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The determinants of capital gains tax compliance: evidence from the RJR Nabisco leveraged buyout

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Abstract

Inability to observe both actual and reported capital gains has impeded studies of capital gains tax compliance. This study overcomes such limitations through access to both confidential tax returns and internal shareholder records. Tests are conducted at the individual taxpayer level for associations between compliance rates for capital gains taxes generated by RJR Nabisco shareholders during its leveraged buyout and income, marginal tax rates, socioeconomic characteristics, and measures of the taxpayer's perception of the noncompliance penalty. We find noncompliance decreasing in taxable income, including RJR Nabisco capital gains, first-dollar marginal tax rates, self-employment income, rental income, and other interest paid.

Keywords: Capital gains tax compliance; Evasion; Acquisitions

JEL classification: H24; H26; G34

1. Introduction and motivation

Despite the importance of capital gains taxes as a source of individual tax

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revenue and their documented understatement on tax returns, little is known about the determinants of capital gains tax compliance. This omission in the literature exists because researchers have been unable to observe both actual and reported capital gains. This study overcomes this hurdle through access to both confidential individual tax returns, provided by the Internal Revenue Service, and confidential shareholder records, provided by RJR Nabisco. These data enable us to test for associations among the socioeconomic characteristics of individual shareholders, their tax return information, including marginal tax rates, and their compliance rates for the capital gains taxes generated by the 1989 RJR Nabisco leveraged buyout (LBO).

Capital gains taxes are assessed at realization on the difference between sales proceeds and the investor's tax basis in the disposed property. Although theory (Constantinides, 1983; Stiglitz, 1983; Scholes and Wolfson, 1992, among others) suggests that perfect substitutability among financial assets could preclude capital gains taxes, individuals continue to report sizable capital gains. For example, in 1997, even after deducting capital losses, net capital gains comprised 7 percent of adjusted gross income (AGI), trailing only wages as an income source (IRS Statistics of Income Files). This percentage has doubled since 1991, and the sustained bull market in the 1990s portends an increasing importance of capital gains as a revenue source.

Moreover, the limited publicly available data suggest that taxpayers realize more capital gains than they report on their tax returns. IRS estimates from the nine Taxpayer Compliance Measurement Program (TCMP) surveys from 1965 to 1988 indicate that the percent of actual capital gains that appear on tax returns ranges from 61 percent in 1976 to 93 percent in 1988.[1] This compares with 99 percent compliance for wages and 98 percent for interest in the 1988 TCMP survey.

Several factors aid capital gains noncompliance. Capital gains transactions are irregular and infrequent, making it difficult for the taxing authorities to establish baselines cross-temporally or cross-taxpayers. In addition, tax bases are not tracked by third-party reports, and unless brokers are employed, no third-party reports are required to track sales proceeds.

A few studies (Clotfelter, 1983; Feinstein, 1991, among others) analyze TCMP data to assess the determinants of overall tax evasion, and their findings guide our tests. However, to our knowledge, Poterba (1987) is the sole study that attempts to identify determinants of capital gains tax compliance. Using aggregated TCMP data for 6 years from 1965 to 1982, he regresses the total capital gains reported on tax returns as a percentage of the total IRS-computed capital gains on the marginal

[1]In a review of 1979 tax returns, Thompson (1987) notes that capital gains tax compliance rates for stocks, the asset under investigation in this study, is higher than for business property and personal residences. Also, the 1988 increase in capital gains compliance may be attributable to the Tax Reform Act of 1986 requirement that brokers report proceeds to the IRS.