IRS to Scrutinize Investors' Capital Gains and Losses

A new bill introduced in March 2006 will make it even more vital for investors to accurately track capital gains and losses from investments. Sen. Evan Bayh, D-Ind., introduced S. 2414 (the Simplification Through Active Reporting Tax Act), which will require broker-dealers and mutual fund companies to report the adjusted cost basis of securities (purchase price minus commissions) as well as the sale price of individual accounts. This information will be sent to clients and the Internal Revenue Service when the shares are sold. The bill is intended to reduce the "tax gap," or the difference between capital gains taxes that *should* be paid and those that *are* being paid.

The new bipartisan legislation was cosigned by Sens. John Kerry, D-Mass., Barack Obama, D-Ill., Tom Coburn, R-Okla., Carl Levin, D-Mich. and Tom Carper, D-Del. The bill reflects the intent of both Congress and the IRS to raise revenue without raising tax rates. Although some brokers and mutual fund companies already track these figures and provide it to their clients, the information is not sent to the IRS. Other companies do not provide investors with an accurate review of capital gains and losses, making the investors solely responsible for tracking cost basis and for calculating their own gains and losses (including knowing if such gains were short or long term). If this bill passes, all financial institutions will be required to provide the information. As a result, the IRS will know if the taxpayer reported the correct amount. Currently, only investment proceeds for sales are currently reported--not the capital gains. The IRS cannot detect errors in basis reporting unless an individual taxpayer audit is conducted.

Sen. Bayh said the goal of the proposed legislation is to reduce the estimated $17 billion dollars of unreported capital gains income per year--3 percent of the looming $350 billion in taxes that are legally owed each year and not paid. In addition, states and cities are negatively impacted by the unreported gains as they base their taxes on what is reported at the federal level. Bayh said a portion of this tax gap results from taxpayers not understanding their capital gains. However, another source of the problem is taxpayers who intentionally inflate the original value of their purchases, thereby concealing gains or manufacturing losses. "Since the IRS has virtually no ability to detect this misreporting, it can be done with impunity, leaving honest taxpayers to pick up the tab," Bayh said. "This bill really does three things: it collects money that is already owed to the government; it simplifies the process for the millions of taxpayers who want to do the right thing; and it stops people trying to cheat the system by changing the purchase basis price."

Bill supporters claim it makes the tax code more fair by ensuring that the IRS receives an independent verification of individuals' investment value (as currently occurs with wages). Taxpayers can't underpay their taxes because employers provide W-2 forms to the IRS. It will also make it easier for the 32 million Americans who report capital gains and losses each year.

Since its March introduction, the bill has been under review by the Senate Finance Committee. If it fails to go before Congress by the end of 2006, Sen. Bayh plans to reintroduce the bill in early 2007. A house version, HR 5367, was also introduced by Rep. Rahm Emanuel, D-Ill., in May.

Bayh said the promise that this bill will raise revenue without raising taxes could provide the momentum for it to become a law. “This legislation will help reduce the deficit by billions while making our tax code simpler and fairer,” Bayh said.

By Mary Scott for GainsKeeper