



## Treasury Inspector General for Tax Administration Office of Audit

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

Issued on December 20, 2010

## Highlights

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

### **IMPACT ON TAXPAYERS**

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

### **WHY TIGTA DID THE AUDIT**

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

### **WHAT TIGTA FOUND**

The IRS should increase the number of examinations of tax returns with losses from rental real estate activity. TIGTA found that the criteria used to select tax returns included in the Compliance Initiative Programs (CIP) are producing results that are more productive than tax returns selected for examination based on other criteria. TIGTA determined if the IRS performed more examinations through their rental real estate CIPs, it could increase the potential tax assessments by \$27.3 million over a 5-year period.

TIGTA also found that requiring taxpayers with prior year unallowed Passive Activity Losses to submit Passive Activity Loss Limitations (Form 8582) and increasing the amount of data input from tax returns to the Master File would further improve the efficiency of the programs used to select tax returns with questionable real estate activities for further examination.

### **WHAT TIGTA RECOMMENDED**

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

IRS management agreed with all three recommendations. The IRS, in connection with the development of compliance strategies, plans to consider whether additional CIP examinations are appropriate. In addition, the IRS plans to revise the 2011 Instructions for Form 8582 and transcribe the information taxpayers provide to report the net amount of income earned, or losses incurred, from being a real estate professional.

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

### **READ THE FULL REPORT**

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2011reports/201130005fr.pdf>.

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