). Of these three components, the largest is typically the underreporting gap.<sup>114</sup> These components can be broken down further by type of tax (e.g., individual income tax, corporation income tax, employment tax, estate tax, and excise taxes), of which the individual income tax typically accounts for the largest share of the tax gap.<sup>115</sup>

The most prominent and widely cited tax gap estimate was completed by the IRS originally, in large part, through its Taxpayer Compliance Measurement Program (TCMP) and, more recently, through its National Research Program (NRP).<sup>116</sup> The original TCMP methodology consisted of a detailed line-by-line audit of individual tax returns.<sup>117</sup> These audits yielded IRS estimates of “true” reported items, which, when compared to “actual” individual reported items, allowed the IRS to generate estimates of underreported income and/or underreported taxes.<sup>118</sup> Using different research methods, the IRS also generated estimates of the nonfiling gap and the underpayment gap; for example, there has been an ongoing IRS compliance program that attempts to identify and to assess nonfilers (although its use in measuring the size of the nonfiling gap has been somewhat sporadic).<sup>119</sup>

The most recent IRS tax gap estimates for 2006 used data gathered under the NRP.<sup>120</sup> The NRP is a similar, if somewhat smaller, audit program whose intent is the same as that of the TCMP. However, instead of auditing every item on the NRP returns, greater emphasis is placed on discerning which items to examine, based on a broader array of third-party and other data about the taxpayer.<sup>121</sup>

For tax year 2006, 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.<sup>122</sup> Within the 2006 net tax gap estimate of \$450 billion, the IRS attributed \$376 billion, \$28 billion, and \$46 billion to the underreporting, nonfiling, and underpayment gaps, respectively.<sup>123</sup> The tax gap associated solely with the individual income tax was \$296 billion, consisting of an underreporting tax gap of \$235 billion, a nonfiling tax gap of \$25 billion, and an underpayment tax gap of \$36 billion.<sup>124</sup> In

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114. See Toder, *supra* note 113.

115. *Id.*

116. The National Research Program (NRP) is the successor to the Taxpayer Compliance Measurement Program (TCMP). 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 the 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>.

117. More specifically, the TCMP was a detailed line-by-line audit of a stratified random sample of approximately 50,000 individual tax returns on a three-year cycle. Each item on the return was examined by a specially trained auditor, who compared what the taxpayer actually reported with the auditor’s estimate of what should have been reported. The IRS used discriminant analysis to estimate the relationship between the likelihood of a substantial audit assessment and individual tax return characteristics, with the returns separated into classes based on such things as the amount and types of income reported; the dependent variable in this estimation was the auditor’s total recommended tax change for a return, and the independent variables were various return items reported by the taxpayer. The output of this analysis was a formula that assigned a score (known as the “DIF score”) to every tax return within the audit class, based upon the reported return characteristics. The returns with the highest DIF scores were the ones predicted to have the greatest potential for a substantial audit assessment, and these returns were then selected for possible audit consideration, subject to the availability of examination resources. See *Bologna v. Dep’t of Treasury*, 73 A.F.T.R.2d 94-1825 (1994) (“DIF scores are standards used by the IRS for the selection of tax returns for audits.”).

118. Note that there are no longer line-by-line audits in the NRP.

119. See Brian Erard & Ho Chih-Chin, *Searching for ‘Ghosts’: Who Are the Non-Filers and How Much Tax Do They Owe?*, 81 J. PUB. ECON. 25 (2001).

120. INTERNAL REVENUE SERV., TAX YEAR 2001 FEDERAL TAX GAP (EXTENDED VERSION) (IRS Office of Research, Analysis, and Statistics 2006), available at <http://www.irs.gov/pub/irs-soi/01rastg07map.pdf>.

121. Bob Brown & Drew Johns, *National Research Program: Methods and Plans*, IRS RESEARCH BULL. (2007) (Publication 1500), available at <http://www.irs.gov/pub/irs-soi/07resconfbrown.pdf>.

122. INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH: TAX YEAR 2006 TAX GAP ESTIMATION (IRS Office of Research, Analysis, and Statistics 2012), available at <http://www.irs.gov/pub/irs-soi/06rastg12overvw.pdf>.

123. *Id.*

124. *Id.*



comparison, previous IRS estimates for tax year 2001 indicated a tax gap of \$345 billion, a voluntary compliance rate of 83.7 percent, and a tax gap attributable to the individual income tax of \$245 billion, of which the underreporting tax gap was the largest component at \$197 billion.<sup>125</sup>

Of particular importance for our tax basis revenue loss estimates, the IRS studies have also estimated the underreporting of income by different income sources.<sup>126</sup> Through its audits, the IRS has established the Net Misreporting Percentage (NMP) for different sources of income, which measure the unreported (or “misreported”) income as a fraction of the estimated “true” income.<sup>127</sup> As indicated in Table 1 (for 2001),<sup>128</sup> the IRS estimated that the NMPs are lowest for income types that are matched with third-party information sources and highest for nonmatched income types. For example, the NMP for wage income (aside from information-return matching, e.g., Form W-2, which is also subject to employer withholding) is virtually zero, at 1.2 percent; in contrast, the NMPs for income that is not subject to third-party matching (e.g., nonfarm business income, farm income, other gains, and rent and royalties) all exceed 50 percent.

TABLE 1

**IRS Estimates of Net Misreporting Percentages, 2001 Tax Gap Estimates**

Source of Income	Net Misreporting Percentage (%)
Wages and Salaries	1.2
Interest and Dividends	3.7
Pensions and IRA Income	4.1
Unemployment Income	11.1
S Corps, Partnerships, and Trusts	17.8
Capital Gains	11.8
Alimony Income	7.2
Nonfarm Business Income	57.1
Farm Income	72.0
Other Gains	64.4
Rent and Royalties	51.3
Other Income	63.5

Updated IRS estimates for the 2006 tax gap (see Table 2) depict a largely similar pattern,<sup>129</sup> although the updated estimates report the NMP only for broader categories. These NMPs indicate that income misreporting is quite low when subject to third-party reporting; they also indicate that income misreporting is comparatively high when it has “transaction invisibility,” i.e., an absence of third-party information reporting (which historically has been the case with respect to tax basis reporting).

TABLE 2

**IRS Estimates of Net Misreporting Percentages, 2006 Tax Gap Estimates**

Type of Income	Net Misreporting Percentage	Percent age of Tax Gap (%)
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125. See INTERNAL REVENUE SERV., *supra* note 120.

126. See INTERNAL REVENUE SERV., TAX YEAR 2001 FEDERAL TAX GAP, *supra* note 120; INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH, *supra* note 122.

127. To illustrate, suppose that unreported income equals \$20 and reported income equals \$80. Then the NMP equals  $(\$20 / [\$20 + \$80])$ , or 20 percent.

128. See INTERNAL REVENUE SERV., *supra* note 120.

129. See INTERNAL REVENUE SERV., *supra* note 122.

	(%)	
Subject to <u>substantial</u> information reporting <u>and</u> withholding (wages and salaries)	1	5.3
Subject to <u>substantial</u> information reporting (pensions and annuities, unemployment compensation, dividends, interest, Social Security benefits)	8	5.8
Subject to <u>some</u> information reporting (deductions, exemptions, partnerships and S corporation income, capital gains, alimony income)	11	30.9
Subject to <u>little or no</u> information reporting (nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income, adjustments)	56	58.0

With this tax gap information in mind, we first estimate the overall annual revenue loss associated with tax basis misreporting.<sup>130</sup> We then attempt to estimate the specific annual revenue loss associated with taxpayers inflating the tax basis that they have in their pass-through entity investments.<sup>131</sup>

### 1. Overall Revenue Loss Associated with Tax Basis Misreporting

In terms of estimating the overall revenue loss associated with tax basis misreporting, the NRP does not currently examine taxpayers' tax basis reporting practices. Doing so would require the NRP to estimate the NMPs for a much finer breakdown of income type (e.g., capital gains realizations) than is currently feasible.

Despite the NRP's inability to make tax basis misreporting determinations, several prior studies have attempted to determine the NMP with respect to capital gain realizations. The first study used data gathered from the 1979 TCMP and focused exclusively on capital gains.<sup>132</sup> It concluded that the NMP for capital gains was 32 percent, which implies a 2001 tax gap associated with inflated tax bases to be \$23 billion. (Recall that the 2001 overall underreporting tax gap for the individual income tax was estimated to equal \$197 billion.)<sup>133</sup> The next study used data gathered from the 1988 TCMP to estimate an NMP of 25 percent, which generates a \$16 billion tax basis misreporting tax gap in 2001.<sup>134</sup> A subsequent study used the same TCMP data but estimated a much lower NMP of 7 percent, which implies a 2001 tax basis misreporting tax gap of only \$4 billion.<sup>135</sup> A final study once again used data based on the 1988 TCMP<sup>136</sup> to argue that the NMP on capital gains income was 22.6 percent.<sup>137</sup> With reported capital gains income in 2001 of \$325 billion, this NMP implies a tax basis misreporting gap of \$95 billion.

Building upon these prior approaches, we make three critical assumptions in order to provide updated overall estimates of the tax basis misreporting tax gap.

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. These bounds are based on the previous IRS

130. See *infra* Subpart II.D.1.

131. See *infra* Subpart II.D.2.

132. Thomas A. Thompson, *1979 Individual Income Tax: Capital Gains Income Reporting Noncompliance*, IRS TREND ANALYSIS AND RELATED STATISTICS (1987).

133. See INTERNAL REVENUE SERV., *supra* note 120.

134. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD- 95-39, TAX COMPLIANCE STATUS OF THE TAX YEAR 1994 COMPLIANCE MEASUREMENT PROGRAM (Dec. 30, 1994), available at <http://www.gao.gov/assets/90/84711.pdf>.

135. INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992, at 8 (IRS Office of Research, Analysis, and Statistics rev. Apr. 1996) (Publication 1415), available at <http://www.irs.gov/pub/irs-soi/p141596.pdf>.

136. Charles W. Christian, *Voluntary Compliance with the Individual Income Tax: Results from the 1988 TCMP Study*, IRS RESEARCH BULL. (rev. Sept. 1994) (Publication 1500).

137. KIM M. BLOOMQUIST, TRENDS AS CHANGES IN VARIANCE: THE CASE OF NONCOMPLIANCE (2003) (paper presented at the 2003 IRS Research Conference), available at <http://www.irs.gov/pub/irs-soi/bloomquist.pdf>.

estimates of NMPs by income category, as well as the estimates of other researchers.<sup>138</sup> They are meant to capture the wide range of estimated NMPs, including the conclusion reached by each study that the NMP is higher for nonmatched third-party income such as has historically been the case for capital gain income.

Second, we assume that these NMPs apply to all capital gains reported on IRS Form 1040 (line 13). For the years 2001 to 2011, these reported amounts vary quite considerably and average (in current dollars) \$433.7 billion.

Third, to calculate the lost tax revenues due to tax basis misrepresentation, we use the standard capital gains tax rate of 15 percent that applied over this time period.<sup>139</sup>

Our resulting estimates are provided in Table 3. The tax gap's size correlates with increases in the amount of reported capital gains, 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, then the tax gap is \$33.6 billion. The upper bound estimate (40 percent) generates an even higher tax gap of \$89.6 billion.

TABLE 3

**Estimates of Tax Basis Misreporting Tax Gap, by Net Misreporting Percentage (\$ billions)**

Year	Reported Capital Gains (billions)	Tax Basis Misreporting Tax Gap		
		Net Misreporting Percentage (NMP) (billions)		
		5%	20%	40%
2001	\$325.2	\$2.6	\$12.2	\$32.5
2002	238.4	1.9	8.9	23.8
2003	294.0	2.3	11.0	29.4
2004	471.7	3.7	17.7	47.2
2005	663.1	5.2	24.9	66.3
2006	771.0	6.1	28.9	77.1
2007	895.7	7.1	33.6	89.6
2008	466.6	3.7	17.5	46.7
2009	231.2	1.8	8.7	23.1
2010	363.8	2.9	13.6	36.4
2011	375.3	3.0	14.1	37.5
Average	433.7	3.4	16.3	43.4

138. See *supra* notes 132–37.

139. As a result of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296, the capital gains tax rate can now range as high as 20 percent.

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

Which of these estimates of the NMP seems most likely to be accurate? It is, of course, impossible to answer this question with certainty. Nevertheless, we combine the findings of the four prior studies and determine the NMP to be 21.7 percent, or the average of the following figures: 32, 25, 7 and 22.6 percent.<sup>140</sup> We believe that this is a conservative figure, particularly because third-party tax basis reporting has historically been absent. Notwithstanding our conservatism, in 2014 the estimated amount of annual revenue loss attributable to overall tax basis misreporting is a staggering \$24 billion.<sup>141</sup>

## 2. Annual Revenue Loss Associated with Pass-Through Entity Tax Basis Misreporting

Our second estimate—namely, the revenue loss associated with taxpayers inflating the tax basis that they have in their pass-through entity investments such as partnerships and S corporations—is even more challenging to compute. The reason for this challenge is the fact that available capital gain and loss data fails to make category distinctions between and among capital asset classes (i.e., whether they are equity investments (e.g., stock) versus some other form of capital asset ownership (e.g., personal residence)).

We therefore make the following critical assumption: taxpayer gain/loss reporting should generally correlate to the underlying value of each asset category. For example, if partnerships in the United States house 10 percent of the value of the nation’s overall assets, we would therefore anticipate 10 percent of the reported taxpayer gain/loss to be roughly attributable to the sale or disposition of such partnership interests.

There are several studies that categorize asset ownership as a percentage of overall asset values in the United States.<sup>142</sup> One recent study (see Table 4) indicates that 18 percent of the United States’ wealth in 2010 was owned in the form of unincorporated business equity (defined as “[n]et equity in unincorporated farm and non-farm businesses and closely-held corporations”)—in other words, pass-through entities, in the vernacular of this analysis.<sup>143</sup> The same study also indicates that the value of assets held by these pass-through 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)<sup>144</sup> are appropriately ignored.<sup>145</sup> That being the case, if the overall revenue loss attributable

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140. Note that another noncompliance study using NRP data for 2001, but focusing on the distributional effects of noncompliance also suggests a capital gains NMP of approximately 20 percent. These authors find a sharply increasing NMP with higher income; they also find significantly higher NMP for income sources that are not subject to third-party reporting requirements. In particular, the authors calculate an NMP for capital gains income of 24 percent for individuals in the 95–99 income percentile and 20 percent for individuals in the 99–99.5 income percentile. See Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 67(3) NAT’L TAX J. 397 (2010). Note that most capital gains income is reported by filers in the top income quintile. Janette Wilson & Pearson Liddell, *Sales of Capital Assets Reported on Individual Tax Returns, 2007*, 29(3) SOI BULL. 76 (2010).

141. The computation is conducted as follows. Recall that the applicable formula is  $NMP = \text{Misreported Income} / (\text{Misreported Income} + \text{Reported Income})$ . If we know (or assume) the values for NMP and Reported Income, we can then solve for Misreported Income:  $\text{Misreported Income} = \text{Reported Income} \times (NMP / (1 - NMP))$ . Applying this 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, Pub. L. No. 111-312, 124 Stat. 3296, the capital gains tax rate depends upon a taxpayer’s adjusted gross income and is often 20 percent. The resulting tax gap is thus \$24 billion ( $\$120 \text{ billion} \times .2$ ). Other tax gap estimates are made in a similar fashion.

142. See, e.g., Barry W. Johnson & Brian G. Raub, *Estimates of U.S. Personal Worth, 2001*, in COMPENDIUM OF FEDERAL ESTATE TAX AND PERSONAL WEALTH STUDIES (ch. 6), available at <http://www.irs.gov/pub/irs-soi/11pwcompench6d01.pdf>.

143. Edward N. Wolff, *The Asset Price Meltdown and the Wealth of the Middle Class*, at tbl.5 (NBER, Working Paper No. 18559, 2012).

144. I.R.C. § 121(a).

145. In 2010, since the percentage value of taxpayers’ principal residence and pension accounts were 31.3 and 15.3, respectively, taxpayers’ remaining capital assets constituted 54.4 percent of taxpayers’ overall net worth (i.e.,  $100 - 31.3 - 15.3$ ). If the value of pass-through entity investments constitutes 18 percent of taxpayers’ overall worth, then the value of such investments constitute approximately one-third of taxpayers’ reportable capital gains (i.e.,  $18/54.4$ ).

to capital gains misreporting is \$24 billion, then we would anticipate the portion attributable to pass-through entities misreporting to be one-third of this amount, or \$8 billion.<sup>146</sup>

Table 4. Composition of Total Household Wealth, 1983 – 2010 (Percent of gross assets)									
Wealth component	1983	1989	1992	1995	1998	2001	2004	2007	2010
Principal residence	30.1	30.2	29.8	30.4	29.0	28.2	33.5	32.8	31.3
Other real estate <sup>a</sup>	14.9	14.0	14.7	11.0	10.0	9.8	11.5	11.3	11.8
Unincorporated business equity <sup>b</sup>	20.1	18.0	18.8	17.2	17.7	17.9	17.7	17.2	17.1
Liquid assets <sup>c</sup>	17.4	17.5	12.2	10.0	9.6	8.8	7.3	6.6	6.2
Pension accounts <sup>d</sup>	1.5	2.9	7.2	9.0	11.6	12.3	11.8	12.1	15.3
Financial Securities <sup>e</sup>	1.8	4.2	3.4	5.1	3.8	1.8	2.3	2.1	1.5
Corporate stock & Mutual funds	11.8	11.4	9.0	6.9	8.1	11.9	14.8	14.8	11.9
Net equity in personal trusts	2.6	2.4	3.1	2.7	3.2	3.8	4.8	2.9	2.3
Miscellaneous assets <sup>f</sup>	1.7	1.3	4.9	2.5	2.8	1.8	1.8	1.8	1.7
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Debt on principal residence	12.9	6.3	8.6	9.8	11.0	10.7	9.4	11.6	11.4
All other debt <sup>g</sup>	6.8	6.4	6.0	5.3	4.2	3.1	3.9	3.9	4.5
<b>Total debt</b>	<b>13.1</b>	<b>15.0</b>	<b>15.7</b>	<b>16.3</b>	<b>15.0</b>	<b>12.5</b>	<b>15.3</b>	<b>17.4</b>	
<b>Selected ratios in percent:</b>									
Debt / equity ratio	15.1	17.6	18.7	19.4	17.6	14.3	18.4	18.1	21.0
Debt / income ratio	68.4	87.6	88.8	91.3	90.9	81.1	115.0	118.7	127.0
Net home equity / total assets <sup>h</sup>	21.4	18.4	23.8	21.6	20.1	19.5	18.2	18.8	21.8
Principal residence debt as a ratio to house value	41.2	20.9	28.6	32.7	36.0	37.0	33.4	34.8	34.9
Stocks, directly or indirectly owned as a ration to total assets <sup>i</sup>	17.8	11.3	10.2	13.7	16.8	22.6	24.5	17.5	16.8

Source: own computations from the 1983, 1989, 2001, 2004, 2007, and 2010 SCF.

a. In 2001, 2004, and 2007, this equals the gross value of other residential real estate plus the *net equity* in non-residential real estate.

b. Net equity in unincorporated farm and non-farm businesses and closely-held corporations.

c. Checking accounts, savings accounts, time deposits, money market funds, certificates of deposits, and the cash surrender value of life insurance.

d. IRAs, Keogh plans, 401(k) plans, the accumulated value of defined contribution pension plans, and other retirement accounts.

e. Corporate bonds, government bonds (including savings bonds), open-market paper, and notes.

146. See also Wilson & Liddell *supra* note 140, at 85 (table of reported sale of capital assets indicates that “net gain/loss” from “partnership, s corporation, and estate and trust interests” and “passthrough gains or losses” totaled approximately 45% of all such nets gains/losses).

- f. Gold and other precious metals, royalties, jewelry, antiques, furs, loans to friends and relatives, future contracts, and miscellaneous assets.
- g. Mortgage debt on all real property except principal residence; credit card, installment, and other consumer debt.
- h. Ratio of gross value of principal residence less mortgage debt on principal residence to total assets.
- i. Includes direct ownership of stock shares and indirect ownership through mutual funds, trusts, and IRAs, Keogh plans, 401(k) plans, and other retirement accounts.

### III. FRAMEWORK FOR LEGISLATIVE REFORM

Solutions for addressing misreported tax basis have their roots in the legislative process. Even if the IRS were much better funded and it increased the number of audits it conducts, it is unlikely that this would accomplish much as tax basis misreporting is hard to detect.<sup>147</sup> Likewise, even if the judiciary took a tougher stance against taxpayers' estimations, given the paucity of such judicial actions, most taxpayers would probably remain undeterred from taking aggressive tax basis reporting positions.

The suggested legislative reform measures detailed below are in three distinct different areas of the law: (A) simplification of partnership and S corporation tax basis computations,<sup>148</sup> (B) enhancement of tax information returns,<sup>149</sup> and (C) curtailment of tax basis estimations.<sup>150</sup>

#### A. *Simplification of Partnership and S Corporation Tax Basis Computations*

As previously pointed out, the existing tax basis rules engender significant complexity that few taxpayers and tax practitioners comprehend. That being the case, Congress should overhaul these rules. Below are proposals for the simplification of the (1) partnership tax basis rules<sup>151</sup> and (2) S corporation tax basis rules.<sup>152</sup>

##### 1. *Partnership Tax Basis Rules*

The vast majority of the partnership tax basis rules are fairly straightforward. A taxpayer essentially makes an initial investment in a partnership via a capital contribution or purchase, and this initial tax basis is annually upwardly and downwardly adjusted by the partnership's income and losses.<sup>153</sup> Complexity is introduced by Code section 752 pertaining to partnership liabilities. Accordingly, we focus our reforms on this Code section.

During the tenure of partnership interest ownership, there are two primary reasons that taxpayers seek robust tax bases in their partnership interests. First, if the partnership experiences losses, then tax basis enables taxpayers to deduct these losses.<sup>154</sup> Second, if the partnership makes cash distributions, then tax basis enables all or a portion of such distributions to be shielded from taxation.<sup>155</sup>

To augment tax basis in their partnership interests, taxpayers have historically had partnerships borrow funds; as a result, the tax bases in their partnership interests are correspondingly increased.<sup>156</sup> Conversely, as these partnership liabilities are paid off, tax bases in

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147. See INTERNAL REVENUE SERV., *supra* note 99.

148. See *infra* Subpart III.A.

149. See *infra* Subpart III.B.

150. See *infra* Subpart III.C.

151. See *infra* Subpart III.A.1.

152. See *infra* Subpart II.A.2.

153. See *supra* notes 31–32 and accompanying text.

154. I.R.C. § 704(d).

155. *Id.* § 731(a)(1).

156. *Id.* § 752(a).

their partnership interests correspondingly decrease.<sup>157</sup> These increasing and decreasing tax basis adjustments related to partnership liabilities belie their inherent complexity. The harsh reality is that virtually no taxpayer truly understands how these complex rules operate, and, even among those who do, few record their annual tax basis adjustments.

Given such unmanageable complexity, Congress should take action. It should either repeal Code section 752 in its entirety or, alternatively, limit its application strictly to real estate partnerships—those partnerships in which the majority of a partnership’s assets are real property in nature<sup>158</sup> and in which partnership borrowings are commonplace. By eliminating or greatly narrowing the scope of Code section 752, partnership tax basis rules would be far easier to understand and apply, opening the door for taxpayer compliance and IRS oversight. Admittedly, if Code section 752 were repealed or its application limited, one of the central conduit features of Subchapter K would be lost.<sup>159</sup> However, on balance, this would not significantly detract from the overall pass-through nature of partnerships.

For the vast majority of partnerships, the elimination of Code section 752 is eminently sensible as it rarely comes into play in any meaningful way.<sup>160</sup> Suppose that a partnership were to borrow funds, and suppose further that no upward partnership tax basis adjustments were afforded individual partners. While each partner would be at greater risk that partnership losses would be disallowed and partnership distributions would be taxable, as a practical reality such fears are unfounded. More specifically, if the partnership was considering borrowing funds on a recourse basis and, at the partner level, the absence of an upward tax basis adjustment associated with such partnership debt was a true concern, then the funds could be individually borrowed by each partner (admittedly, a bit cumbersome) and then contributed by each partner to the partnership. (This capital contribution would result in an upward tax basis adjustment.)<sup>161</sup> Conversely, if the partnership was considering borrowing funds on a nonrecourse basis, due to the application of the at-risk rules (assuming the borrowed funds did not constitute qualified nonrecourse financing),<sup>162</sup> then partnership losses would in all likelihood be disallowed; while partnership distributions would be more apt to be taxed, this outcome is theoretically justified as the recipient distributee partner has experienced an accretion to wealth<sup>163</sup> and is not liable for the underlying partnership debt.<sup>164</sup>

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157. *Id.* § 752(b).

158. See Shumofsky, Lee & DeCarlo, *supra* note 4, at 84 fig.E (in measuring the value of all partnership assets, 23.1% are in the nature of real estate, rental, and leasing assets), 80 fig.B (indicating that approximately half of all partnership tax return submissions relate to real estate, rental, and leasing assets).

159. Some commentators might thus consider the repeal of Code § 752 to be heresy. However, considering the number of taxpayers who engage in business through the use of partnerships (i.e., several million) and the number of taxpayers who truly understand even the basics of Code § 752 (i.e., several thousand?), there is something fundamentally askew. Tax academics can continue to pretend that tax professionals uphold the sanctity of Code § 752, but it is important to consider how many tax professionals truly have mastery over these extraordinarily arcane and complex set of rules.

160. In the sphere of partnership tax, Congress might have to adopt rules similar to Code §§ 357 and 358, applicable when taxpayers contribute property subject to liabilities to corporations. Were partners to contribute property subject to a liability to a partnership, adaptation of these rules would produce the following outcome: contributing taxpayers would generally not experience an income tax recognition event (*see* Code § 357), but they would have to correspondingly reduce their outside tax basis by the amount of the assumed debt (*see* Code § 358).

161. I.R.C. § 722.

162. *Id.* § 465(a)(1).

163. See Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 32 (1992) (“Accretions to wealth increase a person’s economic power to control society’s scarce resources.”).

164. See Calvin H. Johnson, *Don’t Let Capital Accounts Go Negative*, 129 TAX NOTES 127 (2010) (offering a proposal that would prohibit partnership capital accounts from going below zero based upon a theory that Congress is otherwise underwriting a tax shelter).

Taxing a partner upon receipt of a distribution is not punitive in nature but rather simply a timing issue. Consider a simple fact pattern in which a partnership has two equal partners, A and B, and the partnership owns a depreciated building with an adjusted basis of \$0 and a \$200 fair market value. Assume that the partnership secures \$200 vis-à-vis nonrecourse financing and distributes the \$200 proceeds in equal \$100 allotments to each partner.

Under current law, as a result of the partnership nonrecourse refinancing, A’s tax basis in his partnership interest would increase by \$100. I.R.C. § 752(a). This augmented tax basis would enable the \$100 of the refinancing proceeds that were distributed to be distributed on a tax free basis. I.R.C. § 731. Upon the subsequent disposition of the partnership building, however, each partner would experience a \$100 taxable gain ((\$200 assumed fair market value – \$0 adjusted basis) x .5). *Tufts v. Comm’r*, 461 U.S. 300 (1983).

Congress may nevertheless harbor the belief that real estate partnerships—in which the level of tax sophistication may be higher than non-real estate partnerships—require specialized tax treatment. Therefore, Congress might allow the application of Code section 752 for those partnerships electing its use. In crafting this specialized election, Congress would not have to reinvent the wheel. To the contrary, for the last several decades, Code section 897 defines a *U.S. real property holding company* to be a company in which 50 percent or more of its assets are in the nature of real property.<sup>165</sup> This definition could essentially be replicated in the Subchapter K arena such that if a partnership's real property assets constituted 50 percent or more of the overall assets of the business enterprise, Congress could allow the partnership to make an irrevocable election to apply the current version of Code section 752, enabling its partners to reap the concomitant benefits of a higher investment tax basis.<sup>166</sup>

We recommend that Congress place a premium on simplifying the partnership tax basis rules and not make any special allowances to the real estate industry. Indeed, in the absence of Code section 752, there is every reason to believe that the real estate industry will adapt: the number of real estate refinancings would probably decline; were this to happen, when the real estate industry encountered future economic calamities, the absence of refinancings would likely prove to be a helpful anchor of economic stability. If Congress lacks the political fortitude to eliminate Code section 752 in its entirety, however, limiting its application strictly to the real estate industry will prove beneficial to the vast majority of all other partnerships.

## 2. S Corporation Tax Basis Rules

The S corporation tax basis rules, like their partnership counterparts, are seemingly simple in nature. Shareholders generally make either an initial capital contribution or purchase that determines their initial tax basis in the S corporation enterprise. As the S corporation earns income or experiences losses, annual upward and downward tax basis adjustments are accordingly made.<sup>167</sup> Again, complexity arises when the issue of debt—in this case, directly to the S corporation shareholder—adds an unnecessary layer of complexity to tax basis determinations.

As previously pointed out, there are specialized rules that apply if a shareholder lends funds to an S corporation.<sup>168</sup> The shareholder's loan is treated as tantamount to an investment in the S corporation.<sup>169</sup> This treatment effectively augments the shareholder's tax basis in the enterprise and thus enables losses to flow through to the S corporation shareholder who loaned funds to the business enterprise.<sup>170</sup>

There are several problems associated with the scope of the basis-for-debt rule and its application. First, shareholders often do not understand the tax implications associated with

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Under the proposed rule, the taxpayer's tax basis in his partnership interest would not increase as a result of the partnership securing the nonrecourse financing (i.e., each partner's outside basis would \$0). That being the case, the \$100 cash distribution to each partner would be taxable. I.R.C. § 731. However, upon the partnership's subsequent disposition of the building, the partnership would experience a \$200 gain (\$200 assumed fair market value less \$0 basis), and each partner would therefore be taxable on his \$100 allotment. I.R.C. § 702. Taxpayer A would therefore increase his tax basis in his partnership interest correspondingly (I.R.C. § 705(a)(1)) and, assuming the partnership received no monetary proceeds (i.e., the purchaser took the property subject to the nonrecourse loan), A would have a \$100 offsetting loss (\$0 realized – \$100 adjusted basis) upon the partnership's liquidation. I.R.C. § 731(a)(2).

165. I.R.C. § 897(c)(2).

166. Congress would also have to institute an antiabuse rule that voided this election if—say, over a three-year time period—the average percentage of the enterprise's real estate assets did not equal or exceed the defining 50 percent threshold. *See, e.g.*, Treas. Reg. § 701-2 (setting forth antiabuse rules in the partnership arena). In those circumstances when the Code § 752 election were voided and liabilities thereby no longer available to buoy taxpayers' tax basis in their partnership interests, taxpayers whose tax basis might otherwise be reduced below zero would have to recognize income sufficient to get their tax basis equal to zero. *See, e.g.*, I.R.C. § 357(c) (in the corporate tax arena, requiring shareholders to recognize income if their tax basis in shares were theoretically ever to be below zero).

167. *See supra* notes 57–58 and accompanying text.

168. *See supra* notes 59–62 and accompanying text.

169. *See supra* notes 59–62 and accompanying text.

170. *See supra* notes 59–62 and accompanying text.



informally loaning funds to the S corporation (referred to in the Treasury regulations as *open account debt*) or with documenting such funding (referred to in the Treasury regulations as *separate written instruments*).<sup>171</sup> Second, in seeking allowable losses, shareholders commonly mischaracterize personal guarantees as equivalent to shareholder loans for tax basis computational purposes.<sup>172</sup> Third, the IRS has historically considered back-to-back loans secured from related parties as mere shareholder gamesmanship that should be disregarded, notwithstanding taxpayers' adherence to proper form.<sup>173</sup>

Aside from the confusion surrounding the rules associated with shareholder loans, shareholders ordinarily confront nettlesome bookkeeping issues associated with their application. Recall that if the S corporation experiences losses and the shareholder lacks adequate tax basis in the S corporation shares, then the tax basis of the shareholder in the debt instrument is supposed to be reduced; in the future, if the S corporation makes profits, then the tax basis in the debt instrument is supposed to be restored and only then will a shareholder's S corporation tax basis increase.<sup>174</sup> After a lengthy period of time during which the S corporation sustains losses and underlying principal payments are made on the loan outstanding, it seems unlikely that taxpayer shareholders will properly monitor the tax basis that they have in the debt instrument and that the IRS will be able to do the same. Instead, there is a much greater likelihood that taxpayer shareholders will fall short of the mark and that the IRS will not detect the derelictions.

To alleviate taxpayer and IRS confusion, the Treasury Department has recently issued a detailed set of proposed regulations pertaining to shareholder S corporation loans.<sup>175</sup> The question nevertheless remains whether the Code and the newly issued regulations justify retention of this specialized basis adjustment rule. When addressing this issue, the following must be kept in mind: taxpayers who are anxious to increase their tax basis and secure S corporation losses remain at liberty to make direct cash capital contributions; if and when such shareholders subsequently desire a return on their investment, they can always seek to have the corporation redeem all or a portion of their newly issued shares.

Given the practical alternative of utilizing capital contributions as a means of securing S corporation losses, it seems unlikely that little would be sacrificed if Congress repealed the S corporation debt basis rule. Eliminating the S corporation debt basis rule would eradicate much taxpayer confusion regarding the tax basis that taxpayers have in their S corporation investments and would greatly facilitate the IRS's ability to monitor compliance.

### *B. Enhancement of Tax Information Returns*

As currently configured, Schedule K-1s for both partnerships and S corporations convey much vital information to both taxpayers and the IRS, including a litany of items that must be reported on each investor's return (e.g., capital gains, ordinary income, capital losses, ordinary losses, and tax credits).<sup>176</sup> Many of these reported items affect taxpayers' tax basis in their pass-

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171. Compare Treas. Reg. § 1.1367-2(a)(2)(i) ("The term open account debt means shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed \$25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year."), with Treas. Reg. § 1.1367-2(a)(2)(ii) ("The shareholder advances not evidenced by a separate written instrument, net of repayments, exceeds an aggregate outstanding principal amount of \$25,000 at the close of the S corporation's taxable year, for any subsequent taxable year the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section."). See generally Kevin D. Anderson, *An Open-and-Shut Case? The Open Account Final Regs. for S Corp. Shareholders*, 110 J. TAX'N 148 (2009).

172. See, e.g., Estate of Leavitt, 875 F.2d 420 (4th Cir. 1989), *aff'g* 90 T.C. 206 (1988) (absent an actual economic outlay, shareholder guarantees do not give rise to additional shareholder basis); Rev. Rul. 70-50, 1970-1 C.B. 178.

173. Hitchens v. Comm'r, 103 T.C. 711 (1994); Griffith v. Comm'r, T.C. Memo. 1988-445; Culnen, T.C. Memo. 2000-139; Oren v. Comm'r, 357 F.2d 854 (8th Cir. 2004); Ruckriegel v. Comm'r, T.C. Memo. 2006-78.

174. See *supra* note 61 and accompanying text.

175. See Federal Reg. 134042-07 pmb. (June 6, 2012) (the new rules are designed "to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness.").

176. See Subpart II.B.

through entity investments; however, despite the comprehensive nature of Schedule K-1s, these information-rich returns do not delineate a taxpayer's overall tax basis.

There is one pivotal reason for the absence of this critical information: at the inception of entity ownership, the owner's tax basis in the pass-through business enterprise is often not readily available to the persons charged with the filing of Form 1065 and 1120S and the submission of Schedule K-1.<sup>177</sup> Pass-through entity ownership generally occurs through one of four events: capital contribution, purchase, gift, or inheritance. In the case of capital contribution, taxpayers generally receive a tax basis in the pass-through entity investment equal to the tax basis they have in the contributed assets;<sup>178</sup> in the case of a purchase, taxpayers will have a tax basis in the pass-through entity equal to the purchase price;<sup>179</sup> in the case of a gift, taxpayers will generally have a tax basis equal to the transferor's tax basis;<sup>180</sup> and finally, in the case of an inheritance, taxpayers will generally have a tax basis in their ownership interest equal to the fair market value of the pass-through entity on the decedent's date of death.<sup>181</sup>

Only in the first case, namely, capital contributions, will the pass-through entity itself necessarily have a command of the taxpayer's tax basis. This is because the investor taxpayer will have a tax basis equal to the adjusted basis of the property that the taxpayer contributed to the business enterprise.<sup>182</sup> In the context of a capital contribution, the tax basis rules thus enable the pass-through entity, were it obligated, to project the tax basis of each taxpayer investor.

In contrast to capital contribution cases, persons charged with pass-through tax return completion when taxpayers obtain their investments by purchase, gift, or inheritance will have little or no inkling of taxpayers' tax basis in their pass-through investment. More specifically, when taxpayers purchase their interests from a third party, the pass-through entity is not a party to the sale and is thus not privy to the sale price; when taxpayers acquire their interests by gift, the pass-through entity ordinarily will not know the transferor's tax basis because, under current law, it has no independent obligation to track this information or other information that may result in a tax basis adjustment;<sup>183</sup> and finally, when taxpayers acquire their interests by bequest, the pass-through entity may not know which controlling date was used for tax basis determination purposes, namely, the decedent's date of death or the so-called alternate valuation date (i.e., six months after the decedent's date of death).<sup>184</sup>

The virtue of tax information return usage is that Congress knows that disinterested third parties are generally in a better position than taxpayers themselves to supply the IRS with information.<sup>185</sup> These third parties usually have direct access to information that taxpayers may lack or fail to be forthcoming about.<sup>186</sup> The IRS can then use the supplied information to cross-check taxpayers for the accuracy of their tax return reporting positions.

When it comes to pass-through entity investments, the question is whether a third-party information return requirement can be extended to tax basis reporting. In the four contexts in which pass-through entity investment acquisitions arise, the imposition of a reporting requirement

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177. I.R.C. § 6031(a).

178. *Id.* §§ 722, 358(a).

179. *Id.* § 1012(a).

180. *Id.* § 1015(a). At the time of the gift, if the transferor's tax basis exceeds the fair market value of the property and the property is subsequently sold at a loss, the property's fair market value is to be used for computational purposes. *Id.*

181. *Id.* § 1014(a). However, if the decedent's estate made a so-called *alternative valuation election*, the date-of-death valuation may not control. *Id.* § 1014(a)(2).

182. Adjustments would have to be made to account for liabilities on the contributed properties. *See* I.R.C. § 358(d) (in the case of corporations, the tax basis of the ownership interest is reduced by the amount of liabilities assumed by the business enterprise). In those cases when the amount of the liability exceeded the aggregate basis of the taxpayer's contributed assets, gain would have to be recognized. *See id.* § 357(c) (gain recognized on corporate contributions to the extent that liabilities on the contributed property exceed the taxpayer's aggregate tax basis in the contributed assets).

183. For example, if gift tax was paid on the transfer, it may result in a possible tax basis adjustment. *Id.* § 1015(d).

184. *Id.* § 2032(a).

185. *See, e.g.,* Lederman, *supra* note 93.

186. *Id.*

is manageable. Consider each of the four pass-through entity acquisition cases seriatim, namely, capital contributions, purchases, gifts, and inheritances.

Capital contributions present the easiest case for tax basis tracking. The pass-through entity will undoubtedly know the tax basis of the contributed assets (and the associated liabilities on the contributed properties) and will therefore know with a great degree of certainty the contributing taxpayer's tax basis in the pass-through entity. (The pass-through entity must know the adjusted bases of the contributed property for depreciation and computational gain/loss purposes.)

The same ease of information culling does not exist in the other three contexts, namely, purchases, gifts, and bequests. Even so, such information deficiencies are not insurmountable.

Consider how the pass-through entity could ascertain tax basis information in cases related to purchases, gifts, and bequests. In the case of purchases, Congress could require as a condition of ownership that the pass-through entity can be given access to a bill of sale with the purchase price specified.<sup>187</sup> In the case of a gift, assuming that the entity possesses knowledge of the transferor's basis (which it presumably should know under the proposed reforms), by extension it should generally know the transferee's tax basis. Finally, in the case of a taxpayer's death, the pass-through entity will generally supply information to the decedent's estate to enable the latter to ascertain the fair market value of the decedent's interest in the business enterprise; this information plays a pivotal role in tax basis determinations in the inheritance context.

Evident from this discussion is that, notwithstanding the difficulties associated with a pass-through entity ascertaining a taxpayer's initial tax basis in the entity itself, the ascertainment of such initial basis determinations is manageable. Depending upon circumstances, the pass-through entity will have to make important inquiries (e.g., in cases of purchases, request a bill of sale), but in the vast majority of cases these will not be resource-intensive endeavors. The by-product of these data-gathering missions would be information returns that on their face contained each taxpayer's adjusted tax basis in the pass-through entity, placing taxpayers in a much better position to comply with their future tax-reporting obligations and the IRS in a much better position to monitor such compliance.

Were Schedule K-1s to contain a tax basis dollar figure, it would concededly be susceptible to possible taxpayer manipulation. For example, taxpayer investors could supply the pass-through entity with fabricated bills of sale. But in accepting the taxpayer's information, the pass-through entity would be held accountable to act in good faith; if the information provided appeared materially flawed and the entity acted in bad faith, the entity would risk being penalized.<sup>188</sup> Furthermore, the IRS would play its traditional backup role and investigate those instances when the supplied tax basis information seemed suspicious and warranted an audit.

In sum, the vulnerability of taxpayer-supplied information to manipulation should not detract from the overall virtues of this reporting proposal. Under the current system, taxpayers supply all of the tax basis information, and no third party conducts an independent inspection. Under the proposal, the pass-through entity would have an obligation to make a good faith examination of the taxpayer's initial investment tax basis and would subsequently adjust it during the tenure of taxpayer ownership. In comparison to the existing state of affairs, adoption of this proposal would constitute a tremendous step toward greater taxpayer compliance.

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187. The term *purchase* would also include a compensatory arrangement in which a taxpayer received an ownership interest in return for the performance of services. In lieu of a bill of sale, the pass-through entity would have to issue either a Form 1099 (in the case of a partnership) or a Form W-2 (in the case of an S corporation), and this reported dollar figure would constitute the taxpayer's tax basis in the business enterprise.

188. Treas. Reg. § 1.6664-4(b)(2), ex. (3) (if taxpayers have no reason to know that an information return is incorrect, they may rely upon it; conversely, if taxpayers have reason to know that the information return is incorrect, they may not rely upon it).

### C. Curtailment of Tax Basis Estimations

As previously discussed,<sup>189</sup> in those instances when taxpayers lack documentation to substantiate their tax return reporting positions, the Cohan doctrine permits them to make estimations. This doctrine's genesis was likely sparked by equity concerns and the recognition that taxpayers are inherently fallible. Simply put, the Cohan doctrine epitomizes the notion that minor record-keeping infractions do not warrant harsh tax outcomes.

Since this doctrine's introduction in 1930, Congress has periodically scaled back its application. For example, in the case of business meals and entertainment expenses, Congress does not permit estimations; instead, taxpayers must substantiate these expenses or risk disallowance.<sup>190</sup> Congress has conducted this kind of periodic pruning of the Cohan doctrine when the tax stakes are modest and tax outcomes potentially produce only minor inequities (i.e., the ultimate tax burden that a taxpayer endures may be slightly higher than is truly warranted).<sup>191</sup>

Congress obviously harbors an appreciation for the Cohan doctrine as it has never sought to legislatively overrule it.<sup>192</sup> Indeed, doing so would be politically unacceptable. By way of example, consider a situation in which a taxpayer, sometime in 1980, purchased 100,000 shares of IBM stock and, upon their subsequent sale in 2014, could not locate his original purchase records. Suppose further that, during 1980, IBM stock traded between \$7 and \$10 per share. To deny the taxpayer a tax basis in his shares at least equal to \$700,000 (\$7 x 100,000 shares) seems patently unfair and unlikely to garner any political support.

Tax basis reform measures must strike a balance between equity concerns and the need for accurate taxpayer reporting. Accordingly, reform should take one of two different approaches. First, if Congress instituted the information return requirement posited in Subpart III.B, then a taxpayer who claimed a higher tax basis than that indicated on the face of the Schedule K-1 would have to supply documentation to justify such increase rather than being permitted to rely upon estimates.<sup>193</sup> This seems only fair; upon receipt of their Schedule K-1s, taxpayers who believed the reported tax basis to be inaccurate would be on notice that any adjustment would require supporting documentation.

In the absence of Congress instituting the tax basis information return requirement found in Subpart III.B, Congress could graft another limitation to the application of the Cohan doctrine.<sup>194</sup> A taxpayer's tax basis in a pass-through entity would be segregated into two components: (a) the tax basis at ownership inception and (b) tax basis adjustments made throughout the tenure of entity ownership. In terms of the first component, this proposal would maintain the application of the Cohan doctrine because initial tax basis determination information might be old and difficult to locate. In terms of the second component, Congress should deny the application of the Cohan doctrine because this information should be more readily accessible and easier to locate; if it is not, then taxpayers are culpable for not properly maintaining their pass-through entity investment records.

Scaling back the application of the Cohan doctrine in the fashion just described should not trigger any public outcry. The overall taxpayer dollar stakes are much smaller than if Congress simply eliminated the application of the Cohan doctrine to pass-through entity tax basis determinations (i.e., determining that the tax basis in these business enterprises would equal \$0 if supporting documentation could not be offered). Furthermore, limiting the application of the Cohan doctrine in the fashion described would hopefully highlight for taxpayers the importance

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189. See *supra* Subpart II.C.2.

190. I.R.C. § 274(d).

191. See, e.g., *id.* § 274(d)(4) (expanding substantiation requirements to so-called *listed property* as defined in Code § 280F(d)(4), including passenger automobiles and computer equipment).

192. By way of contrast, see *id.* §§ 311(b)(2), 336 (eliminating the General Utility Doctrine that permitted, in certain instances, tax-free liquidations). See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269.

193. See *supra* Subpart III.B.

194. See *supra* Subpart III.B.

of tax basis determinations and the pivotal role that they play in making accurate income assessments under the Code.

#### IV. IMPLICATIONS

Were the reform proposals set forth in the prior Part instituted, their salutary effects would be widespread. Subpart A details the benefits of simplifying the pass-through entity tax basis regime.<sup>195</sup> Subpart B extols the virtues associated with expanded information reporting in the context of tax basis reporting.<sup>196</sup> Finally, Subpart C highlights the post-reform implications associated with the curtailed application of the Cohan doctrine.<sup>197</sup>

##### A. *The Benefits of Simplifying the Pass-Through Entity Tax Basis Regime*

Over the last several decades academics and politicians have repeatedly derided the Code's complexity.<sup>198</sup> When it comes to pass-through entities, such derision is even more acute.<sup>199</sup> Article after article propounds how this facet or that facet of partnership tax law is unmanageable<sup>200</sup> or, alternatively, why, since the advent of the limited liability company (which are taxed as partnerships), retention of the S corporation tax regime is no longer necessary.<sup>201</sup>

The points raised by these polemics are important ones and, in many cases, items that Congress should address. Proposals to simplify the extraordinarily complex special allocation rules for partnerships are particularly welcome.<sup>202</sup> Indeed, it is probably fair to say that pass-through entity tax regime complexities have enabled tax shelter promoters and investors to camouflage their misdeeds, costing the government billions of dollars of lost revenue.<sup>203</sup>

However, many of the proposals that reformists champion would not have a wide-scale impact because the majority of pass-through entity day-to-day operations are business motivated with no hidden tax agenda at hand. Anecdotally, owners of these pass-through entities harbor rather simple expectations, namely, if the entity is profitable, they anticipate paying tax on such profits and, conversely, if the entity endures losses, they anticipate that they will be entitled to deduct such losses.

This is why the tax basis reforms that this analysis advocates are vitally important: without exception, tax basis concerns touch upon the ownership of all pass-through entities and each and every one of their owners. It is the one area of reform that could, for the vast majority of taxpayers, erase much of the complexity associated with pass-through entity ownership. Put differently, it could empower pass-through entity owners to master an area of the law that has been, for all intents and purposes, shrouded in mystery and relegated to guesswork.

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195. See *infra* Subpart IV.A.

196. See *infra* Subpart IV.B.

197. See *infra* Subpart IV.C.

198. See, e.g., Joe Spellman, *Michael Graetz Briefs Practitioners on Prospects for Tax Reform*, 74 TAX NOTES 1248 (1997) (noting that throughout the 1980s, people criticized the income tax as unnecessarily complex); NINA OLSON, NATIONAL TAXPAYER ADVOCATE: 2010 ANNUAL REPORT TO CONGRESS 3 (Taxpayer Advocate Serv. 2010), available at [http://www.taxpayeradvocate.irs.gov/files/ExecSummary\\_2010ARC.pdf](http://www.taxpayeradvocate.irs.gov/files/ExecSummary_2010ARC.pdf) (in her annual report to Congress, the Taxpayer Advocate declared that the Code's complexity was the number one compliance issue facing taxpayers).

199. Postlewaite, *supra* note 27, at 451; Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 109 (1998); Berger, *supra* note 27, at 105; Noel B. Cunningham, *Commentary, Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991).

200. William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Karen Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677 (1998).

201. See, e.g., Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749 (2009) (advocating the elimination of S corporations).

202. David Hasen, *supra* note 50; Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2012); Darryll Jones, *Toward Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047 (2006); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980).

203. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-104T, CHALLENGES REMAIN IN COMBATING ABUSIVE TAX SHELTERS 10 (2003), available at <http://www.gao.gov/new.items/d04104t.pdf> ("IRS has information that suggests the scope of abusive shelters totaled tens of billions of dollars over about a decade. . .").

Consider the implications were Congress to enact the reforms that this analysis advocates. Taxpayers who established pass-through entities would have immediate command of their tax basis in the enterprise, readily enabling them to determine the allowance of their losses,<sup>204</sup> the tax consequences associated with entity distributions,<sup>205</sup> and gains/losses upon disposition of their ownership interests.<sup>206</sup> This would obviate the need to journey on a historical mission going back years or even decades to trace the tax basis in their pass-through entity investments. The reforms would eliminate the single most common frustration associated with pass-through entity taxation ownership, namely, taxpayers' lack of accurate tax basis knowledge.

### *B. The Virtues Associated with Expanded Information Reporting*

As previously pointed out,<sup>207</sup> the use of tax information returns generally ensures greater taxpayer compliance. However, the issuance of tax information returns is not a cost-free endeavor; third parties must collect tax data, process it, and then submit it to both taxpayers and the government.<sup>208</sup> For third-party tax information reporting to be financially efficacious, compliance benefits must clearly outweigh associated costs.

In a recently published essay,<sup>209</sup> Professor Leandra Lederman identifies six key factors that, she argues, portend successful tax information reporting.<sup>210</sup> These six factors along with a description of their meanings are as follows:

1. **Arm's-Length Parties.** Arm's-length parties are those that act in their own self-interest rather than trying to collude at the government's expense. Arm's-length dealings are most likely to occur when the third party and the taxpayer have opposing financial agendas (e.g., beholden to its shareholders and owners, a bank is responsible for issuing accurate Form 1099s to depositors, thereby avoiding the imposition of tax penalties).<sup>211</sup> Collusive dealings are most likely to occur when parties have parallel financial agendas, such as in the cases of related parties (e.g., parent and subsidiary corporations) and between and among family members (e.g., grandparent and grandchildren).<sup>212</sup>

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204. I.R.C. § 704(d).

205. *Id.* §§ 731-33.

206. *Id.* § 1001(a).

207. See TAX YEAR 2006 OVERVIEW, *supra* note 68.

208. Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX L. REV. 317, 388-92 (2007-2008) (detailing the need to conduct a cost/benefit analysis of third-party reporting); OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008, at 194-95 (2007), available at <http://www.gpo.gov/fdsys/pkg/BUDGET-2008-PER/pdf/BUDGET-2008-PER.pdf>.

The challenge is to find ways to improve compliance without unduly burdening compliant taxpayers or the economy. For example, as noted above, income reported to the IRS by third parties is claimed on tax returns at a far higher rate than other income. Requiring third-party reporting of all income would likely raise compliance levels. However, this is not possible in all cases and even where it is possible it might require burdensome new reporting requirements for individuals and businesses. For example, individuals paying a contractor or purchasing a car might be required to file reports to the IRS reporting these transactions. Such broad expansions of reporting requirements would be excessively burdensome, and that [*sic*] this consideration outweighs the gains they might bring in increased compliance.

Similarly, requiring much more detailed documentation, such as evidence supporting claims for deductions and credits or providing accounting records supporting business income claims, would quite possibly improve compliance. In some cases more detailed documentation may be appropriate. However, unless carefully targeted, this is likely to impose an unacceptable increase in cost on both taxpayers and the IRS and to decrease privacy.

209. Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010).

210. *Id.* at 1739-41.

211. See, e.g., UFE, Inc. v. Comm'r, 92 T.C. 1314, 1326 (1981) ("[T]he record supports the conclusion that the purchase price was the fair, arm's-length bargain of opposing parties with antagonistic interests."). See generally Jay A. Soled, Leonard Goodman & Anthony Pochesci, *Penalty Exposure: Incorrect Tax Basis Reporting on Tax Information Returns*, 119 J. TAX'N 82 (2013).

212. See, e.g., Dorzback v. Collison, 195 F.2d 69, 71 (3d Cir. 1952) ("We have not overlooked the principle that transactions between husband and wife calculated to reallocate family income or reduce family taxes are subject to careful scrutiny."); Cuyuna Realty Co. v. United States, 382 F.2d 298, 300-01 (Cl. Ct. 1967) ("Claim to a debt relationship in a parent-subsidiary transaction merits particular scrutiny because the control element suggests the opportunity to contrive a fictional debt, an opportunity less present in an arms-length transaction between strangers."); Diesel Country Truck Stop, Inc. v. Comm'r, 2000 T.C.M. (RIA) 1759, 1774

2. **Bookkeeping Infrastructure.** Third parties that have the resources to collect, retain, and disseminate tax data are ideally situated to participate in the issuance of tax information returns.<sup>213</sup>

3. **Centralization.** If there is one third party and many taxpayers who are employed by or invested in it, then there are efficiencies associated with the third party collecting important tax data.<sup>214</sup>

4. **Complete Reporting.** When tax information reporting results in the collection of important tax data that populates a tax return (e.g., wage or interest dollar figures), the IRS is ideally situated to verify taxpayer accuracy. By contrast, incomplete reporting is less advantageous to the IRS since the agency cannot match the information it receives with tax return submissions (e.g., prior to the institution of Code section 6045(g),<sup>215</sup> brokers were required to report only gross proceeds resulting from a sale, not the taxpayer's actual gains or losses).<sup>216</sup>

5. **Few Alternative Arrangements.** Taxpayers who cannot readily avoid third-party information reporting (e.g., bank depositors who earn interest income and who cannot secure other modest-risk investments) are better candidates to be subject to information reporting than those taxpayers who can readily circumvent tax information reporting obligations (e.g., hairstylists who avoid becoming employees and instead lease their "chairs," gaining independent contractor status).<sup>217</sup>

6. **Contributor to Tax Gap.** Third-party tax information returns are most utilitarian in those situations when there is a tax compliance problem. Otherwise, the imposition of a tax information return requirement produces an unnecessary and undue economic burden on the responsible third party with little apparent gain to the IRS.<sup>218</sup>

An analysis of the foregoing six factors suggests that the expansion of information reporting pertaining to the tax basis of pass-through entities makes much sense. Many pass-through entities are arrangements between and among unrelated parties; that being the case, owners will ordinarily operate at arm's length and likely will not collude to report inflated tax bases at the risk of possible penalty exposure. Second, pass-through entities typically have secretarial staffs, computer networking systems, and filing systems that lend themselves to information retention. Third, because most pass-through entities have multiple members and shareholders, the entity can serve in a centralized collection capacity and as a repository of tax data. Fourth, assuming that tax basis information is required to be reported, this information would enable the IRS to match it

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(1990) ("[T]ransactions between related parties are subject to close scrutiny."); *Maxwell v. Comm'r*, 95 T.C. 107, 117 (1990) ("In determining whether the form of a transaction between closely related parties has substance, we should compare their actions with what would have occurred if the transaction had occurred between parties who were dealing at arm's length.").

213. See HENRIK JACOBSEN KLEVEN, CLAUS THUSTRUP KREINER & EMMANUEL SAEZ, **WHY CAN MODERN GOVERNMENTS TAX SO MUCH? AN AGENCY MODEL OF FIRMS AS FISCAL INTERMEDIARIES**, available at <https://nber.org/papers/w15218> ("Modern firms have a large number of employees and carry out complex production tasks, which requires the use of accurate business records.").

214. See *id.*

Because such records are widely used within the firm, any single employee can denounce collusive tax cheating between employees and the employer by revealing the true records to the government. We show that, if a firm is large enough, such whistleblowing threats will make tax enforcement successful even with low penalties and low audit rates.

215. See **Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854-55.**

216. Joseph Bankman, *Eight Truths about Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 512 (2007) ("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.").

217. See Jay A. Soled, *Nude Dancing: A Guide to Industrywide Noncompliance*, 98 TAX NOTES TODAY 182-98 (Sept. 21, 1998) (explaining how exotic dancers circumvent tax-reporting obligations and how other industries might replicate this noncompliance model).

218. See *supra* note 204 and accompanying text.

with what taxpayers actually report on their tax returns. Fifth, pass-through entities are considered tax efficient relative to the main alternative choice-of-business entities, namely, C corporations; taxpayers who therefore sought to avoid compliance with this proposed reporting obligation would find few, if any, attractive alternative ways to conduct business. Finally, as pointed out in Subpart II.D above, pass-through entity basis misreporting is a significant contributor to the tax gap; as such, tax basis information reporting of the sort proposed could greatly enhance taxpayer compliance.<sup>219</sup>

Under current law, every pass-through entity owner must individually try to compute his tax basis in the business enterprise. This is not cost efficient, and the IRS does not have the resources or ability to monitor annually the millions of reported tax basis dollar figures. By mandating tax basis reporting for the owners of pass-through entities, tax basis computations would not have to be repeatedly performed by numerous professionals and/or taxpayers, all at their own individual cost and with different skill sets. Instead, a single tax professional, one who is intimately familiar with the pass-through entity, would handle this task, and the IRS could successfully ride on the coattails of these computations.

### *C. Post-Reform Implications Associated with the Curtailment of the Cohan Doctrine*

Were information returns expanded to include tax basis information, there would be significant implications concerning the Cohan doctrine and its application. Recall that the Cohan doctrine enables taxpayers to make reasonable estimations in the absence of substantiating documents.<sup>220</sup> Historically, one of the judiciary's guiding principles has been that equity should prevail in the face of exactitude.<sup>221</sup>

But in a world in which pass-through entities rather than taxpayers themselves will be charged with the retention of tax basis data, the post-reform application of the Cohan doctrine would come into play in several new ways.

First, the pass-through entity will be responsible for tax basis data gathering and processing information supplied by taxpayer investors. If the information supplied appears satisfactory (e.g., a legitimate bill of sale), then the entity should be entitled to accept this information at face value. Conversely, if the reported tax basis information appears fundamentally flawed (e.g., the supplied date-of-death value of the pass-through interest appears greatly inflated), the entity would have a duty of due diligence. If the supplementary information received were to prove unsatisfactory (e.g., the supporting date-of-death appraisal is prepared by the taxpayer rather than by a qualified appraisal firm), then the entity would not be responsible for reporting the taxpayer's tax basis. Instead, on the information return, the pass-through entity would, in lieu of supplying a tax basis dollar figure, provide a code letter signifying insufficient information. Because the entity would lack sufficient information to make a reasonable estimation, the Cohan doctrine would not be available to enable it to supply a tax basis dollar figure.

When taxpayers receive information returns populated with tax basis information, they would be at liberty either (a) to accept the reported tax basis dollar figure because it appeared accurate or (b) to reject it because of its supposed inaccuracy. Consider the consequences associated choosing either option.

(a) Acceptance of Reported Tax Basis. In those cases in which taxpayers opt to accept the reported tax basis dollar figure, upon audit, they could rely upon the application of the Cohan doctrine; that is, taxpayers could supply supporting documentation plus an explanation for why the reported tax basis dollar figure was accurate. Assuming that the taxpayers acted in good faith, the IRS should not impose accuracy-related penalties if the supplied tax basis figure subsequently proves erroneous; conversely, if in relying upon the tax basis figure found on the information

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219. See *supra* Subpart II.D.

220. See *supra* notes 105-11 and accompanying text.

221. See *supra* notes 105-11 and accompanying text.



return the taxpayers acted in bad faith, the Cohan doctrine should be deemed inapplicable and, if appropriate, accuracy-related penalties imposed.

(b) Rejection of Reported Tax Basis. If taxpayers choose to reject the reported tax basis dollar figure found on the information return, then they would have the burden of proof to demonstrate the accuracy of another tax basis dollar figure. Ideally, taxpayers should immediately identify the misreported tax basis dollar figure and call it to the pass-through entity's attention; alacrity is critical because this is when remedial measures are easiest to institute and the putative misinformation not permitted to be perpetuated on future tax information returns. However, if taxpayers are dilatory in their responses, then the courts should be reluctant to apply the Cohan doctrine because the taxpayers were culpable in allowing the perpetuation of the reported tax basis dollar figure errors.

## V. CONCLUSION

This analysis demonstrates that pass-through entity tax basis determinations are a complex enterprise that few taxpayers understand and manage well and that the IRS cannot properly oversee. These systemic shortcomings require the institution of important reforms. We recommend that Congress simplify tax basis computations for both partnerships and S corporations, require the submission of more detailed information returns, and curtail taxpayers' ability to use tax basis estimations. Absent the institution of such reforms, taxpayer compliance in the pass-through entity arena will remain bleak.

Politicians should keep in mind that taxpayer noncompliance is not something they can blithely ignore. Its effects are corrosive, causing noncompliant taxpayers to take more aggressive reporting positions and compliant taxpayers to question whether they should remain compliant.<sup>222</sup> Such taxpayer noncompliance produces financial inequities as noncompliant taxpayers' incomes escape taxation. Furthermore, taxpayer noncompliance can stymie the institution of meaningful tax reform measures that rely upon accurate tax basis reporting. Thus, those politicians who continue to ignore taxpayer noncompliance risk sapping the Code of its ability to raise revenue, render frail its equity features, and marginalize its ability to respond to change.

This indictment of the status quo leads to one conclusion: Congress must reform tax basis determinations for pass-through entities.<sup>223</sup> Absent reform, taxpayers will continue to be left to their own devices to determine the tax basis that they have in their pass-through entity investments; and, if history serves as a guidepost, the by-product will be a tax system marred by inaccuracies, inequities, and revenue forfeiture. The present congressional laissez-faire approach to tax basis determinations for pass-through entities sends an unfortunate message to the tax community, namely, that tax compliance is not a pressing priority. At a point in time when the nation is beset with burgeoning budget deficits, this is exactly the wrong message to be sending.

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222. Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1469 (2003); Robert Cialdini, *Social Motivations to Comply: Norms, Values, and Principles*, in 2 TAXPAYER COMPLIANCE 200 (Jeffrey A. Roth & John T. Scholz, eds. 1989) (people behave based upon the actions of others).

223. The institution of the suggested reforms does not have to be immediate. Rather, in order to enable taxpayers to learn about the law changes, permit them to change the way they conduct business, and afford them the opportunity to put compliance measures into place, the suggested reforms can be gradually implemented. See Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996) (when instituting tax reforms, stressing the need for Congress to consider offering transitional relief to taxpayers); Daniel S. Goldberg, *Tax Subsidies: One-Time Vs. Periodic: An Economic Analysis of the Tax Policy Alternatives*, 49 TAX L. REV. 305 (1994) (same); J. Mark Ramseyer & Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 VA. L. REV. 1155 (1989) (same); Note, *Setting Effective Dates for Tax Legislation: A Rule of Prospectively*, 84 HARV. L. REV. 436 (1970) (same). Compare Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 87 (1977) ("Recent tax legislation has tended to institutionalize expectations of grandfathered effective dates in the tax context. This should be reversed. The tax law must remain a flexible instrument of public policy. When a provision has outlived its usefulness, it should be eliminated without the delay and windfall gains inherent in grandfathering prior transactions. People should make investments with the expectation that political policies may change."); Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. (1993) (arguing that the occasional and unexpected use of retroactive taxes may provide a potential source of revenue).