

GAO

Report to the Chairman, Subcommittee
on Treasury, Postal Service, and General
Government, Committee on
Appropriations, House of
Representatives

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TAX ADMINISTRATION

Alternative Filing Systems





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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The Honorable James R. Lightfoot
Chairman, Subcommittee on Treasury, Postal
Service, and General Government
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

Questions have been raised about the viability of reducing the burden of annually filing tax returns by millions of taxpayers even though most have fully paid their taxes through the withholding system. The Internal Revenue Service (IRS) currently offers taxpayers several choices for filing tax returns that are less burdensome than preparing paper tax returns, such as filing returns electronically, over the telephone, or through use of personal computers. Millions of taxpayers in at least 36 other countries that also have tax withholding systems do not have to prepare income tax returns because these countries have alternative filing systems not currently available in the United States.

Generally, there are two types of such alternative filing systems found in other countries. One type of filing system, which provides that the taxing authority prepares the return for the taxpayer, can be referred to as the "tax agency reconciliation" system. The other type of filing system provides that taxpayers' income tax is withheld at the source and remitted to the tax agency by employers and other payers who are responsible for withholding taxes that equal but do not exceed each taxpayer's tax liability. It can be referred to as a "final withholding" filing system.¹

To explore the issues involved in considering the use of such approaches in the United States, we initiated a review to determine the possible benefits, impediments, or costs to individual taxpayers, IRS, and others of establishing a tax agency reconciliation filing system under existing federal income tax laws that taxpayers could voluntarily participate in. This report was prepared under our basic legislative responsibilities for reviewing federal programs and activities.

Because of the Subcommittee's continuing interest in the efficiency of IRS' operations, you asked that we address this report to you.

¹The tax agency reconciliation and final withholding systems are commonly referred to as "return-free" filing systems.

This report focuses on a tax agency reconciliation type system because this kind of system would not require any tax law changes while a final withholding type system would require tax law changes. We do, however, provide some information about how a final withholding type system might operate in the United States, in appendix I.

To examine the alternative of a tax agency reconciliation filing system, our objectives were to (1) estimate how many taxpayers would not have to prepare returns under such a system, (2) identify the operational characteristics such a system might have, (3) identify the potential pros and cons to taxpayers and IRS under such a system, and (4) identify any major impediments to or costs in establishing this type of filing system under the current federal tax laws.

Results in Brief

We estimated that as many as 51 million or about 45 percent of the 113.6 million taxpayers who filed tax year 1992 returns would not have to prepare returns if IRS were able to establish a voluntary tax agency reconciliation filing system. These taxpayers consisted of those who claimed the standard deduction and had income from only wages, interest, dividends, pensions, and unemployment compensation.

One general concept of such a system would be for IRS to produce tax returns for individuals who volunteered to be covered by the system on the basis of (1) income reported on information returns and (2) information on filing status and dependents provided by taxpayers on a new simpler tax form. IRS would then mail the returns and refunds or tax bills to taxpayers, who would need to review their returns and notify IRS whether they agreed with the return information.

While both individual taxpayers and IRS could benefit from such a tax agency reconciliation system, significant obstacles would have to be overcome and some affected parties—such as tax preparers, some financial institutions, and employers—might be negatively affected. For example, we estimated that taxpayers could reduce the amount of time they spend preparing tax returns by as much as 155 million hours annually and could save millions of dollars in fees paid to tax return preparers. A tax agency reconciliation system would also be likely to further reduce the volume of paper documents IRS would have to process, which is one goal of IRS' long-term business vision. Such a system could also reduce IRS' returns processing and compliance costs by as much as \$37 million annually.

However, taxpayers would have to continue to keep records to be able to accurately review the IRS-proposed tax return and tax assessment. It is unclear to what extent taxpayers would continue to rely on tax preparers to assist them in reviewing their returns, but tax preparers would likely lose some business under such a system.

A major operational impediment to establishing a tax agency reconciliation system is that IRS does not currently process information returns in sufficient time to send taxpayers their tax returns before the April 15 tax return filing date. Payers are required to file information returns by the last day of February. However, under IRS' current information returns processing operations, it is about 6 months later, or the end of August, before information returns, including wage statements, could be used to create tax returns. The 6-month interval occurs because of the amount of time it takes to process paper information returns, payer extensions for filing information returns, and payee corrections to information returns.

As part of its business vision, IRS plans to be able to match information return data against tax return data sooner; but the plans are not specifically directed to having all information returns processed before the April 15 filing date, as would be necessary for use in a tax agency reconciliation system unless the filing date were changed. IRS has two initiatives under way aimed at speeding up information returns processing. One initiative deals with electronically scanning paper information returns, and the other is working with the Social Security Administration (SSA) to get employers to file wage documents electronically. IRS has planned a third initiative to start in fiscal year 1997 to get payers to file more nonwage information returns electronically.

In a 1987 study, IRS found that a tax agency reconciliation system was not feasible then because of the amount of time it took to process and correct information return data. The study indicated that with technological advances such a system could be feasible in the future. Electronic filing of tax data may be one such technological advance that could make a tax agency reconciliation system a more viable filing option if IRS could get more payers to file information returns electronically. Electronically filed information returns can be processed faster and with fewer errors than returns submitted on paper or magnetic media. While faster filing of information returns or increased use of electronic filing would increase the feasibility of an alternative filing system, additional costs or burdens

may result for businesses or other entities responsible for filing information returns.

Although federal tax law could be changed to delay the return filing date past April 15 to permit sufficient processing of information returns to make a tax agency reconciliation system more feasible, the April 15 return filing date is important for some state income tax purposes. We estimate that 15.8 million or 31 percent of the 51 million taxpayers whose returns could be prepared by IRS under a tax agency reconciliation system may not need their federal tax return to calculate state taxes. These taxpayers resided in states that either have no state income tax or are not linked to the federal tax system. Another 29.6 million taxpayers (58 percent) resided in states where state taxes are based on federal adjusted gross income, which could be calculated from information return data sent to taxpayers as well as IRS. The remaining 5.6 million taxpayers eligible for tax agency reconciliation resided in 11 states that used either the federal taxable income or tax liability as the basis for calculating their state income tax liability. These taxpayers might be less likely to volunteer for tax agency reconciliation if IRS were unable to provide their returns before April 15. Otherwise, these taxpayers would have to compute their federal taxable income or tax liability or file their state tax returns late, which could subject them to state penalties for filing late returns.

According to an IRS focus group conducted in 1993, taxpayers may be reluctant to rely on IRS to prepare their tax returns under a tax agency reconciliation system, regardless of when IRS could produce tax returns, because they may not trust IRS to accurately calculate their taxes. Representatives of the paid preparer community also told us that many of their clients do not trust IRS to prepare accurate returns and would continue to rely on paid preparers for return preparation services under a tax agency reconciliation system. Also, some taxpayers may not want to participate in such a system because they may not get their refunds as early in the tax filing season as they currently do. However, if IRS could demonstrate through a pilot test of a tax agency reconciliation option the capability to produce timely and accurate tax returns, taxpayer acceptance of such a voluntary system might be enhanced.

Background

Of the 36 countries with alternative filing systems, only Denmark and Sweden have tax agency reconciliation systems. The remaining 34 countries have final withholding filing systems. There are several potential barriers to adopting a final withholding system in the United States.

Specifically, before a final withholding system could be instituted in the United States, the law would have to be changed to require employers to calculate employees' tax liability and adjust employees' last paychecks so that total yearly withholdings would equal employees' tax liability. Also, unlike many countries with final withholding systems, the United States tax system does not exempt or limit taxes on interest and dividend income, nor does it require married couples to file separately. (Appendix I lists these 34 countries and describes how final withholding systems generally operate in those countries.)

A tax agency reconciliation system would be easier to implement in the United States because it would not require statutory changes. In general, under a tax agency reconciliation type system, the tax agency is to calculate the tax liability on the basis of information returns or income reports received from payers, such as wage reports prepared by employers and interest income reports prepared by financial institutions. The tax agency then is to send the taxpayer a printed tax return or reconciliation statement. Upon receipt of the tax return, the taxpayer is to review and correct its contents, add information if any is missing, and return the completed return to the tax agency. After the tax agency receives and reviews the tax return, it is to send the taxpayer either a refund or tax bill.

In 1994, Denmark prepared tax returns for 85 percent of its 4.5 million taxpayers, and Sweden prepared returns for 74 percent of its 7.3 million taxpayers.

In 1987, in response to a provision in the Tax Reform Act of 1986, IRS studied the feasibility of a tax agency reconciliation filing system.² IRS estimated that 55 million individual taxpayers would be eligible to use such an alternative filing system. This estimate included all taxpayers who were filing Form 1040EZ, most taxpayers who were filing Form 1040A, and a few who were filing Form 1040.

Under the system IRS studied, employers and payers would be required to submit wage statements (Form W-2) and information returns (Form 1099) by the end of January, instead of the end of February as is now required. IRS would spend the next 4 to 6 weeks processing these documents. Some taxpayers would receive their returns in early March, but most taxpayers would start receiving theirs in early April.

²Department of the Treasury, Internal Revenue Service, Current Feasibility of a Return-Free Filing System, Oct. 1987.

IRS concluded that the tax agency reconciliation filing system it studied was not feasible primarily because it would be very difficult to receive, verify, and post over 900 million wage and information documents in time to generate tax returns. IRS determined that checking all of the documents for accuracy and correcting them in time to generate returns was beyond its capabilities.

Objectives, Scope, and Methodology

Our objectives in describing the potential benefits and impediments of a voluntary tax agency reconciliation type filing system were to (1) estimate how many taxpayers would not have to prepare returns under this kind of system, (2) identify the operational characteristics such a system might have, (3) identify the pros and cons of such a system to taxpayers and IRS, and (4) identify any major impediments to or costs in establishing such a system under the current federal tax laws.

It is important to note that we focused our work on the impact that an alternative filing system might have for individual taxpayers and IRS. We recognize that establishing such a system would affect other stakeholders such as (1) some employers and financial institutions that would probably incur additional costs to modify existing systems or establish new systems for information reporting and (2) tax preparers who might lose revenue from reduced demand for their services or might have to change the services they offer to meet any new type of demand from taxpayers. However, we did not attempt to quantify the benefits and costs to them of implementing such a system. Rather, we viewed the approach to considering the feasibility and desirability of devising an alternative filing system as encompassing two levels of efforts: first, an initial look using readily available data to determine whether additional research by IRS might be warranted and second, a more detailed effort that might involve gathering and analyzing additional data, including specific impacts on third party stakeholders. While we restricted our effort to the first of these two levels of effort, we did make a presentation, on how a tax agency reconciliation system would work, to IRS' Information Reporting Program Advisory Committee, which is composed of representatives from third-party stakeholders, such as financial institutions, employers, and other payers. We also discussed a tax agency reconciliation system with officials of the American Institute of Certified Public Accountants and H&R Block, Inc., which is a national tax return preparation company.

To estimate the number of taxpayers that would be eligible for a tax agency reconciliation system, we used IRS' tax year 1992 Statistics of

Income (SOI) file to extract records that met the income and deduction criteria we established for a hypothetical tax agency reconciliation system. These criteria were that taxpayers would only have income that was reported on information returns and that taxpayers would not itemize deductions.

To identify the operational characteristics a tax agency reconciliation type system might have, we reviewed IRS' 1987 return-free filing study. We also interviewed officials at the Department of the Treasury and IRS to determine what administrative changes would have to be made to the federal tax system to have a voluntary tax agency reconciliation type system. We also reviewed the literature on how the tax agency reconciliation systems worked in Denmark and Sweden. We compared information on the operations of tax systems in these countries with the operations of our federal income tax system to determine how they differed. We also interviewed representatives from local consulates to Denmark's and Sweden's foreign embassies about how their tax agency reconciliation filing systems worked.

To determine potential pros and cons of a tax agency reconciliation type system for taxpayers, we reviewed the return preparation tasks IRS published in its 1994 individual income tax booklets. We compared these tasks with the type of tasks taxpayers would have under a tax agency reconciliation type system. We also reviewed literature on costs to taxpayers to have paid preparers complete their tax returns.

To determine any potential benefits and costs to IRS under a tax agency reconciliation system, we applied IRS' methodology for estimating its cost to process tax returns to the filing population eligible for tax agency reconciliation to estimate the cost to process documents under such a system. We also used IRS' costing methodology to estimate the cost to process tax returns under the current system for the population eligible for tax agency reconciliation.

To identify the impediments to establishing a tax agency reconciliation type system, we reviewed IRS' procedures for processing information returns and obtained IRS officials' views on potential impediments. To determine the effect of a tax agency reconciliation system on taxpayers' ability to file state income tax returns, we discussed a hypothetical system with representatives of the Federation of Tax Administrators and state tax officials who attended the federation's national conference held in Cleveland, Ohio, in June 1995. We also reviewed an IRS document on

taxpayers' opinion of a tax agency reconciliation system and discussed the conclusions with IRS officials.

Our work was done from November 1994 through April 1996 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Commissioner of Internal Revenue, and on August 19, 1996, we received written comments from the Deputy Commissioner. His comments are discussed on pages 21 to 22 and a copy of the comments appear in appendix III. We also requested and received comments on a draft of this report from the American Institute of Certified Public Accountants and IRS' Information Reporting Program Advisory Committee. These comments are discussed on pages 22 to 24.

Millions of Taxpayers Could Be Covered by a Tax Agency Reconciliation Type Filing System

To determine how many taxpayers potentially could be covered by a tax agency reconciliation system, we used income and deduction criteria that would maximize the number of taxpayers that could be included in the system, while minimizing administrative changes. Taxpayers who met these criteria included those who

- had taxable income from wages, interest, dividends, pensions, and unemployment compensation;
- did not itemize deductions and, instead, took the standard deduction; and
- did not take any tax credits except the earned income tax credit.

We estimated that about 51 million taxpayers who filed tax year 1992 returns, which was the latest year that data were available to make our estimate, met these conditions. The 51 million taxpayers accounted for about 45 percent of the 113.6 million taxpayers who filed tax year 1992 returns and had about 14 percent of the total individual income tax liability reported that year. Also, the majority of these taxpayers, about 28.7 million or 56 percent, had taxable income from wages only.

We limited eligibility for the system to taxpayers with taxable income from wages, interest, dividends, pensions, and unemployment compensation because IRS receives information returns on these income types, which could be used to calculate taxpayers' tax liabilities. Taxpayers with other types of income, such as rents, royalties, capital gains, and self-employment (i.e., nonemployee compensation), were excluded from eligibility because the information returns with these types of income showed gross income amounts and needed to be reduced by taxpayers'

costs to determine the net taxable amounts. IRS does not receive information returns on taxpayers' costs to produce income.

Similarly, taxpayers who itemized deductions were excluded from the eligible population because some itemized deductions, such as medical expenses and charitable contributions, are not reported on information returns. Regarding tax credits, the earned income tax credit was the only individual tax credit that could be calculated with the income and entity information that would be available to IRS.³

Characteristics of a Tax Agency Reconciliation Type System

The following sections describe one way a tax agency reconciliation system might work. This version of a tax agency reconciliation system would consist of four operational characteristics.⁴

Taxpayer information needed by IRS: To calculate taxpayer tax liability and the earned income tax credit, if applicable, some of the information IRS would need on each taxpayer would include the following:

- name and address,
- Social Security Number (SSN),
- filing status,
- name and SSN of spouse,
- name and SSN of dependents and qualifying children,⁵
- relationship of dependents and qualifying children to taxpayer, and
- number of months dependents and qualifying children lived with taxpayer during the year.

Taxpayers are currently required to report these data on their tax returns. While IRS records would contain taxpayer entity information data from prior year returns, IRS would need to develop a process or form to collect

³Individuals can claim a credit for child and dependent care expenses and a credit for the elderly or the disabled. Both of these credits require a separate tax form and contain taxpayer information that is not provided to IRS by third parties. Individuals engaged in business or with certain types of investments can also get tax credits. However, our hypothetical tax agency reconciliation system excludes these types of taxpayers.

⁴The characteristics of this hypothetical system are similar to those described in IRS' 1987 return-free filing system study.

⁵For earned income tax credit purposes, a qualifying child is a child who (1) is either the taxpayer's son, daughter, adopted child, grandchild, stepchild, or foster child, and; (2) was, at the end of the tax year, either under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled; and (3) lived with the taxpayer in the United States for more than half of the tax year (or all of the tax year if a foster child).

this information for the current year or to confirm or change its prior year's records.⁶

IRS could use the taxpayer identification information part of the tax return package it sends to taxpayers at the beginning of the tax year to confirm the necessary taxpayer information. Taxpayers who volunteered to be covered by tax agency reconciliation filing could send the necessary information to IRS at the start of the tax filing season, perhaps on a form developed for that purpose. As an alternative to having all taxpayers mail a form to IRS, the system could be developed so that only taxpayers whose prior year's information was in error or needed updating would make corrections and send them to IRS. Other taxpayers who volunteered to be covered by a tax agency reconciliation system could confirm the information to IRS via telephone.⁷

IRS preparation of tax return: IRS would need to process the taxpayer information and enter the data onto the taxpayer's master file record. IRS would associate all the information return data it received from employers and other payers with the taxpayer information. Using these data, IRS' computers would calculate the taxpayer's tax liability and, if eligible, the earned income tax credit. A computer-generated tax return and a list of information returns used to create the tax return would be produced and sent to the taxpayer for verification.

IRS could either send the refund to the taxpayer at the same time the return is sent or it could wait until the taxpayer verified the return information.⁸ Factors for consideration in deciding when to send the refund include the risk that the taxpayer would accept a refund without verifying that the return information was accurate and the length of time it would take IRS to send the refund after the taxpayer verified the return information. IRS could develop a test to determine whether the risk involved in sending the refund with the return would be acceptable.

⁶Currently, under IRS' TeleFile program, which allows taxpayers to file Form 1040EZ via touch-tone telephones, IRS identifies taxpayers who are eligible to participate in the program on the basis of their prior year return.

⁷Because we had no basis for determining how many taxpayers would have changes from one year to the next, we developed our hypothetical tax agency reconciliation system so that all taxpayers would submit information to IRS on a form. Also, in its 1987 study of a tax agency reconciliation system, IRS assumed that all taxpayers would mail their taxpayer information to IRS.

⁸For the alternative filing system described in IRS' 1987 return-free filing study, the refund was sent along with the IRS-generated tax return.

The tax return would serve as a tax bill if the taxpayer's income tax withholdings did not cover the taxpayer's tax liability. About 43.3 million or 85 percent of the 51 million taxpayers who met the criteria for eligibility for a tax agency reconciliation system either received refunds or owed no taxes in 1992. The remaining 7.7 million taxpayers owed an average of \$253 in additional taxes.

To facilitate taxpayer communication by telephone, IRS could also assign personal identification numbers to each taxpayer that would serve as their electronic signature, which is essentially what IRS currently does under its TeleFile program.

Taxpayer review of tax return: When taxpayers received the computer-generated tax return, they would need to compare the information on the form to their records (e.g., information returns). Taxpayers who agreed with the return information could notify IRS of their acceptance, possibly by telephone using their personal identification number as their electronic signature. Taxpayers with changes could either make corrections to the tax return, sign the return, and send it back to IRS or make corrections via telephone, using their personal identification number. Using IRS data, we estimated that about 275,000 of the possible 51 million computer-generated tax returns would be likely to be questioned by taxpayers because of erroneous information return data. (See app. II for information on how we developed this estimate.)

IRS corrections to tax returns: When IRS receives the results of a taxpayer's review of the tax return data (either via the return itself or by telephone), it would process any corrections and, if necessary because of the corrections, send the taxpayer either a revised refund or a revised tax bill.

Pros and Cons of a Tax Agency Reconciliation System to Taxpayers, IRS, and Others

Under a tax agency reconciliation system, taxpayers could save millions of hours in tax return preparation time and millions of dollars in paid preparer fees. A tax agency reconciliation system would also benefit IRS by helping to achieve its business vision goals and reducing its returns processing and compliance costs. However, while tax preparation burden could be reduced for individual taxpayers, others now involved in the process such as tax preparation firms, financial institutions, and other payers could be negatively affected. We did not identify a readily available basis for estimating the time or assistance required by taxpayers to submit taxpayer information to IRS or review the IRS-generated returns.

Taxpayers' Return Preparation Time and Costs Would Be Reduced

On the basis of IRS data, we estimated that the 51 million taxpayers who could be covered by a tax agency reconciliation system spend about 262 million hours collectively on tax return preparation tasks.⁹ Breaking the data into task groupings, we estimated that these taxpayers could reduce time spent on certain return preparation tasks by as much as 155 million hours. For example, taxpayers would be relieved of the requirement of preparing tax returns and the related burden of learning how to do so. However, taxpayers would still have to complete the taxpayer information form and send it to IRS. Similarly, taxpayers would still need to keep records on their income to be able to verify that IRS accurately computed their income tax liability. Also, taxpayers would have to notify IRS of their agreement or disagreement with IRS' computer-generated tax returns. Appendix II provides a detailed explanation of how we arrived at our estimates.

Under a tax agency reconciliation system, taxpayers who use paid preparers could be free of the task of finding and paying for their services. We estimated that 16.6 million or almost one-third of the 51 million taxpayers used paid preparers and could save millions of dollars in paid preparer fees.¹⁰

An Alternative Filing System Could Help IRS Achieve Its Business Vision Goals

The tax agency reconciliation system could help IRS achieve one of its long-term business vision goals, which is to reduce the amount of paper documents it has to process. Under this system, IRS would have to process the taxpayer information documents it receives, but this would require less paper than some tax returns.

Currently, IRS envisions reducing the amount of paper documents it processes, by increasing electronic filing of tax returns. Some taxpayers can file electronically by telephone through IRS' TeleFile program, but most electronic filing is done through a tax return preparer or an electronic return transmitter. Taxpayers generally pay from \$15 to \$40 for such services.

⁹These tasks consist of recordkeeping; learning about the law or tax form; preparing the form; and copying, assembling, and sending the form to IRS.

¹⁰One national return preparer service charges an average of \$30 to prepare a form 1040A. (See George Gutman, "Electronic Filing: Who Pays, Who Benefits," *Tax Notes*, Mar. 20, 1995, pp. 1750-1759.) However, while tax preparers would be affected by a tax agency reconciliation system, the extent of that impact (or cost reduction for taxpayers) could be affected by whether additional services are provided, such as services to assist taxpayers to review their IRS-generated returns.

Electronic filing has several benefits for taxpayers, including ensuring that (1) the returns are mathematically accurate and (2) information on the returns has been accurately posted to the taxpayers' accounts in IRS' records. These same benefits would be available to taxpayers under a tax agency reconciliation system. And, taxpayers would get the benefits of electronic filing without incurring the costs, since under a tax agency reconciliation system IRS would be electronically filing returns for taxpayers.

Processing and Compliance Costs of a Tax Agency Reconciliation System Should Be Less Than Current System

Another benefit to IRS of a tax agency reconciliation system is that the combined cost to process taxpayer information forms and computer-generated tax returns should be less than the cost to process taxpayer-submitted tax returns. Using IRS data, we estimated that it would cost IRS about \$182.3 million to process tax returns under the current system for the 51 million taxpayers who could be covered by a tax agency reconciliation system. In comparison, we estimated that the cost associated with processing taxpayer information forms, generating tax returns, processing tax payments, and handling taxpayer inquiries under an alternative system could be about \$160 million. This would result in an approximate savings of \$22 million for IRS. Appendix II gives details on how we made our cost estimates.

IRS would also benefit from a tax agency reconciliation system because its compliance costs could be reduced. Savings would result from not subjecting the 51 million taxpayers to IRS' underreporter program. This computerized compliance program matches income shown on information returns with income that taxpayers report on their tax returns to determine whether taxpayers reported all their income. When discrepancies are found, IRS contacts taxpayers to resolve the issue and assess additional taxes, if required.

Under a tax agency reconciliation system, document-matching would not be necessary because IRS would prepare returns and assess taxes on the basis of the information returns and taxpayer-supplied entity data it has in its computers. As a result, compliance resources that would have been spent on working potential underreporter cases that may have resulted from taxpayer-prepared returns would be saved. We estimate that about 858,000 of the 51 million tax agency reconciliation eligible taxpayers would have been pursued by IRS under its underreporter program at a cost of \$17.61 per taxpayer. Therefore, under a tax agency reconciliation system, the underreporter program cost savings would be about

\$15 million. Thus, the net processing and compliance cost for such a tax agency reconciliation system would be about \$145 million, as compared with about \$182 million under the current system for an approximate savings of \$37 million. Appendix II shows how we developed these estimates.

**Tax Preparers and Others
Might Be Negatively
Affected Under a Tax
Agency Reconciliation
System**

As noted above, about one-third of the taxpayers who met the criteria we identified for eligibility to file under a tax agency reconciliation system used tax preparers to file their tax returns in 1992. A tax agency reconciliation filing system could eliminate the need for such assistance, with the consequence that tax preparers could lose a substantial part of their business. On the other hand, since many of the filers who are eligible for such a system file relatively simple returns, their need for assistance to do so may suggest that under a tax agency reconciliation system, they might also need assistance to send IRS the necessary taxpayer information or review the IRS-generated tax return. We had no readily available basis to estimate the extent to which this business substitution might occur. Nonetheless, the impact of a tax agency reconciliation system on tax preparers would need to be considered in deciding whether to adopt such a system.

Although IRS' business vision already contemplates improving the filing and processing of information returns through increased use of electronic filing, the introduction of a tax agency reconciliation system could put additional burdens on employers, some financial institutions, or others who would be obligated to file information returns more quickly or in electronic form. We had no readily available basis to estimate the costs or other difficulties with such an additional reporting burden. Nonetheless, as with the tax preparer industry, the impact on these third-party participants in the tax system would need to be considered during deliberations on the feasibility of an alternative filing system.

**Significant
Operational
Impediments Exist to
Implementation of a
Tax Agency
Reconciliation System**

A major impediment to a tax agency reconciliation type system is that IRS' present time frame for processing information returns is too long for tax returns to be verified by taxpayers by April 15, which is the filing date for federal returns. However, IRS has several initiatives that could eventually allow it to process information returns sooner. Further, taxpayers in 11 states would need information from their federal returns before April 15 so that they could file their state tax returns on time. However, even if IRS could produce tax returns prior to April 15, some taxpayers may be

reluctant to participate in this voluntary program because they distrust IRS to accurately prepare their returns or because they would not be able to get access to refunds early in the tax filing system.

Information Returns Not Processed in Time for a Tax Agency Reconciliation System

A major stumbling block to a tax agency reconciliation system is the amount of time it presently takes IRS to process information returns. Currently, many information returns, including form W-2s, are not processed until August or 6 months after the due date for filing them.

Currently, IRS receives over 1 billion information returns each year. About 200 million are form W-2s that employers are required to submit to SSA by the end of February. According to an SSA official, about 35 percent of the form W-2s are submitted on paper and the rest are submitted on magnetic media. After SSA processes the form W-2s, they are sent weekly beginning in March to IRS on computer tapes. The remaining 800 million information returns are primarily the Form 1099 series of information returns, such as those reporting interest income, which are due to taxpayers at the end of January and to IRS at the end of February. Most of the 800 million information returns are sent directly to IRS' Martinsburg Computing Center on magnetic media. Payers send their paper Form 1099 information returns to IRS service centers for processing. About 7 percent of the information returns are paper.

Although information returns are due by the end of February, certain factors tend to lengthen the time it takes to process them. These factors include the time it takes to process paper information returns, payer extensions for filing returns, and payee corrections to information returns. However, according to IRS and SSA officials, the most significant factor for processing delays is that about 10 percent of the information returns must be sent back to payers because they cannot be processed by either IRS or SSA. Various reasons contribute to this problem, such as incomplete data and incorrect data format. When information returns are sent back to a payer for replacement, IRS allows a minimum of 45 days to correct and send back the data.

According to IRS data, over 80 percent of Form 1099 information returns and about 65 percent of the forms W-2 are processed and validated by the end of June. It is not until the end of July that IRS has usually processed 95 percent of the information returns and not until the end of August that 93 percent of the forms W-2 have usually been processed.

IRS Initiatives Could Speed Up Information Returns Processing

Given the current April 15 filing due date, the key to making a workable tax agency reconciliation system would be receiving and processing information returns sooner. As part of its long-term business vision, IRS plans to have the capability to process information returns sooner so it can match information return data to tax returns to identify unreported income sooner. Its business vision does not include using information returns for a tax agency reconciliation system, but it does include more up-front matching of information returns to tax returns before refunds are issued.

IRS currently has a couple of initiatives under way that should speed up information returns processing. These initiatives are not specifically directed to having all information returns processed before April 15.

One initiative is the Service Center Recognition/Image Processing System, which is a multimillion dollar system designed to process Form 1040EZ income tax returns and information returns by electronically scanning the document. While only about 7 percent of the information returns are filed on paper, these paper information returns are usually not processed until sometime after April 15. This system, if proven successful, should allow IRS to process paper information returns soon after the February 28 filing date.

Also, IRS and SSA are involved in a multiagency project called the Simplified Tax and Wage Reporting System (STAWRS), which deals, in part, with the processing of forms W-2. STAWRS has projects under way dealing with the electronic transmission of Form W-2 data and with employer validation of employees' SSNs via telephone and computer. The success of these projects could help improve the accuracy of Form W-2 data and speed up Form W-2 processing. However, STAWRS officials did not have estimates on when these projects would become operational.

As part of its business vision, IRS has an electronic filing strategy that focuses primarily on getting taxpayers to file their tax returns either electronically or by touch-tone telephone. A smaller component of this strategy is an initiative to target large volume information returns such as forms 1099 on interest and dividends for electronic filing beginning in fiscal year 1997. IRS already receives some information returns electronically. For 1995, IRS estimated that it received about 42.8 million electronically filed nonwage information returns and estimated that 48.9 million will be filed in 1998. The estimated volume of electronically filed information returns is small, compared with the 800 million nonwage

information returns that are filed annually. IRS officials said these estimates could change depending on the number of payers who are willing to file electronically.

Electronic filing of information returns could be one way to get information returns processed in time to be used for a tax agency reconciliation system. In its 1987 study on return-free filing, IRS concluded that such a system was not feasible when the study was made. IRS found that the amount of time it took to process information returns was the primary administrative obstacle to return-free filing because of the amount of time it took to correct information returns data. However, the study noted that long-term technological improvements in IRS' tax processing could result in such a system being feasible in the future. The study further indicated that IRS would consider a tax agency reconciliation filing concept in connection with its ongoing tax system redesign efforts.

Since its 1987 study, IRS has not reexamined the operational characteristics of a tax agency reconciliation filing system as a potential alternative for filing tax returns, even though technological improvements, such as electronic filing, may make it possible to speed up information returns processing. One of the benefits of electronic filing is that returns, whether tax returns or information returns, can be processed faster and with fewer errors because IRS computer programs are designed to detect errors before its computers will accept electronically filed returns. However, it is unknown how many payers would file information returns electronically and whether electronically filed information returns would shorten the time frame needed to make a tax agency reconciliation system workable.

Some Taxpayers Need Federal Income Tax Data to Prepare Their State Income Tax Returns

Federal income tax return information is not used exclusively for federal tax purposes. A majority of states require their taxpayers to use information from their federal tax returns to calculate state taxes. Table 1 shows the tax base for the 50 states and the District of Columbia and the estimated number of taxpayers potentially eligible for tax agency reconciliation filing in each state.

Table 1: Tax Bases of States With Tax Systems Linked to Federal Law

Tax base	States	Estimated number of tax agency reconciliation filers
Federal adjusted gross income	Arizona, California, Connecticut, Delaware, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Virginia, West Virginia, Wisconsin, and the District of Columbia	29.6 million
Federal taxable income	Colorado, Hawaii, Idaho, Minnesota, North Carolina, Oregon, South Carolina, and Utah	5.2 million
Federal tax liability	North Dakota, Rhode Island, and Vermont	0.4 million
State income tax not linked to federal system	Alabama, Arkansas, Mississippi, New Hampshire, New Jersey, Pennsylvania, and Tennessee	7.3 million
No state income tax	Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming	8.5 million

Source: Federation of Tax Administrators and IRS' tax year 1992 SOI data.

As shown in table 1, 36 states and the District of Columbia have income tax systems that are linked to a federal tax base. These states typically require taxpayers to use information from their federal income tax return as a starting point for state tax computation. Taxpayers in such states are usually required to report either their federal adjusted gross income, federal taxable income, or federal tax liability on their state tax returns.

Under a tax agency reconciliation system, 45.4 million or 89 percent of the potential 51 million filers would not need their federal return to calculate state income taxes. For example, the 29.6 million taxpayers that reside in states that use federal adjusted gross income as the tax base could calculate their state income tax from information returns they receive from employers and other payers because the total income shown on the information returns would equal federal adjusted gross income. Also, 7.3 million taxpayers reside in states that are not dependent on the federal

tax return for state income tax calculations, and 8.5 million taxpayers reside in states that do not assess a state income tax.

The 5.6 million potential return-free filers who reside in the 11 states that use either federal taxable income or federal tax liability as the state income tax base might be less likely to volunteer to participate in the system if they did not receive their federal tax returns in time to meet state filing requirements, which is typically April 15. Unless IRS is able to get returns to taxpayers before this date, these taxpayers would have to compute their federal taxable income or tax liability or file their state tax returns late. If they filed their state returns late, they could be subject to state penalties for filing late returns.

Taxpayers May Not Want to Participate in a Tax Agency Reconciliation System

A taxpayer focus group IRS held in 1993 did not support a tax agency reconciliation system. According to IRS officials, the participants, who expressed varying degrees of mistrust toward IRS, doubted that IRS had complete and correct data with which to prepare their returns. Many participants also felt that their tax liability would increase because IRS would try to assess more taxes than they might otherwise owe. Also, the participants expressed doubt that procedural remedies would be available for obtaining adjustments if they disagreed with the return prepared by IRS.

Representatives of the paid preparer community also told us that many of their clients do not trust IRS to prepare accurate returns and would continue to rely on paid preparers for return preparation services under a tax agency reconciliation system.

Taxpayers may also be reluctant to participate in a tax agency reconciliation system if IRS could not issue refunds as early as it does when taxpayers file their returns. Some taxpayers currently receive refunds by late January. According to IRS data, about 57 million or 72 percent of the 93 million taxpayers who received refunds in 1995 were issued them by the end of April. Under a tax agency reconciliation system, IRS may not be able to issue refunds this early.

There may be no easy way to get taxpayers to change their attitude about trusting IRS to accurately assess their taxes. However, taxpayers who volunteer to participate in a tax agency reconciliation system would have copies of their information returns to verify that IRS used the correct income to calculate their taxes. Also, over 2 million taxpayers participated in IRS' tax year 1995 TeleFile program in which they relied on IRS to

accurately calculate their taxes. On the other hand, one of IRS' selling points for using TeleFile was that taxpayers would receive their refunds sooner than if they filed paper returns. According to IRS, about 23 million taxpayers who filed tax year 1995 forms 1040EZ were eligible to participate in the TeleFile program in 1996, which was the first year the program was available nationally.

As with other alternative filing options that IRS has introduced, such as electronic filing and TeleFile, getting taxpayers to volunteer to participate in a tax agency reconciliation system may depend upon how well the system works. If IRS could produce timely and accurate tax returns, taxpayer acceptance could be enhanced.

Conclusions

As many as 51 million taxpayers, primarily wage earners, would not have to prepare tax returns under a tax agency reconciliation type system. Instead, IRS could prepare their returns for them on the basis of taxpayer supplied information, such as filing status and dependents, which along with information returns would be used to produce tax returns.

We estimated that under a tax agency reconciliation system, taxpayers could save up to 155 million hours collectively on tax return preparation tasks and millions of dollars in tax return preparer fees. Such a system would also benefit IRS by reducing its returns processing and compliance costs. An unknown, however, is the extent to which taxpayers would voluntarily participate should such a system be adopted in the United States. Key considerations in this regard would be taxpayers' perceptions of how efficiently, accurately, and fairly IRS could administer such a system. In addition to addressing these perceptions, IRS would need to design the system to minimize, to the extent possible, its own administrative problems and any additional burden imposed on other stakeholders, including employers and affected financial institutions in providing information returns electronically and more timely.

A major impediment to establishing a tax agency reconciliation system is the length of time it takes IRS to process information returns. IRS' current processing time frame would not allow it to provide taxpayers' federal returns before April 15, which is the due date for filing tax returns. IRS' 1987 study of return-free filing also noted this impediment as the major reason why a return-free system could not be implemented at that time. Technological advances, such as electronic filing, since that study may

make it possible to have a tax agency reconciliation system in the future if more information returns were filed electronically.

Recommendation

A tax agency reconciliation type filing system could make it easier and cheaper for taxpayers to fulfill their tax return filing responsibilities. Because of these factors and the technological advances made since IRS' 1987 return-free filing study, we recommend that the Commissioner of Internal Revenue reexamine the feasibility and desirability of designing and implementing a tax agency reconciliation system.

The reexamination should include a determination of methods to increase trust among taxpayers in IRS' ability to administer such a system fairly and accurately. It should also assess the added burdens and costs that such a system would have on employers, affected financial institutions, and other stakeholders and develop ways of mitigating these burdens and costs.

Because of the uncertainty about stakeholder receptivity to such a system, we also recommend that, if the reexamination results in IRS initially determining that an agency reconciliation system may be feasible and desirable, the Commissioner expand the reexamination to include a limited pilot test. Such a test would provide IRS with useful data for addressing stakeholder concerns and demonstrating its ability to administer such a system fairly and accurately. If all of the improvements necessary to fully implement a tax agency reconciliation system are not feasible in the short term, it may still be possible to test the concept in one or more states that have no income tax.

Comments and Our Evaluation

We requested comments on a draft of this report from the Commissioner of Internal Revenue, the American Institute of Certified Public Accountants, and IRS' Information Reporting Program Advisory Committee.

IRS Comments

In written comments on a draft of this report (see app. III), the IRS Deputy Commissioner was supportive of exploring any proposal that would reduce taxpayer burden and the volume of paper that needs to be processed. He indicated that a reexamination of the feasibility and desirability of designing and implementing a tax agency reconciliation system could become part of the Tax Settlement Reengineering project, which is an IRS initiative that uses a structured methodology to examine

IRS' business processes and ways to reduce paper processing. However, he noted that it would be a difficult task to do a complete cost-benefit analysis of a tax agency reconciliation because much of the information needed to do the analysis, such as private sector costs, may not be available. We recognize the difficulty of obtaining complete information on private sector costs, but we believe that IRS should be able to do an adequate evaluation of the feasibility of a tax agency reconciliation system because it has experience in evaluating other alternative filing systems such as TeleFile.

The Deputy Commissioner noted that our report identified that the Service Center Recognition and Image Processing System and the Simplified Tax and Wage Reporting System as steps that IRS is taking to accelerate information returns processing. However, he stated that the draft report did not describe how close these activities are to accelerating information returns processing and therefore did not accurately portray the impact of this obstacle on a tax agency reconciliation system. During the course of our work, we asked for, but IRS did not provide estimates of when these initiatives are projected to be able to accelerate information returns reporting. The Deputy Commissioner's letter is also silent in this respect.

Finally, the Deputy Commissioner commented that the costs of a tax agency reconciliation system would be more than the costs to process electronically filed returns. We agree that the costs associated with the type of tax agency reconciliation system described in the report would be more than the costs to process the same number of returns electronically filed. However, we estimated that only 8 million of the 51 million taxpayers who could have been included in an alternative filing system in tax year 1992 filed electronically. If IRS could get most taxpayers to file electronically there may be no need for other alternative filing systems.

American Institute of
Certified Public
Accountants Comments

In its written comments, the American Institute of Certified Public Accountants stated that it did not believe that IRS has the ability to implement a tax agency reconciliation system in the foreseeable future because of (1) the current uncertainty of IRS budget and staffing levels, (2) the inability of IRS to process and payers to file complete and accurate information returns on a timely basis, (3) the unknown effect on voluntary compliance that could occur if taxpayers fail to report income to IRS from sources not covered by information returns, and (4) the potential for IRS to make more errors processing taxpayers' changes to IRS prepared returns

under an alternative system than it currently makes processing tax returns.

We believe that the issues raised by the Institute are valid. Budget constraints could hamper IRS' ability to adopt a tax agency reconciliation system, but this should not prevent it from reexamining the concept. Similarly, if information returns processing cannot be accelerated in time to issue tax returns well before April 15, IRS would not be able to implement the type of tax agency reconciliation system described in the report unless federal and state laws are changed. We expect that information return filing and processing would be the key element in IRS' examination of the system. In regards to whether taxpayers who volunteer for the system may not let IRS know when they have income not covered by information returns, we agree that the reporting of income not subject to information returns is potentially problematic. However, that problem exists today for paper returns and TeleFile, and we see no evidence it would be worse under a tax agency reconciliation system. As part of its examination of a tax agency reconciliation system, IRS may be able to get a handle on this type of noncompliance by evaluating a sample of TeleFile participants to determine whether they failed to report noninformation return income. As to whether the IRS would be more error-prone in processing tax changes under a tax agency reconciliation system than processing tax returns, we assume that IRS would have controls and procedures that would minimize errors under any system it develops.

The Institute noted that a tax agency reconciliation system is too dependent on future IRS and SSA improvements and that it is too costly for IRS to undertake such a system until after the successful implementation of these future improvements. The Institute stated that paper processing may be more efficiently reduced by expanding opportunities for electronic filing and TeleFile and it concluded that IRS is correctly focusing its attention on these initiatives. We agree that IRS should continue to reduce taxpayer burden and paper processing through electronic filing and TeleFile. Our recommendation is to have IRS reexamine a tax agency reconciliation system to determine its feasibility as a supplement to these voluntary alternative filing systems.

**Information Reporting
Program Advisory
Committee Comments**

In its written comments, the Information Reporting Program Advisory Committee raised similar issues on IRS' budget constraints, information returns filing and processing constraints, and potential decreases in voluntary taxpayer compliance levels that were raised by the American

Institute of Certified Public Accountants. The Committee also stated that because many of the taxpayers who could be covered by a tax agency reconciliation system already use electronic filing and TeleFile, our estimates of cost savings are overstated. Our costs estimates were based on the combined costs to process the Form 1040 series of returns, which included both paper and electronically filed returns. The costs of TeleFile returns were not considered because we used tax year 1992 return data, and TeleFile was not implemented nationwide until 1996 for tax year 1995 returns. According to IRS, about 2.8 million taxpayers used TeleFile in 1996.

The Committee also pointed out that the report did not address the costs to the paid preparer community of a tax agency reconciliation system. These costs dealt with the loss of federal revenues due to a decrease in taxable income reported by paid preparers and the costs of unemployment insurance and public assistance payments if the paid preparer industry experiences a significant loss of jobs. These types of costs are difficult to quantify. However, our report acknowledges that paid preparers may see a decrease in business if most taxpayers volunteer to be covered by a tax agency reconciliation system. The report also states that the effect on paid preparers and payers would need to be considered before such a system is adopted. We would expect IRS to include an analysis of these costs in any examination of a tax agency reconciliation system.

We will send copies of this report to the Ranking Minority Member of this Subcommittee, the Commissioner of Internal Revenue, and other interested parties. We also will make copies available to others upon

request. The major contributors to this report are listed in appendix IV. If you have any questions, please call me at (202) 512-9044.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Natwar M. Gandhi". The signature is fluid and cursive, with a large initial "N" and a long, sweeping underline.

Natwar M. Gandhi
Associate Director, Tax Policy and
Administration Issues

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Abbreviations

EIC	Earned Income Credit
IRS	Internal Revenue Service
SOI	Statistics of Income
SSA	Social Security Administration
SSN	Social Security Number
STAWRS	Simplified Tax and Wage Reporting System

Characteristics and Operations of Final Withholding Type Filing Systems

This appendix describes some of the major characteristics of final withholding type filing systems found in other countries. It also discusses how final withholding works in other countries and how a United States final withholding system might work.

Final Withholding Systems in Other Countries

Although none of the countries with final withholding type filing systems are exactly alike, many share common characteristics such as (1) withholding on wages, (2) exempting or limiting taxes on interest and dividend income, and (3) requiring each spouse in a marriage who elects final withholding to be taxed as an individual instead of jointly.

Under a final withholding system, as long as the proper amount of taxes have been withheld from wages and other income sources, no tax return has to be filed. However, there are differences among the countries using this system in when and how employers calculate the final withholding. For example, under the United Kingdom's cumulative final withholding system, the employer must calculate the employee's tax for a given pay period as well as the cumulative tax to date and then make any necessary adjustments. To determine how much tax employers need to withhold, the employee is to submit a form to the United Kingdom's tax agency showing basic factors affecting the taxpayer's tax status, such as the number of dependents and amount of allowances the taxpayer is entitled to claim. From this information, the tax agency is to develop a code and give it to the employer who then applies the code to tax tables to determine the amount of taxes to withhold. Tax agency auditors are to later verify whether employers withheld the correct amounts of taxes. More than three-fourths of the 22.4 million taxpayers eligible for final withholding in the United Kingdom did not have to file tax returns in 1994.

Germany's final withholding system is similar to the United Kingdom's except that at the beginning of the calendar year the tax agency is to issue a certified wage card to each employee, listing basic factors affecting the employee's tax status. The employee is to present the wage card to the employer for use in determining the amount of taxes to withhold. At the end of the year, the employer is to summarize the wage and withholding information, and if necessary, adjust the employee's last paycheck so that the correct amount of taxes is withheld.

Under Japan's final withholding system, employees are to submit to the tax authorities, through their employer, statements providing exemption information, which include the names of dependents and other necessary

particulars. Employers are to use the exemption information to withhold income tax on employment income according to tax tables based on variables, including the size of the income, number of exemptions, and periodic employment income. At the end of the year, the employer is to compare the taxes collected with the yearly tax amounts due and adjust the last paycheck so that the withholding equals the tax liability.

Many countries with final withholding filing systems reduce the number of taxpayers required to file tax returns by either exempting, limiting, or taxing interest and dividend income at the source. Fourteen countries exempt all or a portion of interest, while another 14 countries tax interest with a flat amount at the source (e.g., tax on interest is withheld by the financial institution).

Countries with final withholding filing systems may not allow married taxpayers to file joint returns. Twenty-two countries with a final withholding filing system specifically require married taxpayers to file separately. Other countries either require joint tax returns or give married couples that option. According to International Monetary Fund officials, administering a final withholding system with a “married filing joint” filing status would be very difficult if both spouses work. In that circumstance, each employer would need to take the income of the taxpayer’s spouse into consideration when calculating the final withholding amount.

Under nearly all final withholding systems, including those of the United Kingdom, Germany, and Japan, taxpayers are required to file returns under some circumstances. For example, Chile requires employees to file tax returns if they have a second employer. In Luxembourg, where the total income of husband and wife is aggregated, a tax return must be prepared when both spouses work.

Table I.1 describes the characteristics of the tax system for 34 countries with a final withholding filing system.

**Appendix I
Characteristics and Operations of Final
Withholding Type Filing Systems**

Table I.1: Tax System Information for 34 Countries With Final Withholding Systems

Country	No return requirement	Interest income requirement	Marital filing status requirement
Argentina	if earned income only	savings/bank interest exempt	married filing separate if wife employed
Austria	if earned income only	flat tax at source	married filing separate
Chile	if earned income only from one job	taxed through tax return	married filing separate if wife employed
Colombia	if earned income less than threshold	flat tax at source	married filing separate
Costa Rica	if earned income only	flat tax at source, reconciled through tax return	married filing separate
Czech Republic	if income taxed at source or if only earned income	flat tax at source	married filing separate
Dominican Republic	if earned income only	interest exempt	married filing separate
Ecuador	if earned income and employed by one company	flat tax at source, reconciled through tax return	married filing separate
Egypt	if earned income only	savings/bank interest exempt	married filing separate
Germany	if earned income under a certain threshold	interest above threshold withheld at source	either joint or separate, but taxed on joint
Hungary	if sole income from one employer or less than threshold	flat tax at source	married filing separate
Indonesia	if income from one employer only	flat tax at source	married filing joint
Iran	if income from one source and less than threshold	taxed through tax return	married filing separate
Ireland	if earned income only	flat tax at source	either joint or separate, but taxed on joint
Japan	if one employer and earned income and other income less than threshold	flat tax at source	married filing separate
Kenya	if earned income from one employer and no change in personal circumstances	flat tax at source	married filing joint
Republic of Korea	if earned income only	flat tax at source	married filing separate
Luxembourg	if earned income only, one employer, and less than threshold	amount above threshold taxed through tax return	married filing joint
Malawi	if earned income only	amount above threshold taxed through tax return	married filing joint
Mexico	if employed by one employer through 12/31	flat tax at source	married filing separate

(continued)

**Appendix I
Characteristics and Operations of Final
Withholding Type Filing Systems**

Country	No return requirement	Interest income requirement	Marital filing status requirement
Morocco	if earned income from one employer only	taxed through tax return	married filing separate
Netherlands	if earned income only	taxed through tax return	married filing separate
Nigeria	if earned income only and less than threshold	flat tax at source, reconciled through tax return	married filing separate
Panama	if one source of income from wages	flat tax at source	either joint or separate
Papua New Guinea	if earned income only	savings/bank interest exempt	married filing separate
Peru	if earned income only	taxed through tax return	either joint or separate
Poland	if earned income only	savings/bank interest exempt	either joint or separate
Romania	if earned income only (employer files return for taxpayer)	savings/bank interest exempt	married filing separate
Russian Federation	if one company and less than threshold	savings/bank interest exempt	married filing separate
South Africa	if earned income less than threshold	amount above threshold taxed through tax system	married filing joint
Tanzania	if earned income only	amount above threshold taxed through tax return	either joint or separate, unless in business with spouse
Turkey	if earned income less than threshold	savings/bank interest exempt	married filing joint
Uganda	if earned income only	taxed through tax return	either joint or separate
United Kingdom	if earned income only	amount above threshold taxed at source	married filing separate

Source: GAO analysis based on Price Waterhouse Individual Taxes: A Worldwide Summary, 1991 and 1994.

A United States Final Withholding System Would Require Tax Law and Other Changes to Work Effectively

Before a final withholding system could be instituted in the United States, the law would have to be changed to require employers to calculate employees' tax liability and adjust employees' last paychecks so that total yearly withholdings would equal employees' tax liability. Also, unlike many countries with final withholding systems, the United States tax system does not exempt or limit taxes on interest and dividend income nor does it require married couples to file separately. These features are potential barriers to adopting a final withholding system in the United States. Without changes to address these features, taxpayers that could be

covered by final withholding would be limited to those who only had wage income, which is the only income source generally subject to withholding.

To determine how many taxpayers in the United States potentially could be covered by final withholding, we identified criteria for eligibility for a final withholding filing system. The final withholding criteria were identified to minimize tax law and administrative changes, limit burden on employers and other payers, and maximize the number of taxpayers that could be included in the system. To meet these criteria,

- taxpayers would not be able to itemize deductions and, instead, would take the standard deduction;
- taxpayers could have only wage income because other types of income are generally not subject to withholding;
- only taxpayers with one employer could be covered by final withholding because taxpayers with more than one employer would increase the burden on employers, who would have to know the income received from other employers to withhold the correct amount of taxes;
- married couples where both spouses had income were excluded because employers would have to know the income of both spouses to withhold the correct amount of taxes; and
- taxpayers could not claim any credits because employers would have to calculate the credit, which would impose additional recordkeeping burdens on them.

We estimated that about 18.5 million taxpayers in 1992 met these conditions and could be covered under this type of final withholding system.¹¹ These 18.5 million taxpayers represented about 16 percent of the taxpayers who filed returns, and they accounted for about 4 percent of the total reported individual tax liability.

How a Final Withholding System Might Operate

One way a final withholding system might work would be to have IRS develop a new withholding form for taxpayers who volunteer for final withholding. Employees would submit the withholding form to their employers for withholding and tax calculation purposes. The new form would have to contain such taxpayer entity data as

- name and address,

¹¹To make this estimate, we used IRS' tax year 1992 Statistics of Income (SOI) data and U.S. Bureau of Census data. Census supplied data on the number of wage earners that had only one job and the number of married couples where only one spouse worked. We adjusted the SOI data with the Census data to make our estimate.

- SSN,
- filing status, and
- name and SSN of spouse and dependents.

A new withholding form would have to be developed because the current withholding form, Form W-4, Employee Withholding Allowance Certificate, does not contain complete filing status information or information on the employee's spouse and dependents. Similar to current procedures, employers would use the information from the new withholding form to calculate the amount of income tax to be withheld each pay period. However, unlike current procedures, employers would enter Employer Identification Number on the new withholding form and send it to IRS.

IRS would receive the new withholding form and enter the information on its records. IRS could use this information for compliance purposes, such as verifying the taxpayer's and dependents' SSNs. For the last pay period of the year, the employer would have to calculate the employee's tax liability on the basis of the information provided on the employee withholding certificate. The employer would need to compare the tax liability with the amount withheld during the year and adjust the employee's last pay check so that the total yearly withholdings equaled the tax liability. If during the year the withheld taxes exceeded the tax liability, the employee's net pay on the last paycheck would be higher than usual. However, if not enough taxes were withheld during the year, the employee's last paycheck would be smaller than usual.

Potential Benefits and Costs of Final Withholding

Final withholding would reduce the time taxpayers spend preparing returns and possibly eliminate the cost of paying tax return preparers. Thus, such a system would reduce taxpayer burden. However, it would have a negative impact on paid preparers. On the other hand, IRS' returns processing costs would be reduced because it would not have to process tax returns.

Final withholding would increase employers' burden and costs in complying with tax laws and regulations. For example, in addition to knowing about current withholding requirements and forms, employers would need to become familiar with separate withholding and reporting requirements for employees who volunteer for final withholding and those who do not. Unlike under the current employment tax requirements, employers would need to ensure that they accurately track withheld taxes

so that they could make a year-end adjustment to make the withheld taxes equal to the taxpayer's tax liability. Otherwise, employers could be liable for payment penalties for incorrectly withholding taxes on employees.

Employers and their representatives we talked to expressed concern over some final withholding aspects. Some employers believed that final withholding would require revising the entire payroll process to accommodate year-end adjustments. We were told by some employers that the current wage withholding system would need to be completely overhauled because it was not designed to calculate the final amount of taxes owed.

Taxpayers would not have a federal tax return to use to file their state income tax returns. However, except for eligible taxpayers who reside in the eight states that use federal taxable income as their tax base, eligible taxpayers who are required to pay state taxes could calculate their state taxes from the income and withholding information contained on their withholding form. We estimated that about 2 million of the 18.5 million taxpayers who could be eligible for final withholding reside in the eight states where tax systems are linked to federal taxable income.¹² For these taxpayers to meet state tax requirements, they would have to determine their federal taxable income. However, in the absence of federal tax returns, officials from several of these states told us they would consider developing supplemental instructions and worksheets in their tax booklets that would allow taxpayers to calculate federal taxable income so that taxpayers could calculate their state taxes.

¹²The eight states are Colorado, Hawaii, Idaho, Minnesota, North Carolina, Oregon, South Carolina, and Utah.

Population and Cost Estimates for a Tax Agency Reconciliation System

This appendix describes how we derived the population and cost estimates for the tax agency reconciliation type filing system. We used IRS' 1992 Statistics of Income (SOI) data to estimate the number of taxpayers who would have met our eligibility criteria for the system and the amount of time they could save in tax return preparation tasks. We used IRS' Document 6746, Cost Estimate Reference for Service Center Returns Processing for Fiscal Year 1994, to develop costs estimates.¹³

Population and Costs Estimates for Tax Agency Reconciliation System

For a hypothetical tax agency reconciliation system, we made the following estimates: (1) number of taxpayers in tax year 1992 who could have been covered by the system, (2) fiscal year 1994 costs to process tax returns for this population, (3) costs to process taxpayer information forms, (4) costs to produce computer-generated tax returns, (5) costs to process remittances for taxpayers who would owe taxes, (6) costs to handle taxpayer inquiries about their computer-generated tax returns, and (7) potential compliance savings from the underreporter program.

Number of Taxpayers Eligible for a Tax Agency Reconciliation System

Taxpayers who could have been covered by this system included those who had income from wage, interest, dividend, pension, and unemployment and claimed the standard deduction. We estimated that 51 million taxpayers would have met these eligibility criteria for a tax agency reconciliation system.

Table II.1 shows the number of taxpayers included in a tax agency reconciliation system by income type.

Table II.1: Number of Taxpayers by Type of Income for Tax Agency Reconciliation System

Numbers in millions	
Income type	Number of taxpayers
Wages only	28.7
Interest/Dividend only	1.0
Pension only	0.1
Unemployment compensation only	0.1
Other combinations	21.1
Total	51.0

Source: GAO analysis of 1992 SOI data.

¹³This document contained information on labor costs and staff hours for processing returns and performing related functions in the service centers, which are computed using national totals and rates.

**Appendix II
Population and Cost Estimates for a Tax
Agency Reconciliation System**

Included in the 51 million taxpayers, but not shown in table II.1 because they are already included based on their type of income, are 9.9 million or 19 percent of the taxpayers who claimed earned income tax credit (EIC).

**Cost Estimates for
Processing Tax Returns**

Table II.2 shows the number of tax returns by the type of form filed and IRS' combined paper and electronic filing cost to process each form.

Table II.2: Estimates of IRS' Fiscal Year 1994 Processing Costs by Form Type

Numbers and total costs in millions			
Form type	Number of returns	Cost per form	Total cost
1040EZ	19.0	\$ 3.12	\$ 59.3
1040A	23.0	3.69	84.9
1040	9.0	4.23	38.1
Total	51.0	N/A	\$182.3

Source: IRS' 1992 SOI data and Document 6746, Cost Estimate Reference for Service Center Returns Processing for Fiscal Year 1994.

**Tax Agency Reconciliation
System Cost Estimates**

Table II.3 shows the estimated costs associated with the tax agency reconciliation system.

Table II.3: Estimated Processing and Tax Return Costs Under Tax Agency Reconciliation System

Numbers and costs in millions		
Function	Number	Cost
Processing taxpayer information forms	51.0	\$ 46.9
Computer-generated tax returns	51.0	49.5
Processing remittances	7.7	2.3
Handling taxpayer adjustments to returns	.275	1.4
Telephone calls from taxpayers accepting IRS prepared returns	50.725	59.9
Total processing and tax return costs		\$160.0
Less savings from underreporter program		\$ 15.1
Net processing and tax return costs		\$144.9

Source: IRS' 1992 SOI data, IRS' Document 6746, and GAO analysis.

The following sections describe how each of these estimates were done.

Appendix II
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Estimated processing costs for taxpayer information form: For our hypothetical tax agency reconciliation system, we assumed that IRS would need to develop a form to collect taxpayer information that would be needed to calculate a taxpayer's tax liability. Some of the information IRS would need on each taxpayer would include,

- name and address,
- SSN,
- filing status,
- name and SSN of spouse,
- name and SSN of dependents and qualifying children,
- relationship of dependents and qualifying children to taxpayer, and
- number of months dependents and qualifying children lived with taxpayer during the year.

To determine IRS' costs to process a form with these taxpayer information items, we used the costing methodology in IRS' Document 6746. Table II.4 shows the estimated cost to process 1,000 taxpayer information forms.

Table II.4: Estimated Cost to Process 1,000 Taxpayer Information Forms

Type of cost	Cost
Processing cost	\$391.66
Quality assurance (\$12.34 X 2 hr.)	24.68
Subtotal	416.34
Overhead (\$416.34 X 75 percent)	312.26
Subtotal	728.60
Employee benefits (\$728.60 X 25.9 percent)	188.71
Total cost for 1,000 forms	\$917.31
Cost per form	\$0.92

Source: IRS' Document 6746, Cost Estimate Reference for Service Center Returns Processing for Fiscal Year 1994.

Fresno Service Center staff estimated that the processing cost for 1,000 forms would be \$391.66 and would take 43.5 hours of labor to process. We then used these processing costs and hours and Document 6746 quality assurance methodology to determine quality assurance costs. Using Document 6746 methodology, we multiplied the number of hours required for processing taxpayer information forms (43.5 hours) by 4.5 percent to determine the quality assurance time for 1,000 forms, which was about 2 hours (i.e., 43.5 hours x 0.045 = 1.958 or 2.0 hours). To compute the cost of the quality assurance time, we multiplied the 2 hours by the \$12.34 hourly

quality assurance rate used in Document 6746 and determined this cost to be \$24.68 ($\12.34×2.0 hours).

To estimate overhead costs, we used the overhead percentage found in Document 6746, which was 75 percent of direct costs (i.e., processing cost of \$391.66 plus quality assurance cost of \$24.34 for a total of \$416.34. We estimated overhead cost to be \$312.26, ($416.34 \times .75$), which when added to the combined processing and quality assurance costs was \$728.60. To determine employee benefits, we used the 25.9 percent benefit rate found in Document 6746 and multiplied this rate by the direct and overhead costs (i.e., $\$728.60 \times 0.259$). The employee benefits (\$188.71) was added to all other cost to give a total cost of \$917.31 to process 1,000 forms. Thus, the cost per form would be about 92 cents.

Computer-generated tax return: IRS essentially produces computer-generated tax returns now in its document-matching program. Under this program, IRS computer-matches income reported on information returns with income reported on tax returns to determine whether taxpayers reported all their income or failed to file required tax returns. In this matching process, the computer internally creates the equivalent of a tax return from the information return data. When the computer identifies nonfilers, IRS service centers send a series of computer-generated notices to potential nonfilers. Certain nonfiler cases not resolved during the notice process are assigned to the Substitute for Return Program.¹⁴ Under this program IRS uses information returns to prepare a tax return that “substitutes” for the return that the taxpayer should have filed voluntarily. IRS estimated that it costs about 65 cents to produce a substitute return and 32 cents to mail each one. On the basis of these data, we estimated it would cost about \$49.5 million to produce and mail out 51 million computer-generated tax returns.

Processing remittances: On the basis of the SOI data, we estimated about 7.7 million or 15 percent of the 51 million taxpayers would owe taxes when they received their computer-generated tax returns. The remaining 43.3 million either would receive a refund or owe no taxes. IRS Document 6746 data for fiscal year 1994 showed that it cost about 30 cents to process a remittance. Therefore, we estimated the cost to process 7.7 million remittances would be \$2.3 million.

¹⁴This program is authorized under section 6020 of the Internal Revenue Code. It authorizes the Secretary of the Treasury or his delegate to prepare tax returns for persons who file a false or fraudulent return or fail to file a return.

Handling taxpayer adjustments to IRS prepared returns: On the basis of the results of IRS' underreporter program, it is likely that some of the information returns that IRS receives will be in error and result in erroneous tax returns. For the tax year 1991 underreporter program, IRS created about 9.1 million potential underreporter cases for the 114.7 million returns filed that year. About 112 million of the returns had at least 1 of the 5 types of income included in our tax agency reconciliation model (i.e., wages, interest, dividends, pensions, and unemployment compensation). IRS found that about 2.3 million or 2 percent of the 112 million taxpayers potentially underreported 1 or more of the 5 tax agency reconciliation system income types.

To determine how many of the 51 million taxpayers eligible for tax agency reconciliation filing would be potential underreporters, we assumed that the underreporter caseload was spread out evenly among all 112 million taxpayers who reported 1 of the 5 tax agency reconciliation system income types. Therefore, we estimated that 46 percent (i.e., 51 million divided by 112 million) or 1.1 million of the 2.3 million (2.3 million x 46 percent) potential underreporter cases could be eligible for tax agency reconciliation filing.

IRS worked about 1.8 million of the 2.3 million potential underreporter cases. IRS found when it investigated the 1.8 million cases that about 900,000 or 50 percent resulted in no change to the taxpayers' tax liabilities because taxpayers had reported either the income on their returns, which was not detected in the computer-match, or the information returns were in error. Using the 50 percent no-change rate, we estimated IRS would have found that about 550,000 of the 1.1 million tax agency reconciliation potential underreporters would not have underreported their income.

IRS does not maintain data on the number of erroneous underreporter cases that are created because of erroneous information returns. However, IRS Fresno Service Center officials estimated for us that between 5 and 10 percent of the no-change underreporter cases worked were due to erroneous information returns. To be conservative, we assumed that 50 percent of the no-change underreporter cases would not be correct because of erroneous information returns. We applied this 50 percent erroneous information return rate to the 550,000 no-change underreporter cases and estimated that IRS would create about 275,000 flawed tax returns because of erroneous information returns. To be conservative, we assumed that taxpayers who received these flawed returns would correspond with IRS to resolve the erroneous conditions rather than

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resolve them by telephone. IRS' Document 6746 data showed that it costs about \$4.93 to handle a piece of correspondence from an individual taxpayer. Therefore, on the basis of this data, we estimated it would cost \$1.4 million to handle the 275,000 taxpayer inquiries. Table II.5 shows the calculations we made to estimate the cost of handling taxpayer inquiries to process adjustments to IRS prepared tax returns.

Table II.5: Methodology for Estimating Cost to Process Adjustments to IRS Prepared Returns

Data used to calculate underreporter cases	Estimates
Number of taxpayers with wage, interest, dividend, pension, and unemployment income in tax year 1992.	112 million
Number of taxpayers eligible for tax agency reconciliation filing system.	51 million
Percent of taxpayers eligible for tax agency reconciliation filing to total taxpayers. (51 million/112 million)	46 percent
Number of taxpayers who IRS identified as potential underreporters of wage, interest, dividend, pension, and unemployment income in tax year 1991.	2.3 million
Number of taxpayers eligible for tax agency reconciliation filing who were identified as potentially underreporting their income in 1991. (.46 X 2.3 million)	1.1 million
No-change rate for tax year 1991 underreporter cases with wage, interest, dividend, pension, and unemployment compensation that were worked by IRS.	50 percent
Number of tax agency reconciliation underreporter cases with no change. (1.1 million x 50 percent)	550,000
Percent of no-change cases that were due to erroneous information returns.	50 percent
Number of tax agency reconciliation system no-change cases that were due to erroneous information returns. (550,000 x 50 percent)	275,000
Average cost to handle a piece of taxpayer correspondence.	\$4.93
Cost to process taxpayer inquiries for adjustments to IRS prepared returns that were due to erroneous information returns. (\$4.93 x 275,000)	\$1.4 million

Source: GAO's analysis of IRS' tax year 1991 underreporter data.

Handling telephone calls from taxpayers accepting IRS prepared returns: We assumed that the estimated 50,725,000 taxpayers who would agree with their IRS prepared tax returns would telephone IRS with their acceptance. IRS estimated that for fiscal year 1994, it cost about \$1.18 for each taxpayer service call. Using these data, we estimated that the cost to IRS to handle 50,725,000 telephone calls would be about \$59.9 million.

Savings from the Underreporter Program: Since the 51 million computer-generated returns are created from information returns, the 51 million taxpayers covered by return-free filing would not be subject to the underreporter program. Therefore, IRS would not incur underreporter costs associated with investigating taxpayers who are part of the tax agency reconciliation system. To determine the underreporter costs savings that could result under a tax agency reconciliation system, we used the results of IRS' tax year 1991 underreporter program.

As discussed above, IRS worked about 1.8 million or 78 percent of the 2.3 million potential underreporter cases that have the 5 types of tax agency reconciliation filing income (i.e., wages, interest, dividends, pensions, and unemployment compensation). We also assumed that since the 51 million taxpayers eligible for tax agency reconciliation filing represented 46 percent of the taxpayers with the 5 income types that the same percentage would apply to the potential underreporter population. Therefore, the tax agency reconciliation underreporter population would be 1.1 million taxpayers (2.3 million x 46 percent). Since underreporter costs are only associated with cases that IRS worked, and it handled 78 percent of its cases in 1991, we estimated that IRS would have worked 858,000 of the 1.1 million tax agency reconciliation eligible cases. IRS estimated that it cost about \$17.61 to work and close a tax year 1991 underreporter case. Thus, the cost savings of not having to work these underreporter cases would be about \$15.1 million (858,000 x \$17.61). Table II.6 shows how we calculated this cost-savings estimate.

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Table II.6: Methodology for Estimating Underreporter Cost Savings Due to Tax Agency Reconciliation System

Data used to calculate underreporter cases	Estimates
Number of taxpayers with wage, interest, dividend, pension, and unemployment income in tax year 1992.	112 million
Number of taxpayers eligible for tax agency reconciliation filing system.	51 million
Ratio of taxpayers eligible for tax agency reconciliation filing to total taxpayers (51 million/112 million)	46 percent
Number of taxpayers who IRS identified as potential underreporters of wage, interest, dividend, pension, and unemployment income in tax year 1991	2.3 million
Number of taxpayers eligible for tax agency reconciliation filing who were identified as potentially underreporting their income in 1991 (.46 X 2.3 million)	1.1 million
Number of tax year 1991 underreporter cases with wage, interest, dividend, pension, and unemployment compensation that were worked by IRS.	1.8 million
Percent of underreporter cases worked of total cases created (1.8 million/2.3 million)	78 percent
Estimated number of underreporter cases worked by IRS that also qualify for tax agency reconciliation filing	858,000
Average cost to work an underreporter case	\$17.61
Savings from not working tax agency reconciliation underreporter cases (\$17.61 X 858,000)	\$15.1 million

Source: GAO's analysis of IRS' tax year 1991 underreporter data.

Hours Spent in Tax Return Preparation

IRS has developed estimates of the average amount of time it takes taxpayers to complete and file various types of tax returns and schedules.¹⁵ IRS breaks the return preparation time into four tasks: (1) recordkeeping; (2) learning about the law or the form; (3) preparing the form; and (4) copying, assembling, and sending the form to IRS. Table II.7 shows the average amount of time to complete the four tasks by the three types of individual income tax returns (forms 1040EZ, 1040A, and 1040) and for the Schedule EIC, Earned Income Credit (Qualifying Child Information).

¹⁵IRS' estimated average tax return preparation time are found in the instructions to the tax return packages. We did not evaluate the reliability of these estimates. However, we use the estimates solely for comparison purposes.

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Table II.7: IRS' Estimated Average Time Spent to Complete and File Individual Tax Returns and Schedule EIC

Form type	Record keeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to IRS	Total hours needed to complete form type
1040EZ	5 min.	49 min.	1 hr. 20 min.	40 min.	2.9 hr.
1040A	1 hr. 3 min.	2 hr. 14 min.	2 hr. 51 min.	35 min.	6.7 hr.
1040	3 hr. 8 min.	2 hr. 53 min.	4 hr. 41 min.	53 min.	11.6 hr.
EIC ^a	0 min.	2 min.	4 min.	5 min.	.2 hr.

^aSchedule EIC is filed with forms 1040A and 1040 only.

Source: IRS' 1994 individual tax return instructions.

Table II.8 shows that the 51 million taxpayers eligible for a tax agency reconciliation filing system spent an estimated 316.3 million hours completing and filing returns.

Table II.8: Estimated Time Spent by Taxpayers Eligible for Tax Agency Reconciliation System to Prepare Returns by Form Type

Total time and numbers of taxpayers in million

Form type	Amount of time spent to prepare form (per taxpayer)	Number of taxpayers	Total time
1040EZ	2.9 hr.	19.0	55.1 hr.
1040A with EIC	6.9 hr.	8.7	60.0 hr.
1040A	6.7 hr.	14.4	96.5 hr.
1040 with EIC	11.8 hr.	1.2	14.2 hr.
1040	11.6 hr.	7.8	90.5 hr.
Total		51.0	316.3 hr.

Note: Totals may not add due to rounding.

Source: Table II.7 and GAO's analysis of tax year 1992 SOI data.

On the basis of IRS' 1992 SOI data, we estimated that about 16.6 million of the 51 million taxpayers had their returns completed by paid preparers. We estimated that these taxpayers would have spent an estimated

54.1 million hours preparing their returns.¹⁶ Thus, we estimated that the 51 million taxpayers would have spent 262.2 million hours (316.3 million minus 54.1 million) preparing tax returns.

To determine the number of hours taxpayers would spend on return preparation tasks associated with a tax agency reconciliation system, we analyzed the potential population of tax agency reconciliation filers by the types of income they reported and their filing status. We estimated that 30 million of the 51 million taxpayers had income from wages, interest, and unemployment compensation, their filing status was either single or married filing joint returns, and they had no dependents. Taxpayers with these characteristics would have return preparation tasks associated with taxpayers who could file Form 1040EZ. The remaining 21 million taxpayers reported income that included either dividends or pensions or had dependents. Taxpayers with these income characteristics, regardless of filing status, would have return preparation tasks associated with taxpayers who could file Form 1040A. Using these data, we estimated the time required for preparing tax returns under a tax agency reconciliation system.

- Recordkeeping: We assumed the 30 million taxpayers who had Form 1040EZ characteristics and the 21 million taxpayers who had Form 1040A characteristics would have the same recordkeeping time IRS estimated for these forms, as shown in table II.7. We estimated that the 51 million taxpayers would spend 24.6 million hours on recordkeeping tasks.
- Learning about the law or form: We made the same assumptions for this task as we did for the recordkeeping task. We estimated that the 51 million taxpayers would spend an estimated 71.4 million hours on this task.
- Preparing the form: To estimate the average time that would be spent on preparing the taxpayer information form, we used IRS' time estimates for completing Schedule EIC. Schedule EIC contains information on the identity of qualifying children for taxpayers claiming the earned income tax credit, which is similar to the information that would be contained on the taxpayer information form. IRS estimated that it takes taxpayers 4 minutes to complete Schedule EIC. We assumed that taxpayers could take twice as long to complete the taxpayer information form because taxpayers may have to enter twice as much data on the taxpayer information form.

¹⁶To make this estimate, we took the amount of time spent to prepare returns from the "preparing the form" column shown in table III.7 and multiplied that number by the appropriate number of return types, which was 5.4 million forms 1040, 8.9 million forms 1040A, and 2.3 million forms 1040EZ. We also multiplied the 4 minutes time spent to prepare the Schedule EIC shown in table III.7 by the 5 million taxpayers who, according to SOI data, claimed the credit and used paid preparers. We summed these calculations to determine the amount of time taxpayers saved by using paid preparers.

Therefore, we estimated that the 51 million taxpayers would spend an estimated 6.8 million hours preparing the form.

- **Copying, assembling, and sending the form to IRS:** For this task, we also used IRS' average time estimates for Schedule EIC, which was 5 minutes. We assumed that since the taxpayer information form is a one-page form like the Schedule EIC that the amount of time would be the same. Therefore, we estimated that the 51 million taxpayers would spend about 4.3 million hours on this task.

In total, we estimated that taxpayers eligible for a tax agency reconciliation system would spend about 107.1 million hours on preparing tax returns, which is 155.1 million hours (262.2 million hours minus 107.1 million hours) less than estimated for preparing tax returns prepared under the current return filing system.

Comments From the Internal Revenue Service



DEPUTY COMMISSIONER

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

August 19, 1996

Ms. Lynda D. Willis
Director, Tax Policy and Administration Issues
General Accounting Office
Washington, DC 20548

Dear Ms. Willis:

We appreciate the opportunity to comment on your recent draft report, Tax Administration: Alternative Filing Systems. We are supportive of exploring any proposal which would reduce both taxpayer burden and the volume of paper that needs to be processed at our service centers. Several initiatives are currently underway to further reduce paper processing including the Tax Settlement Reengineering project, which applies a structured methodology in reexamining our business processes. The report's recommendation that IRS reexamine the feasibility and desirability of designing and implementing a tax agency reconciliation system could conceivably become part of this effort.

However, we believe that there are several serious obstacles which must be overcome before a "return-free system" could become a viable option in this country. The draft report identifies many of these obstacles, including taxpayer acceptance of such a system. In addition, the target population for a return-free system is very similar to the population already serviced by many of our alternative filing options, including the highly successful TeleFile program.

We also want to emphasize that the accelerated processing of information returns well before the April 15 return due date is essential if such a system is to be successful. The draft report concludes that Information Returns Program (IRP) matching does not occur early enough to permit return-free filing, and identifies several steps that the IRS is taking to accelerate the IRP program, including the Service Center Recognition and Image Processing System initiatives and our participation in the Simplified Tax and Wage Reporting System. However, the draft report does not describe how close these activities are to accelerating IRP processing before the April 15 due date, and thus does not accurately portray the impact of this obstacle on return-free filing.

A full accounting of the costs and benefits of a tax agency reconciliation system is a difficult task. Many of the costs and benefits would be borne by the private sector, and are difficult to measure accurately. It may be that much of the information necessary for a complete cost-benefit analysis is not currently available. Finally, the

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Service**


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Ms. Lynda D. Willis

potential savings which would result from such a system require further analysis. The draft report compared the cost of the tax agency reconciliation system to the costs of combined Forms 1040EZ, 1040A and 1040, which include both paper and electronic returns. The electronic returns in each case would be less to process than the agency reconciliation program described in the draft report.

Thank you again for the opportunity to comment on the draft report.

Sincerely,



Michael P. Dolan

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