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THE BENEFITS AND COSTS OF IMPLEMENTING "RETURN FREE" TAX FILING IN THE U.S.

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COMPUTER & COMMUNICATIONS INDUSTRY ASSOCIATION

NAVIGANT
ECONOMICS

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COMPUTER & COMMUNICATIONS INDUSTRY ASSOCIATION

The Computer & Communications Industry Association (CCIA) is an international industry association representing large, medium and small companies in the high technology products and services sector, including computer hardware and software, electronic commerce, telecommunications and Internet products and services. CCIA's membership collectively represents more than $200 Billion in annual revenues across the United States and international technology markets. CCIA is the leading industry advocate in promoting open markets, open systems, and full, fair and open competition.

CCIA seeks to help make our industry's technology serve our citizens and our governments alike and has followed with great interest the efforts by all levels of government to utilize technology to improve e-government. We have encouraged and supported the government's efforts to modernize operations and to appropriately utilize the tools and technologies of the Information Age.

One area in which CCIA has sought to help government is in is its efforts to increase the percentage of Americans who file their taxes electronically. One of the current proposals being considered by the government to further this goal is "I-File", in which the Internal Revenue Service would develop an online tax preparation and e-filing system that would allow individuals to prepare their returns and submit them directly to the IRS.

CCIA has commissioned this study to provide an economic analysis that examines and puts into perspective the costs and benefits of such a system, and reflecting on lessons that can be learned from the experiences of others. We hope that this analysis will add to an informed understanding of the economic issues involved and contribute constructively to the public policy debate.

For further information, please contact CCIA at 900 17th Street, NW, Washington, DC 20006, TEL 202-783-0070.

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I. INTRODUCTION AND EXECUTIVE SUMMARY

Filing tax returns is expensive in both time and money. The Internal Revenue Service (IRS) estimates the average U.S taxpayer spent 26.4 hours and $209 to understand, complete and file his or her 2008 federal tax return, as well as maintain any required records.[1] No one looks forward to "doing" their taxes.

In recent years, proposals have emerged for what sounds like a better way. Rather than having taxpayers fill in the required information, why not have the IRS, using information it receives from employers and financial institutions, fill out our tax returns for us and send them out for us to check over? If we agree the IRS return is accurate, all we need to do is sign and return it to the IRS. "Return-Free Filing" (RFF) (or, as it is sometimes called, the "Simple Return"),[2] is a superficially compelling concept, with what its supporters say is the potential to save taxpayers billions of dollars, while costing the government little or nothing to implement (or even saving it money).

In this paper, we take a closer look at the benefits and costs of RFF and conclude that the case for RFF does not, at the end of the day, add up. Specifically, we conclude:

- RFF advocates suggest that as many as 40 percent of taxpayers would be eligible to participate in an RFF system, but these estimates rest on highly unrealistic assumptions, including (a) that Congress dramatically simplifies key sections of the tax code, and (b) that the IRS is able to compress a schedule for reconciling tax information that currently takes more than six months to a matter of two or three weeks. Even assuming the IRS can dramatically accelerate its schedule for processing information from W-2s and other information returns, *at most* 18 percent of taxpayers would be eligible for RFF.

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[1] *See* Internal Revenue Service, "Estimated Average Taxpayer Burden For Individuals By Activity," 74 *Federal Register* 76 (18439) (April 22, 2009)

[2] RFF is also known as a "no-return" system. One widely publicized experiment with such a system, in California, is called "Ready Return." As noted below, RFF is a misnomer, as taxpayers would still need to file tax returns, with the only difference being that they would be prepared, in the first instance, by the IRS.

- RFF proponents typically estimate the benefits of RFF by assuming that virtually all eligible taxpayers would participate. The evidence shows that, in fact, participation would be much lower, in part because RFF – far from being "return free" – would actually require taxpayers to file *two* returns, an "information return" in January and a second "RFF return" in April. Overall, we estimate that *at most* two percent of taxpayers would participate in RFF.

- While RFF advocates suggest the costs of implementing RFF would be small, and would be more than made up for by offsetting savings, we find the implementation costs would be significant for both the government and the private sector, and the compensatory savings small or non-existent. In particular, we conclude that it would be extremely costly (if not simply impossible) for the IRS to gather and process the information needed to generate RFF tax returns while maintaining the April 15 filing deadline. At best, millions of taxpayers who currently file early would be unable to do so, delaying their receipt of tax refund checks by two months or more.

- While it has sometimes been implied that RFF would reduce under-reporting of income and help reduce the "tax gap," there is virtually no support for this conclusion. To the contrary, even some advocates of RFF concede the potential for RFF to lead to increased under-reporting of income, thus actually increasing the tax gap.

In sum, based on realistic assumptions about participation rates, the costs and feasibility issues associated with implementation, and the likelihood of increased tax evasion, we conclude the costs of RFF would exceed the benefits by a substantial margin, and that taxpayers overall would be harmed, not helped, by the proposal. Simply put, there is nothing "simple" about the "simple return."

The remainder of this paper is structured as follows. Section II describes various RFF proposals, explains why the "exact withholding" systems used in some other countries could not be implemented in the U.S. without major changes to the tax code, and describes the "tax agency reconciliation" system that has been proposed for the United States. Section III discusses the practical aspects of implementing RFF, including limitations on data availability and the effect of those limitations on eligibility. Section IV addresses issues relating to likely participation rates. Section V presents an analysis of the likely effect of RFF on under-reporting and the so-called tax gap. Section VI compares the overall benefits and costs of RFF; Section VII presents

alternative approaches to reducing taxpayer compliance costs. Section VIII presents a brief summary of our conclusions and recommendations.

II. PROPOSALS FOR "RETURN-FREE" FILING

The argument for "return-free" filing proposals is superficially compelling. For many taxpayers with relatively simple tax returns,[3] the IRS receives the information necessary to calculate the amount of taxes owed (or refunds due) from sources other than the taxpayer. Thus, rather than forcing these taxpayers to go through the time and trouble of collecting information and filling out tax returns, the government should simply send them a form showing what they earned, the amount of their total tax liability, and the amount of any refund due or balance owed. This approach is commonly referred to as a "tax agency reconciliation" system, since the government, in the first instance, reconciles the amount of taxes owed against the amount withheld. While tax agency reconciliation proposals are often described as "return free" (and we maintain that convention here), they obviously are not. Rather, they simply move the initial burden of preparing the return from the taxpayer to the government.

Why not go further, and actually eliminate returns altogether? That is, if the government can calculate your taxes at tax time, why not have it calculate them during the course of the year, so that the amount of withholding exactly matches the amount due, eliminating the need for both refunds and payments, and thus making tax returns completely unnecessary? This approach is known as "exact withholding," and it is used in more than 30 nations around the world.

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[3] It is actually difficult to find a "simple tax return," although some misperceive that tax returns Forms 1040EZ and 1040A are simple. That is often not the case. For example, based on IRS' tax year 2007 data, 2.5 million taxpayers claimed EIC on the Form 1040EZ while approximately 13 million claimed the EIC and 9 million claimed and the Child Tax Credit on Form 1040A. Additionally, another 4 million claimed "adjustments" to their income on Form 1040A attributable to education, IRA and other "above the line" deductions. (See IRS, "2007 Estimated Data Line Counts Individual Tax Returns," Rev. 8-2009.)

While these proposals sound straightforward, both the "tax agency reconciliation" and "exact withholding" forms of RFF are far more complicated in operation than they might appear at first glance, especially in this country with our complex income tax laws. Indeed, as we explain below, there is general agreement that an exact withholding system could not effectively be implemented in the U.S. without major changes in the tax code – and, as a result, there does not appear to be any significant support for adopting such a system. Thus, RFF advocates instead propose that the U.S. adopt a tax agency reconciliation system. Below, we first explain briefly why an exact withholding system could not effectively be implemented in the U.S., and then describe the basic characteristics of proposed tax agency reconciliation systems.

A. Exact Withholding Proposals

Under exact withholding systems, taxpayers provide the tax authority (and ultimately their employers) with sufficient information to permit employers to withhold the exact (or nearly exact) amount of taxes due during the course of the tax year. If withholding is performed accurately, most taxpayers do not need to obtain refunds or to pay a balance to the government, and thus are not required to file tax returns.

More than 30 countries have adopted some form of exact withholding system.[4] The United Kingdom, for example, uses a cumulative system, which attempts to withhold exactly the right amount of taxes throughout the tax year; in Germany and Japan, final withholding systems

[4] *See* U.S. Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite*, (December 2003), available at: http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf, [hereafter *Return-Free Report*], at 7. Two U.S. states, Michigan and Louisiana, have enacted legislation calling for exact withholding return-free tax systems. Michigan's program was cancelled after two years when very few taxpayers chose to participate (94 in 1997, 128 in 1998, out of about 4.5 million taxpayers). Louisiana enacted legislation calling for a no-form system in 1997, but the program was not implemented due to Y2K-related problems and has not been revived. *See Return-Free Report* at 10-11.

reconcile the amount owed at the end of the year, typically through adjustments to a taxpayer's final paycheck.

The tax systems in these countries are very different from the U.S. system, and there is general agreement that, as a result, none of them presents a viable model for the U.S. The feasibility of exact withholding depends on the ability accurately to estimate tax liability during the course of the tax year and withhold accordingly. The more complex the tax code, the harder it is to accomplish this basic task. As the Treasury Department concluded in its 2003 report on RFF, "the experience of other countries suggests that a return-free system is easier to operate the simpler the tax system."[5]

Virtually without exception, countries that have implemented exact withholding systems have far simpler tax codes than the United States, with fewer tax brackets, fewer deductions, and fewer tax credits. Furthermore, in contrast to the United States, which treats married couples as a single unit for taxation purposes, the individual is generally the unit of taxation in exact withholding countries, so that individuals' withholding can be calculated without taking into account the earnings of spouses. In addition, income derived from interest and capital gains is generally either taxed at the source at a fixed rate, or not taxed at all.[6]

The relative complexity of the U.S. system affects the feasibility of exact withholding systems in two ways. First, the IRS would need to obtain more information from taxpayers than is required in other countries in order to calculate the amount to be withheld. For example,

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[5] *Return-Free Report* at 2. *See also* William G. Gale and Janet Holtzblatt, "On the Possibility of a No-Return Tax System," *National Tax Journal* 50:3 (1997) at 483.

[6] It should also be noted that there are serious questions about whether exact withholding systems are succeeding in other countries. A recent report by the U.K.'s All Parliamentary Taxation Group (an official parliamentary commission studying tax administration), for example, found that the U.K.'s exact withholding system has an error rate (over- or under-payment of taxes) of more than 15 percent. *See*, BNA, "U.K.'s All Parliamentary Tax Group Blasts Government-Run Electronic Filing System" (May 8, 2008).

married workers would need to provide their employers with information on their spouse's income; homeowners would need to provide information on their mortgage interest; families utilizing the child care credit would need to provide that information; and so on. All of this information would need to be compiled to accurately estimate withholding amounts. Simply put, taxpayers would need to provide the IRS and their employers with all of the information needed to calculate their tax liability in advance – a daunting challenge given the complexity of the U.S. tax system.

Second, each time some aspect of the taxpayer's life changed in a way that affected her tax liability, she would have to file amended information. Thus, each home purchase (or sale), birth or death of a dependent, divorce or marriage, change in jobs, commencement of higher education, or change in outside income (e.g., starting a profitable E-Bay business) would require filing a new form with corrected information. And, each time a new form was filed, the tax agency and the employer would need to recalculate the taxpayer's tax liability and adjust withholding accordingly – imposing new costs on both the IRS and employers.[7]

Nearly all U.S. taxpayers are affected by one or more of these "complicating" aspects of the U.S. tax code. As shown in Table One below, the IRS estimates that in 1999 only about five percent of filers (6.9 million) had wage income from only one job, did not itemize deductions or take credits (other than the child care credit), and were not claimed as a dependent. Moreover, the vast majority of these taxpayers (5.8 million) already file simplified tax returns (either form

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[7] *See* Janet Holtzblatt, "Implications of Return-Free Tax Systems for the Structure of the Individual Income Tax" (June 2006) (available at http://isp-aysps.gsu.edu/academics/conferences/conf2006/Presentation6.pdf) at 20 ("Taxpayers would have to update the [information] form during the year whenever there was a change in a taxpayer's personal or financial circumstances that affected tax liabilities."); *see also* Gale and Holtzblatt at 483 ("[S]ome administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS.")

1040EZ or form 1040A), and would thus experience relatively little relief from exact withholding in terms of reduced compliance costs.

As a result of these and related issues, most observers – including RFF advocates – agree that exact withholding cannot effectively be implemented in the U.S. without significant changes in the tax code,[8] changes which would, as the Department of the Treasury explained, "make it more difficult to achieve other goals of the current income tax."[9]

B. Tax Agency Reconciliation Proposals

While exact withholding is not being actively considered in the U.S., there is serious discussion of adopting a tax agency reconciliation system. Indeed, one such proposal was endorsed by President Obama during his presidential campaign.[10] It is important, therefore, to understand precisely how such a system would work and whether it would achieve its desired goals. In this section, we describe the basic mechanics of these tax agency reconciliation

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[8] *See* Jeffrey Liebman and Daniel Ramsey, "Should Independent Taxation Be a Barrier to Return-Free Filing for the U.S.?" (March 24, 2006) (available at http://www.americanprogress.org/kf/ch6-should%20independent%20taxation%20be.pdf) at 1 ("There are four main simplifications needed for the U.S. to reap the full benefits of return-free [i.e., exact withholding] filing: the complicated existing set of child-related tax provisions would need to be replaced by a simple child benefit; interest and dividend income would need to be taxed at a flat rate and withheld at source; deductions would need to be limited; and married spouses would need to be taxed independently."); *see also* Austan Goolsbee, "The Simple Return: Reducing America's Tax Burden Through Return-Free Filing," *Brookings Institution Discussion Paper* (July 2006) [hereafter "*The Simple Return*"], at 21-22 ("[Exact withholding] would be possible only if major changes were made to the U.S. tax code.").

[9] *Return-Free Report* at 2.

[10] *See* "Obama's September 18, 2007 Speech on Middle Class Tax Fairness" (available at http://www.cnn.com/2007/POLITICS/12/21/obama.trans.taxfairness/) ("It's time to cut through the complexity. When I'm President, we'll put in place a system where 40 million Americans with a job and a bank account who take the standard deduction can do their taxes in less than five minutes. The government already collects wage and bank account information, so there's no reason the IRS can't send Americans prefilled tax forms to verify. This means no more worry. No more wasted time. No more extra expenses for a tax preparer. Making this change would save Americans more than $2 billion in tax preparer fees, more than 200 million hours of work, and an incalculable amount of headache and heartburn.") It should be noted, however, that RFF is not necessarily a partisan political issue. President Reagan highlighted the potential for moving towards a return-free system as one of the benefits of his 1985 tax simplification proposals. *See* Ronald W. Reagan, "Address to the Nation on Tax Reform," (May 29, 1985) (available at http://www.reagan.utexas.edu/archives/speeches/1985/52885c.htm). Other conservatives have addressed the benefits of doing away with tax returns in the context of various tax reform proposals. *See* Lawrence Zelenak, "Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement" *Presentation*

proposals. To avoid unnecessary confusion, we adopt the most commonly used terminology, referring to these proposals as "RFF," despite the fact that, as noted above, they are not literally "return free."

Current RFF proposals envision a system in which the IRS would use information received from employers, financial institutions, and other payers, combined with information from taxpayers, to prepare and mail draft returns ("RFF returns") to taxpayers for their review. Taxpayers would review the information and, if correct, sign and return the form to the IRS. Participation would be voluntary; taxpayers who chose not to use the pre-prepared returns could simply ignore them and file their own returns instead.[11]

To prepare an RFF return, the IRS would need to combine information obtained from the taxpayer (e.g., on whether the taxpayer meets eligibility requirements for various credits) and from information returns (such as W-2 and 1099 forms filed by employers, banks and other financial institutions, and states). While some proposals envision the taxpayer-provided information being gathered from prior-year tax returns, most assume that taxpayers would, at the beginning of each year, send information forms to the IRS containing basic taxpayer information and certifying their eligibility to participate.[12] Then, at the end of the year, the IRS would compile information on the taxpayer's income and withholding to produce an RFF return, which

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to the UCLA Tax Policy Workshop (January 2007) (available at http://www.law.ucla.edu/docs/civic_virtues--zelenak.pdf) at 1.

[11] *See, e.g., The Simple Return* at 5.

[12] *See Return-Free Report* at 36 ("Both studies assume that participating taxpayers would be required to send an information form or postcard to the IRS containing their taxpayer identification number, filing status, number of dependents, and certification of eligibility.") The two studies referred to are the IRS' 1987 study (United States Department of the Treasury, Internal Revenue Service, *Current Feasibility of a Return-Free System* (October 1987)) and the GAO's 1997 study (United States General Accounting Office, *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, (October 1997) [hereafter *GAO Return Free Report*]). *See also* Holtzblatt at 7 and *The Simple Return* at 9.

would be mailed out to participating taxpayers.[13] Taxpayers who agreed with the RFF return would simply sign it and mail it back; those who owed taxes would include a check for the balance.

As discussed below, the practical hurdles that would need to be overcome to implement such a system are extremely high. Simply put, the IRS lacks the necessary information to complete RFF returns for all but a small minority of taxpayers; the agency also lacks the ability to process the information it does receive in time to prepare draft returns on a realistic schedule. Both of these issues pose difficulties which, we conclude, would make implementation of an RFF system costly, if not simply infeasible.

III. ELIGIBILITY AND IMPLEMENTATION

RFF eligibility is, in the first instance, a function of information: Taxpayers for whom the IRS receives sufficient information to complete draft returns would (at least in theory) be eligible; the rest would not. As discussed below, RFF supporters typically suggest that about 40 percent of taxpayers (roughly 50 million) would be eligible.[14] As we discuss in the first section below, such estimates are based on simple counts of the numbers of taxpayers meeting various filing criteria in any given year, and ignore the costs to the IRS, taxpayers and third parties of gathering, submitting and compiling the information required to prepare RFF returns – costs which rise as the eligibility pool expands.

In the second section below, we analyze the challenges and costs of implementing RFF, how the challenges are related to the number of taxpayers who would be eligible and, perhaps

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[13] As noted further below, RFF returns would literally be "mailed out," as the entire program would be paper-based – thus undercutting efforts to shift taxpayers towards electronic filing.

[14] But see Eric J. Toder, "Return-Free Tax Systems and Taxpayer Compliance Costs," Presentation to the President's Advisory Panel on Federal Tax Reform (May 17, 2005) at 12, suggesting that as many as 50 percent of

most importantly, how the system would actually work from the perspective of timing. In the third section, we return to the issue of eligibility, and explain why RFF advocates' estimates of the proportion of taxpayers who would be eligible are overstated.

Overall, this section concludes that, while RFF supporters have suggested the system could be implemented relatively easily and for little or no cost (or even net savings), the evidence demonstrates that an effective RFF system could probably not be implemented without moving the entire tax filing calendar back by at least several weeks (thereby slowing refunds for tens of millions of taxpayers), and that in any case implementation would be costly and fraught with potential problems.

A. Estimates of Potential RFF Eligibility

In its 2003 report, the Treasury Department calculated the number of taxpayers with various characteristics that affect RFF eligibility. The resulting estimates are shown in Table One.

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taxpayers (over 60 million) would be eligible (available at http://www.taxreformpanel.gov/meetings/docs/toder_05172005.ppt).

Table One:
Filers Qualifying for Alternative Return-Free Systems
By Type of Income and Return (1999; units in millions)[15]

Type of Filer	All	1040	1040PC	1040A	1040EZ
All filers	127.1	74.2	5.2	27.0	20.8
No taxable income or in 15 percent bracket:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	6.9	0.8	0.2	2.0	3.8
B) Add dependent filers	9.2	1.1	0.3	2.2	5.7
C) Add those with earnings from more than one job	21.5	2.4	0.7	4.8	13.6
Add those with income only from "withholdable sources"*	34.5	5.2	1.3	10.3	17.8
Add those with EITC	47.5	6.3	1.6	20.5	19.2
Add those with capital gains distributions	47.8	6.6	1.6	20.5	19.2
28 percent and higher brackets:					
Wage income only, no itemized deductions or credits other than child credit					
A) Only those with earnings from one job and not claimed as dependent	1.0	0.2	0.0	0.2	0.7
B) Add dependent filers	1.1	0.2	0.0	0.2	0.7
C) Add those with earnings from more than one job	1.8	0.4	0.0	0.3	1.0
Add those with income only from "withholdable sources"*	3.9	1.3	0.1	0.9	1.6
Add those with EITC	3.9	1.3	0.1	0.9	1.6
Add those with capital gains distributions	4.0	1.4	0.1	0.9	1.6
Total Filers	51.8	7.9	1.7	21.4	20.8
Percent of Total Filers	41%	11%	33%	79%	100%

Table One identifies various categories of taxpayers who might be eligible for RFF, with categories for which RFF could most easily be implemented at the top. As the table shows, the Treasury found that between 6.9 million taxpayers (about five percent) and 51.8 million (about 41 percent) of taxpayers could be eligible, depending on the extent of changes made to the

[15] *Return-Free Report* at 21.

current tax regime. RFF proponents typically cite these figures, or similar ones, in support of their claims that large proportions of taxpayers would be eligible.[16]

The logic of RFF eligibility can be understood by reading Table One from top to bottom. Start with the 6.9 million taxpayers who only have wage income from a single job, do not claim deductions or credits (except perhaps the child credit), are not dependents, and are in the 15 percent tax bracket. Assuming these taxpayers can be accurately identified, most or all of the information required to calculate their tax liability is contained in their W-2 forms, which are sent to the IRS by their employers, and in the tax tables themselves.[17] Next, add the 14.6 million dependent filers[18] and filers with more than one job (either a single filer working two jobs, or a two-earner family). To calculate these taxpayers' liabilities, the IRS would need taxpayers to report their dependent and marital status, and would need to match W-2s from multiple employers and/or multiple individuals. Including these taxpayers brings the total of potentially eligible taxpayers to 21.5 million.[19]

The next group consists of the 34.5 million taxpayers who meet the criteria above but also have income from "withholdable sources," e.g., interest and dividend income reported to the IRS on information returns such as Form 1099.[20] Adding this group would, in addition to the tasks described above, require the IRS to match information from these forms to the wage and other information noted above. If it could do so, an additional 13 million taxpayers could be

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[16] *See, e.g.*, *The Simple Return* at 8-9, calculating that between 9.1 million and 52.4 million taxpayers would be eligible based on 2003 IRS data.

[17] The exception is the child credit, which would require taxpayers to notify the IRS of the number of dependent children.

[18] Dependent filers are not permitted to claim the standard deduction.

[19] *See also The Simple Return* at 9, estimating that including this second group brings the total to 17.1 million and acknowledging that expanded W-4 forms would be required in order to gather the required information.

[20] Income taxes are not actually withheld on such income except under certain circumstances; hence the income is considered "withholdable," but not "withheld."

included. Adding those receiving capital gains distributions adds 300,000 more,[21] bringing the total to 34.8 million.

The next major category of potentially eligible taxpayers is those claiming the Earned Income Tax Credit (EITC). If the IRS could combine all of the information above with information necessary to determine eligibility for, and calculate the amount of, the EITC, an additional 13 million taxpayers would be eligible for RFF, bringing the total to 47.8 million, or 37 percent of all returns.

Finally, as shown in the bottom half of the table, if one includes taxpayers meeting the above criteria, but who had sufficient income to fall into the 28 percent tax bracket, an additional four million taxpayers become eligible, bringing the grand total to 51.8 million, or 41 percent of all returns.[22]

The calculations above are straightforward and, to the extent they simply describe the number of taxpayers falling into various categories, non-controversial. However, in order to implement RFF for any or all of the categories listed above, it would be necessary to make significant changes in the ways private sector participants (taxpayers and other information providers) collect and submit information to the IRS, and in the ways in which the IRS itself processes and uses that information; the more categories of taxpayers eligible, the greater the

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[21] Dividend income would include dividends from mutual funds, but not from asset sales. *See e.g.*, *The Simple Return* at 10.

[22] Compare *The Simple Return* at 9, estimating eligibility based on the same categories at 52.4 million out of 130.6 million returns (40 percent) based on 2003 data; and, Holtzblatt at Table 3, estimating the maximum number of eligible taxpayers at between 46.7 and 50.0 million (36 percent of filers) in 2007 and including those who are not self employed, do not claim above-the-line or itemized deductions, do not claim credits other than the child tax credit, do not pay any special taxes (e.g. Social Security taxes on household employees) and are not subject to the AMT. *See also* Holtzblatt at 17 ("Relative to the earlier [2003] Treasury study, the share of taxpayers who could be subject to a return-free system has fallen by five percentage points. The decline is largely attributable to the creation of new tax credits, such as the savers credit, and expansion of others, such as the education tax credit and the refundable child tax credit, since 1999.") Candidate Obama's estimate of 40 million taxpayers appears to have been

changes would need to be. All of these changes would have costs, some of which would be monetary (e.g., increased resources at the IRS) and others of which would be less tangible (e.g., in the form of reduced accuracy of the information returns provided by payers). And, as we explain below, we conclude that the changes required to extend RFF to taxpayers who receive the EITC or who have non-wage income would simply not be feasible at all. Thus, as we explain at the end of this section, we ultimately conclude that a maximum of about 18 percent of taxpayers (about 27 million) could potentially be eligible for RFF – about half as many as RFF advocates claim.

B. Practical Challenges to Implementation

Implementing RFF would require substantial changes in the tax system. To determine eligibility, taxpayers would need to submit, and the IRS would need to process, millions of additional taxpayer information returns. To calculate tax liabilities, the IRS would need to combine this taxpayer information with nearly two billion information returns filed by employers, financial institutions, and other payers. To get all of this done in time to generate and mail returns, both the IRS and private sector reporting entities would need to dramatically accelerate the schedule for reporting and processing information. All three changes would be costly to implement; the third may well be infeasible (even for very simple returns) at any cost. The three sections below discuss the challenges of (1) determining eligibility, (2) generating and processing returns, and (3) doing all of this within the necessary time frame.

1. Determining Eligibility: The Need for an "Information Return"

The first step in implementing RFF would be to determine which taxpayers were potentially eligible and should therefore receive RFF returns. The data above demonstrates that

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derived from *The Simple Return*, which estimates 39 million eligible taxpayers if those claiming the EITC are

the IRS has the ability to assess eligibility *ex post*, as it did by using data on 1999 tax returns to calculate potential RFF eligibility in the Treasury Department's 2003 report. For RFF purposes, however, eligibility would need to be ascertained for each taxpayer *in real time* – that is, before RFF returns were mailed out.

RFF eligibility could, in principle, be determined in either of two ways. First, the IRS could determine eligibility based on data from prior-year tax returns. Second, it could require potentially eligible taxpayers to file information returns. While some RFF supporters have suggested the first approach,[23] both the Treasury and GAO studies of RFF assume information returns would be required.

The fundamental problem with using prior-year tax returns to assess eligibility is that it would fail to capture changes in taxpayer status during the course of the year, and would thus result in preparation of incorrect RFF returns.[24] To assess the magnitude of this problem, we gathered data on the frequency of changes in just three key demographic characteristics that affect taxpayer eligibility for RFF: marriages and divorces, births, and first-time home purchases. We ignored the myriad other common "life events" that affect taxes such as starting a business (self-employment), changing jobs, going to school, home foreclosures, and caring for aging parents, to name a few.

Because a taxpayer's filing status (and tax liability) depends on their marital status, the IRS would need to know marital status in order to prepare RFF returns. Under the tax laws,

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excluded.

[23] *See The Simple Return* at 9-10 (noting that for some filers, including EITC eligible filers, this approach would only work if "ongoing IRS modernization goes smoothly."). *See also* Bankman at 1432 (noting the California Ready File pilot adopted this approach).

[24] The fact that changes during the course of the tax year would lead to inaccurate returns is acknowledged by RFF supporters, though the magnitude of the problem has not heretofore been estimated. *See, e.g.*, *The Simple Return* at 7 ("Of course, the Simple Return would be valid only if the taxpayer's personal situation had not changed

marital status is determined as of December 31 of the tax year (i.e., a taxpayer who is married on December 31 is considered married throughout the year for tax purposes).[25] U.S. Census Bureau data indicates that there are about 2.2 million marriages and 1.1 million divorces in the U.S. each year,[26] indicating that the marital status of roughly 6.6 million taxpayers (4.9 percent of all filers) changes during any given year.[27] If the IRS prepared RFF returns for these taxpayers based on prior-year tax information, the returns would be incorrect.

Births also affect tax status, since each birth changes filing status, the number of dependents for at least one taxpayer, and may determine eligibility for the Child Tax Credit and/or the EITC. The Census Bureau reports there were 4.3 million births in the U.S. in 2006, affecting an additional 3.2 percent of taxpayers.[28] Again, RFF tax returns prepared for these taxpayers on the basis of prior-year tax information would be incorrect.

Home ownership is also a key factor in determining eligibility for RFF, as a large proportion of home owners itemize deductions in order to take advantage of the home mortgage interest deduction (and are thus ineligible for RFF). A rough estimate of the significance of changes in home ownership status can be obtained simply by looking at the number of first-time homebuyers. In 2006, there were approximately eight million homes sold in the U.S., and approximately four out of ten (3.2 million) of these sales were to first-time home buyers.[29]

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in the intervening period. If a child had been born to or adopted by the filer during the year, for example, the filer would need to file his taxes the conventional way to receive the full child credit.")

[25] Internal Revenue Service, Publication 501, *Exemptions, Standard Deduction, and Filing Information* (available at www.irs.gov/publications/p501/index.html).

[26] *See* U.S. Census Bureau, *Statistical Abstract of the United States* (Table 77) (available at http://www.census.gov/compendia/statab/tables/08s0077.xls).

[27] This percentage is calculated by doubling the total number of marriages and divorces (since each marriage and each divorce affects two taxpayers), and dividing the sum by the number of tax returns in 2006 (134 million).

[28] We assume for this calculation that each birth affects the return of one taxpayer, though in some cases multiple taxpayers could be affected.

[29] *See* Elliot F. Eisenberg, "Characteristics of First Time Home Buyers," January 23, 2008 (available at http://www.nahb.org/generic.aspx?genericContentID=88533).

Assuming these new homeowners begin itemizing deductions in the year in which they purchase the home, use of prior-year returns would result in incorrect RFF returns for an additional 2.4 percent of taxpayers.

Taken together, these admittedly rough calculations suggest that, on the basis of just these three factors (marital status, births, and first-time home ownership) alone, use of prior-year returns would result in an error rate of over 10 percent on RFF returns.[30] Thus, for example, if 27 million taxpayers were eligible for RFF returns, use of prior-year returns would result in the IRS sending out approximately 2.7 million incorrect RFF returns each year.

The same logic suggests that taxpayer information returns necessarily would have to be filed after the end of each tax year, i.e., in early January. For example, if taxpayer information returns were filed on September 30 (i.e., three-quarters of the way through the year), the factors above would result in an error rate of roughly 2.5 percent, or (assuming an eligible pool of 27 million taxpayers), 675,000 incorrect RFF returns. We believe a system which virtually guaranteed such high error rates would be unacceptable to Congress or to taxpayers, and thus conclude that any RFF system adopted in the U.S. would rely on the filing of taxpayer information returns by all potentially eligible taxpayers, with the returns due to the IRS sometime in early January.[31]

It is worth highlighting two practical implications of this conclusion. First, rather than eliminating the requirement for taxpayers to file tax returns (as the "return free" title suggests),

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[30] A complete analysis would almost surely find a much higher error rate. For example, we have not taken into account the effect of deaths of either spouses or dependents, which would affect tax liability in the same ways as the changes described above; nor have we accounted for taxpayers who form sole proprietorships. There were 2.4 million deaths in the U.S. in 2006. In addition, prior-year filings capture the effect of changes in the tax law from year to year which might change the information required to determine eligibility. Between 1986 and 2005 there were approximately 15,000 changes in the tax code, or about 700 changes each year. *See Report of the President's*

RFF proposals would require taxpayers to file two returns, one in January and a second one in April. Second, in order to implement RFF, the IRS would need to process tens of millions of taxpayer information returns sometime in January, just as the heavy burden of the tax season was getting under way. Both implications are discussed further below.

2. Quantifiable and Unquantifiable Costs of Implementing RFF

The most recent official studies of the costs involved in implementing RFF were done by the IRS,[32] in 1987, and the GAO, in 1996. Based partly on those studies (primarily the GAO study, since the IRS study is now more than 20 years old),[33] this section describes the primary factors that would affect the cost of implementation, and presents the available data on costs. First, we consider quantifiable costs. At the end of the section, we briefly discuss difficult-to-quantify costs, such as those associated with increased error rates and reduced use of E-filing. Another form of costs – increased under-reporting of taxable income and the associated increase in the tax gap – is discussed in Section V.

Advisory Panel on Federal Tax Reform, Chapter 2, at 16 (available at www.taxreformpanel.gov/final-report/TaxReform_Ch2.pdf).

[31] As we discuss below, the challenges of assessing eligibility for the EITC are even more daunting.

[32] *See* n. 11 above.

[33] While the specific cost data we report in this section is primarily from the GAO report, our ultimate conclusions are much closer to those of the IRS' 1987 report, which found that an agency reconciliation system would cost the IRS, on net, $175 million annually.

One reason the GAO estimates understate the costs of RFF implementation is that they fail to take into account the fact that most of the tasks associated with implementing RFF would fall during the early months of the year – really, a period of a few weeks, between mid-January and late February or, at the latest, early March – when the IRS already faces "peak load" problems. As the Treasury Department noted, the need to process billions of information returns (from taxpayers as well as third parties) "within a 30 to 60 day time frame" during the normal peak filing season, while at the same time processing regular income tax returns and mailing millions of refunds, would place an "additional resource burden" on both the IRS and the SSA. (*See Return-Free Report* at 39, noting that, unlike the GAO study, "the IRS study anticipates the need to hire and train new employees, purchase more equipment, and lease or build new facilities in order to house the new employees and equipment. The IRS study finds that the 'most dramatic' impact of a return-free system would be the requirement for significant increases in staffing, equipment and facilities for no more than a few months a year.")

First, as discussed immediately above, the IRS would need to take on the new task of distributing and processing millions of taxpayer information returns. RFF information returns would resemble the W-4 forms taxpayers currently submit to their employers when they change jobs or there is a change in the factors affecting withholding, but would include the additional information required to determine RFF eligibility and process RFF returns, including the names and taxpayer identification numbers of spouses and dependents, and a statement by the taxpayer that she expects to be eligible for RFF.

The number of information return forms the IRS would need to distribute would depend on the overall eligibility criteria for the RFF program. Because the IRS would not know *ex ante* which taxpayers are actually eligible, it would need to prepare and mail more forms than the number of eligible taxpayers in any given year. Under any set of assumptions, the costs of distributing the forms – which have not been included in previous studies – would be significant. For example, if 27 million taxpayers were potentially eligible, the IRS might mail out 50 million information returns to be reasonably certain of reaching all potentially eligible taxpayers. Assuming an average cost of $0.32, the total cost of distributing information returns would be $16 million annually.[34] The mailing of this detailed private information also significantly increases the threat of identity theft due to misaddressed mail and incorrect delivery of mail to name two routine examples. When tax booklets are misdirected no direct harm is done. When a government report with extensive personal information goes astray, significant harm can result.

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[34] As a point of reference, the IRS spent $42 million ($0.32 each) to mail 130 million letters to taxpayers informing them of the procedures involved in filing for economic stimulus payments in 2008. *See* "Dear Taxpayer: This Letter Cost You $42 Million" *USA Today* (March 7, 2008) (available at www.usatoday.com/news/washington/2008-03-07-rebate-letters_N.htm). If 26.6 million taxpayers returned the form, first class postage would total an additional $8 million. Because RFF returns would also have to be sent back to the IRS, the additional postage cost to taxpayers is not offset by reduced postage for sending in their ultimate returns.

Next, the IRS would need to receive and process millions of returned forms, input the data into its databases,[35] identify and correct any errors, and produce a list of taxpayers who would receive RFF returns. In its 1996 study, GAO estimated the annual cost of processing 50 million taxpayer information returns would be $46.9 million.[36] Based on inflation (including labor costs), the fact that many of the costs involved are fixed, and the GAO's failure to take into account the "peak load" problem associated with having to process information returns during the peak of the filing season, we believe this estimate should be thought of as a lower bound on the costs of processing 27 million taxpayer information returns today.

To generate RFF returns, the IRS would need to combine the data from taxpayers' information returns with data from employers and other payers. Each year, the IRS receives nearly two billion information returns, such as W-2 forms[37] from employers reporting wage income and 1099-INT forms from financial institutions and others who pay interest or dividends to individual taxpayers. As shown in Table Two below, in FY 2008 (i.e., for the 2007 tax year), the IRS received well over 1.8 billion information returns, the vast majority of them filed electronically.[38]

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[35] It should be noted that there is currently no means for filing information returns electronically, and none of the RFF proposals appear to contemplate electronic filing. *See*, however, Bankman, *Tax Notes*, at 1432, noting that the California "Ready Return" included the capability to review draft returns and make corrections online. The IRS does not presently have this capability with respect to either tax returns or RFF information returns.

[36] *See GAO Return-Free Report* at 36. However, the GAO report did not take into account the fact that these information returns would need to be processed at the same time the IRS was processing over a billion information returns from non-payers, as well as traditional returns from taxpayers not participating in RFF. *See* discussion in Section III.B.3 below.

[37] W-2s are submitted to the Social Security Administration, which shares the resulting information with the IRS electronically.

[38] For background on the types of returns and the numbers of each type of return filed, *See Return-Free Report* at Table D-2.

Table Two:
Information Returns Received by the IRS, FY 2008, By Filing Method[39]

Item	Number or amount
Number of information returns received (millions) [1]:	
Total	**1,883**
Paper	54
Electronic	1,360
Magnetic tape	172
Other [2]	297

[1] Includes Forms 1098 (mortgage interest, student loan interest, and tuition payments); the 1099 series (including interest and dividend distributions); 5498 (individual retirement arrangement and medical savings account information); W-2 (wage and tax statements); W-2G (certain gambling winnings); and Schedules K-1 (partnership, S corporation, and estate or trust distributions). Information from these forms and schedules is matched to that reported on income tax returns.

[2] Includes Forms 1099SA/RRB and W-2 processed by the Social Security Administration.

In order to prepare RFF returns, the IRS would need to compile, match, and process data from all of these various sources. Again, the most recent estimate of the costs of performing these functions comes from the GAO, which estimated the total cost at $49.5 million based on 50 million RFF returns.[40] For the same reasons explained above, we believe this represents a conservative estimate of the costs of processing 27 million RFF returns today.

Indeed, for a variety of reasons, the cost estimates just presented, in our view, are both incomplete and extremely conservative. As noted above, the GAO's estimates fail to take into account the "peak load" problem. Moreover, as discussed further below, the IRS rarely completes projects involving implementation of new IT systems on time or on budget. However, if we simply add up the annual costs mentioned above ($16 million to mail RFF information return forms, $46.9 to process information returns, and $49.5 million to generate RFF returns),

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[39] Internal Revenue Service, *Data Book 2008* at Table 14 (available at http://www.irs.gov/pub/irs-soi/08databk.pdf) [hereafter *IRS 2008 Data Book*].

[40] *GAO Return-Free Report* at 38.

even this partial ballpark accounting places the annual, on-budget cost of implementing RFF at $112.4 million.

Other costs of RFF are more difficult to quantify. First, no RFF proposals have suggested a means by which participants could file returns electronically. Thus, RFF returns would be mailed out and returned on paper, significantly impeding the IRS' efforts to increase the rate of e-filing and capture the significant cost savings associated with processing electronic rather than paper returns.

Second, a large number of RFF returns would be inaccurate, for a variety of reasons. The GAO report found that inaccuracies in information returns submitted to the IRS would lead to the generation of 275,000 inaccurate RFF returns each year;[41] similarly, as discussed further below, Holtzblatt explains that one of the primary reasons many information returns are not processed by the IRS until September of the following tax year is inaccuracies in the original returns. If the filing date for information returns were moved up, as it would need to be to implement RFF, the number of errors in information returns would increase further, resulting in still more inaccurate RFF returns being mailed to taxpayers.

Third, based on the IRS' history of mailing errors, it is a virtual certainty that a significant number of RFF returns would be mailed to the wrong people. In May 2008, for example, it was reported that the IRS mailed 15,000 economic stimulus payment checks to the wrong addresses, and that the forms accompanying the checks included the last four digits of the taxpayers' Social Security number. The IRS explained that the problem resulted from a contractor error in the printing process.[42] While this incident raises privacy concerns, those

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[41] *GAO Return-Free Report* at 39.

[42] *See* Carol Polsky, "IRS: Some Stimulus Checks Sent to Wrong Accounts," *Chicago Sun Times* (May 14, 2008) (available at www.chicagotribune.com/topic/ny-listim0515,0,4165183.story).

concerns pale in comparison with those that would be raised if a similar problem were to occur in the mailing of RFF returns, which would include much more extensive and personally sensitive taxpayer information.[43]

Even this listing of costs is not likely to be complete. The on-budget cost estimates, based on the more-than-a-decade-old GAO report, certainly understate the direct costs to the IRS, and the data simply do not exist to quantify many other costs (such as those associated with higher error rates). Other costs, including the increased costs to private-sector filers of preparing information returns, are discussed further below.

3. The Problem of Time

The fundamental argument in favor of RFF is that the government "already has" the information needed to fill out tax returns, and that it is thus "unnecessary" for taxpayers to have to fill out returns themselves. Joseph Bankman, for example, argues that

> The sad part of [requiring taxpayers to file returns is that] it is largely unnecessary. The government already has the wage and interest data reported by the taxpayer…. Why not have the government tell the taxpayer ahead of time what figures have been reported to it in the taxpayer's name, and the tentative tax liability it believes those figures produce?[44]

Unfortunately, there is a fundamental flaw in this logic: While the IRS does ultimately receive the information necessary to complete simple returns, it does not "have" that information at the time returns are actually filed. Specifically, the IRS does not receive information returns (such as W-2s and 1099s) until the end of March – *after* millions of filers, seeking early refunds, have already filed their Federal tax returns. Moreover, the IRS does not process the information in those W-2s and 1099s until September – more than five months *after* the April 15 filing

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[43] The IRS consistently experiences problems maintaining up-to-date address files. *See, e.g.*, BNA, "TIGTA Says Tax Refunds Sent to Old Addresses Though IRS Has Current Ones" (August 29, 2008)

[44] *See, e.g.*, Bankman, Tax Notes at 1431-2; *see also The Simple Return* at 2.

deadline. Confronted with these facts, RFF advocates suggest the timing problem would be easily solved with more modern IT systems, perhaps combined with a modest adjustment in the filing date for information returns. The evidence suggests this is wishful thinking.

The Realities of the Tax Calendar: Currently, the IRS does not receive the information returns required to prepare RFF returns until the end of March, and does not process them until September. As explained by Janet Holtzblatt, of the Treasury Department's Office of Tax Assessment:

> Beginning in February, SSA [the Social Security Administration] and IRS also validate more than one billion information returns provided by payers. However, these validated and edited returns are not generally accessible to match against tax returns until July. Indeed, even though the IRS begins receiving weekly W-2 information via magnetic tape from SSA in February for the current tax year, less than one percent of 1999 W-2s were posted to the IRS masterfile by April. Over the next several months, the pace accelerates, with the IRS posting to the master file approximately 88 percent of all 1999 W-2s by the end of July and 99 percent by the end of September. While payers send other information returns directly to the IRS, only about 46 percent of valid 1099s were processed by the end of April. This percentage grows to 95 percent by July and 99 percent by September. Delays in the processing of information returns are caused by transcription of paper information returns, payer extensions for filing returns, and payee corrections to information returns (for example, the IRS may detect a missing or invalid taxpayer identification number and request that the payer supply a corrected number).[45]

Thus, the IRS does not actually "have" the information needed to generate RFF tax returns until the end of September – five and a half months after the April 15 filing deadline – and even then it still lacks sufficient information for some taxpayers.

Looking at the calendar from the other side – that is, from the perspective of taxpayers – provides a sense of just how dramatically this schedule would need to be accelerated in order to implement RFF.

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[45] Holtzblatt at n. 26.

First, at the very least, RFF returns would need to be mailed in time for taxpayers to review and return them by April 15. Assuming two weeks for transit and review, this means mailing returns by late March, or at the same time the IRS currently receives the information returns, and a full six months before processing is currently completed.

Second, in 36 states and the District of Columbia, representing about 70 percent of all taxpayers, state tax returns depend upon information (such as Adjusted Gross Income) that is calculated on the taxpayer's Federal return.[46] Giving taxpayers just two weeks to not only review their Federal returns but also use the data to fill out and mail their state tax returns (which may require combining Federal data with state-specific information) would, we believe, not be accepted by taxpayers. If 30 days were allotted, RFF returns would need to be mailed two weeks earlier – that is, two weeks *before* the IRS currently *receives* information returns.

Third, and perhaps most importantly, even a mid-March mail date would significantly delay the distribution and receipt of refunds for millions of taxpayers.[47] More than 80 percent of taxpayers receive refunds,[48] and the vast majority of these file long before the April 15 filing deadline. As shown in Table Three, in 2003, 37.1 percent of tax returns were filed before the end of February, including 44.1 percent of all taxpayers who were due refunds. By the end of March, the figures are much higher: 58.8 of all returns were filed by March 31, representing 67.5 percent of all returns with refunds.[49]

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[46] *GAO Return-Free Report* at 18.

[47] Some RFF advocates acknowledge this problem. *See, e.g.*, Joseph Bankman, "Simple Filing For Average Citizens: The California ReadyReturn," *Tax Notes*, (June 13, 2005), 1431-34 at 1434. ("The major stumbling block is the lack of timely wage data at the federal (although not the state) level. That would cause difficulties not only for the IRS but for taxpayers as well. Returns would be sent out late, producing late refunds for taxpayers, most of whom in the low- and middle-income population would have funds coming.")

[48] *See* Holtzblatt at 22.

[49] The IRS has also reported data for the proportion of RFF-eligible filers who file early. As shown in Table One above, there were (in 1999) 23.3 million taxpayers (in all tax brackets) who have only wage income, do not take deductions, and take no credits or only the child tax credit – the largest group we believe could be eligible for RFF

Table Three:
Tax Returns Filed by Month and Refund Status[50]

Month Filed	Percent of Total Returns	Percent of Total Returns with Refunds
January	8.3	10.1
February	28.8	34.0
March	21.7	23.4
April	24.7	24.4
May or Later	16.5	8.1

These data demonstrate that the IRS could not plausibly wait until March to mail out RFF returns (or, as discussed further below, that doing so would dramatically reduce participation). For example, even if the IRS mailed RFF returns on February 15, and allowing two weeks for turnaround time, RFF returns could not be filed until the end of February – meaning that roughly one third of those filing RFF returns would experience *at least* some delays in receiving their refunds. The greater the delay in mailing returns, the more taxpayers would "opt out" of RFF and file traditional returns instead, in order to get their refunds "on time."

Significant Acceleration of the Process is Not Feasible: RFF supporters have suggested that the timing problem could be solved by a combination of moving up the filing date for information returns and more efficient use of information technology by the IRS. We do not believe, however, that any plausible combination of earlier filing and improved processing would achieve the necessary acceleration.

First, the earliest date information returns could plausibly be filed with the IRS would be January 31, the same date they are made available to taxpayers.[51] Some RFF advocates suggest

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under the current tax system. The IRS reports that 18.2 million taxpayers in these categories (78 percent) received refunds of more than $100, and that 10.5 million (45 percent) had already filed their returns by February 28. Thus, conservatively, about 35 percent of RFF-eligible filers (0.45 times 0.78) who were due significant refunds filed their returns prior to February 28. *Return-Free Report* at Tables E-5 and E-9.

[50] *See* Holtzblatt, Table 9.

[51] *See, e.g.*, *The Simple Return* at 16.

that moving the filing date to January 31 should be do-able, since it would "only" accelerate the process by a month from the current filing date for information returns, which they give as the last day of February.[52] This claim is, at best, highly misleading: The February 28 filing deadline cited by RFF supporters applies only to information returns filed *on paper*. The filing deadline for electronic filing is a full month later, March 31.[53] As shown in Table Two above, fewer than three percent (54 million out of 1.8 billion) of the information returns filed in 2008 were filed on paper. Thus, a January 31 filing deadline would accelerate the process for virtually all information returns by two months, not one.

The costs and consequences of accelerating the filing schedule would be significant. While there appear to be no reliable empirical estimates of the costs businesses would incur to meet the new schedule, there is a general agreement that they would be large, and that they would fall most heavily on small businesses.[54] Moreover, accelerating the deadline would increase the error rate in information returns. As noted above, the IRS (at Congress' behest) recently moved the due date for payers to provide form 1099-B to taxpayers from January 30 to February 15.[55] In explaining the change, the IRS cited the Information Returns Advisory Committee's 2006 finding that:

> Form 1099 reporting has become very complex over recent years. As a result, many broker dealers are currently experiencing 20% amended Forms 1099. *There*

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[52] *The Simple Return* at 15.

[53] Social Security Administration, *Employer W-2 Filing Instructions and Information* (available at www.socialsecurity.gov/employer/gen.htm); Internal Revenue Service, *Tax Calendars for 2008* (Publication 509, October 2007) (available at www.irs.gov/publications/p509/ar02.html).

[54] *See, e.g.*, Holtzblatt at 23-4 ("All information returns would have to be filed earlier, imposing additional costs and burdens on employers, financial institutions, and others required to file information returns. Small businesses, in particular, may find it difficult to absorb the additional costs.")

[55] On January 30, 2009, the IRS issued regulations implementing Section 403 of the Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343, 122 Stat. 3765), which moved the date by which most form 1099s must be provided to taxpayers back by two weeks, from January 31 to February 15 (February 17 in 2009). *See* IRS Notice 2009-11 (available at http://www.irs.gov/pub/irs-drop/n-09-11.pdf).

> *is insufficient time to make the necessary changes in January, verify the data, print the forms and mail them by Jan. 31.*[56]

Thus, Congress and the IRS have already concluded that the error rate associated with providing form 1099s to taxpayers by January 31 is higher than can be tolerated, and moved the date back accordingly. Implementing RFF would force a reversal of this reform, and ensure a continued high rate of errors.

The detrimental effect of a January 31 filing date on accuracy would be further exacerbated by the fact that it would eliminate entirely the current window for taxpayers to identify and correct mistakes in information returns *before* they are filed with the IRS. Currently, taxpayers receive 1099s, W-2s and other information returns six to eight weeks before they are filed with the IRS, and have an opportunity to identify and correct mistakes before the payer submits the information. Indeed, one of the main attractions for businesses to file information returns electronically is the additional month it allows for taxpayers to identify and correct mistakes.[57]

Second, even if the deadline for information returns were accelerated to January 31, the IRS, in conjunction with the Social Security Administration, would still need to compress a process that currently takes roughly six months into (at most) a few weeks. RFF proponents

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[56] *See* Internal Revenue Service, "For Many Investors, Year-End Forms to Arrive Later," (January 30, 2009) (available at www.irs.gov/newsroom/article/0,,id=203200,00.html) (Emphasis added).

[57] *See* e.g., http://www.irs.gov/efile/lists/0,,id=100422,00.html ("The electronic filing deadline for IRS information return copies is March 31; when paper forms are filed, the deadline is February 28. Electronic filing allows mistakes found after February 28 to be fixed before sending the IRS copies on March 31. When paper forms are filed, mistakes found after February 28 can only be fixed by filing corrected returns. 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.")

suggest it could do so through "modernization" and improved use of information processing technology,[58] The evidence suggests otherwise.

First, the IRS' record in technology modernization is, to say the least, not encouraging.[59] In 1986, the agency embarked upon the Tax Systems Modernization (TSM) program, a $4 billion effort to overhaul the IRS' technology and related business processes. In 1996, after spending more than $3 billion, the effort was cancelled – interestingly, at about the same time that GAO was using its prospective success as a basis for concluding that technology improvements would make RFF feasible.[60] TSM was eventually replaced by the current, ongoing Business Systems Modernization (BSM) program, which has run behind schedule and over budget.[61] Throughout

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[58] *See GAO Return-Free Report* at 16. ("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.") *See also The Simple Return* at 17 ("There is no doubt that the Simple Return program would require some modernization of the processing capabilities of the IRS and its ability to match to the Social Security Administration records. The IRS already has a modernization program under way.")

[59] For a more extensive discussion, *see* Robert E. Litan, Jeffrey A. Eisenach, and Kevin W. Caves, *Easing the Burden of Income Tax Return Filing: Are the "I-File" Proposals the Answer?* Computer and Communications Industry Association (April 14, 2008) [hereafter *Litan Study*]. As noted in that study, the Government Accountability Office has designated IRS systems modernization as a "high risk" area since 1995 due to heightened vulnerability to waste, fraud, abuse, and mismanagement. *See* United States General Accounting Office, *High Risk Series* (GAO/HR-95-1, February 1995); *See also* United States General Accounting Office, *State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits* (GAO-07-570, April 2007) at 'Highlights.';

[60] GAO was well aware of TSM's weaknesses. *See, e.g.*, United States General Accounting Office, *Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed* (GAO/AIMD-95-156, July 1995) at 3 ("IRS does not have a comprehensive business strategy to cost-effectively reduce paper submissions, and it has not yet fully developed and put in place the requisite management, software development, and technical infrastructures necessary to successfully implement an ambitious world-class modernization effort like TSM. Many management and technical issues are unresolved, and promptly addressing them is crucial to mitigate risks and better position IRS to achieve a successful information systems modernization.")

[61] United States Government Accountability Office, *Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* (GAO-07-673, April 2007) at "Highlights." Most recently, the IRS has delayed further development implementation of one of the key elements of BSM, the Consumer Account Data Engine (CADE), due to "increasing complexities and questions of scalability with the system." *See* Government Accountability Office, *Internal Revenue Service: Review of the Fiscal Year 2010 Budget Request* (GAO-09-754, June 2009) at 5.

this process, the IRS' technology modernization efforts have been on the GAO's "high risk" list of troubled programs each year since 1995.[62]

Second, as noted above, the IRS relies on the Social Security Administration for wage data: W-2 forms are submitted to the SSA for processing, and the resulting electronic information is then transmitted to the IRS. Therefore, any successful effort to compress the schedule for tax information reconciliation from six months to a few weeks would require both the IRS and the SSA to (1) dramatically alter their respective information processing protocols; and (2) successfully coordinate efforts to meet the accelerated schedule.

These outcomes are not likely. The SSA has just begun an $800 million modernization effort to replace its 30-year-old National Data Center, which is the backbone of its automated data processing system. The GAO has identified the SSA project as a "significant undertaking," and noted that such projects "too frequently incur cost overruns and schedule slippages." [63] At the very least, the replacement of the SSA data center is likely to monopolize SSA's technology management resources for the next several years.

To its credit, SSA has recently announced plans to revamp its automated reporting program for W-2 data. But these "plans" cannot be expected to solve the timing problem any time soon.[64] For one thing, the SSA's announcement indicated that the agency is in the "planning and analysis" stage of a project it expects to take at least five years. In addition, there is no indication that the project is aimed at significantly increasing the speed with which W-2s

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[62] *See* United States Government Accountability Office, *High Risk Series: An Update* (GAO-09-217, January 2009).

[63] The American Recovery and Reinvestment Act of 2009 provides funding for SSA to help replace its 30-year-old National Computer Center, which houses the backbone of SSA's automated operations. *See* United States Government Accountability Office, *Effective Information Technology Management Essential for Data Center Initiative* (GAO-09-662T, April 2009).

are processed. Instead, the agency is making efforts to reduce the frequency of backlogs that have occurred under the current information reporting calendar, since increases in the number of W-2's filed electronically have taxed SSA's electronic processing capabilities.[65]

Moreover, and perhaps most importantly, the delays likely have less to do with the shortcomings in IRS technology modernization efforts than with the underlying nature of the process. The GAO reported, for example, that 10 percent of all information returns contain incorrect identifying information that prevents them from being matched with other data,[66] and, as noted above, Holtzblatt also attributes much of the delay to late or inaccurate filing of information returns. As noted above, Congress only recently passed legislation slowing the process for filing of information returns specifically because of the need to increase accuracy.

To summarize, implementing RFF would be a far more costly and problematic exercise than RFF supporters suggest. Millions of taxpayers would be required to file an additional return – an "information return" – each January, as well as a second "RFF return" a few weeks or months later. Additional millions of employers, financial institutions and other third parties would be forced to file nearly two billion information returns two months earlier than at present. The IRS, working with the SSA, would need to compile all of this data within a matter of weeks instead of months; and, having done so, accurately prepare, print, and mail tens of millions of RFF returns to taxpayers, a task that would require thousands of temporary employees and other temporary facilities. The more categories of taxpayers who are eligible, the greater the burden will be; and, the longer the process takes, the fewer will opt to participate.

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[64] *See* BNA, "SSA Now Working on Five-Year Overhaul Of Automated Wage Reporting, Speaker Says", (May 1, 2009) [hereafter *SSA W-2 Overhaul*].

[65] *See SSA W-2 Overhaul.*

[66] *GAO Return-Free Report* at 15.

C. RFF in Practice: Who Ultimately Would Be Eligible?

The question of who would be eligible for RFF ultimately depends on how the system is designed and implemented – that is, on policy decisions that have not yet been made. That said, and based on the discussion above, it is possible to arrive at a reasonable projection of the maximum extent of RFF eligibility, based on two key assumptions.

First, we do not believe that EITC recipients are likely to be included in RFF at any time in the foreseeable future. Determining eligibility for the EITC is a potentially complicated multi-step process which varies from year to year,[67] and potential EITC recipients would thus be required, at a minimum, to fill out more complicated information returns. More likely, as the Treasury's *Return-Free Report* concludes, EITC recipients would not be eligible for RFF unless Congress made substantial modifications to and simplifications of the EITC eligibility criteria themselves.[68] We do not see any reason to believe such changes are imminent. The same challenge is presented for other commonly used tax benefits, including the Child Tax Credit.

Second, based on the discussion above, we assume the IRS somehow finds a way to process W-2s, which make up slightly less than 20 percent of information returns, on a sufficiently rapid schedule to permit RFF returns to be mailed in time to retain the April 15 filing

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[67] The IRS' EITC eligibility web tool includes 18 questions taxpayers must answer in order to discover whether they are eligible to receive the EITC. The web tool provides questions that can be answered to establish filing status (if not known), the number of children eligible for additional EITC support, and the amount of any EITC payment. In 2004, EITC rules were changed to allow nontaxable combat pay to be included as part of a taxpayer's earned income; in 2006, changes were made in the calculation of EITC benefits to EITC recipients displaced by Hurricanes Katrina, Rita, or Wilma. For the 2008 tax year, the EITC was revised such that taxpayers with homes in "Midwestern Disaster Areas" could, under certain circumstances, elect to use their 2007 earned income to figure their 2008 earned income tax credit. *See* http://www.irs.gov/individuals/article/0,,id=130102,00.html.

[68] *Return-Free Report* at 23. ("Whether a tax agency reconciliation system or exact withholding system is adopted, operating an EITC in a return-free system would be facilitated by simplifying and conforming its eligibility criteria more closely to other child-related tax benefits. For example, a taxpayer currently may claim a child for EITC purposes but not be entitled to claim the same child as a dependent. Thus, unless a uniform definition of child were adopted, a taxpayer would have to notify employers or the IRS whether a child qualified him or her for each specific child-related tax benefit before the correct taxes could be withheld in an exact withholding system or calculated by the IRS in an agency reconciliation system.")

date. To be clear, we regard this as an *extremely* generous assumption. There are approximately 250 million such returns, of which approximately 20 percent are paper.[69] Processing these returns (or even a substantial majority of them) by mid-to-late February, while at the same time implementing and operating systems to mail, receive, and process millions of taxpayer information returns, would be an heroic accomplishment which, for the reasons discussed above, we are confident will not be achieved for at least the next several years. Conversely, we conclude that there is no plausible basis for believing that it will be possible at any time in the foreseeable future to process other information returns (e.g., 1099s) within the required time frame.

On the basis of these two assumptions, we conclude that the *largest possible* eligibility pool for RFF at any time in the foreseeable future would be individuals who do not have non-wage income from withholdable sources and do not receive the EITC. As shown in Table One, in 1999 this group constituted about 23.3 million taxpayers, or about 18 percent of taxpayers.[70] Based on the number of individual tax returns received by the IRS in 2008, these figures imply that about 26.6 million taxpayers would be eligible for RFF.[71]

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[69] *See* Electronic Tax Administration Advisory Committee, *Annual Report to Congress* (June 20, 2008) at 10 [hereafter *ETAAC 2008 Report*]; *see also SSA W-2 Overhaul*.

[70] Equal to 21.5M + 1.8M. This group is essentially equivalent to what Goolsbee refers to as "Wave One." *See The Simple Return* at 9.

[71] The IRS received 154 million individual income tax returns during fiscal year 2008, up from approximately 140 million in fiscal year 2007. The Economic Stimulus Act of 2008 required some individuals who would ordinarily be exempted from a filing requirement to file a return in order to claim an economic stimulus payment; as a consequence, the increase in returns filed from 2007 to 2008 was larger than it would have been otherwise. To correct for this effect, we assume that, in the absence of the stimulus bill, the number of returns filed would have increased by approximately 3.7 percent from 2007 to 2008 (the same rate of increase that occurred between 2006 and 2007). This implies that approximately 26.6 million taxpayers would be eligible for RFF (140M*1.037*(23.3/127.1) ≈ 26.6M). *See IRS 2008 Data Book* at 4; *see also* Internal Revenue Service, *Data Book 2007*, [hereafter *IRS 2007 Data Book*], available at http://www.irs.gov/taxstats/article/0,,id=168593,00.html, at 4.

IV. PARTICIPATION: HOW MANY TAXPAYERS WOULD CHOOSE RFF?

In the discussion so far, we have addressed some of the key factors that would determine the level of participation in an RFF system. Which categories of taxpayers would be eligible? How much information would be required on RFF information returns, and when and how would those returns be filed? When would taxpayers receive RFF returns, and how much would their refunds be delayed as a result of participation? In this section, we review the available data on the consumer preferences – that is, the extent to which taxpayers appear to have a preference for RFF as compared with the current system.

In addition to the issues identified above, taxpayer participation would likely be affected by two sets of taxpayer concerns. First, taxpayers would be concerned about the IRS' ability to maintain the privacy and security of their information under an RFF system. Second, they would be concerned about the accuracy of RFF returns. At the end of this section, and taking all of these factors into account, we provide our assessment of the most likely level of overall participation in an RFF system.

A. Privacy and Security Concerns

Taxpayers may be concerned that an RFF system would cede excessive control to the government, threatening the confidentiality and security of private taxpayer data. In fact, a survey commissioned by the IRS indicates that roughly 70 percent of those eligible for RFF believe that such a system "gives the government too much control of your life."[72] The fear that the IRS may not adequately protect private taxpayer information is certainly not unfounded. As

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[72] *Findings From Year 2000 Research Into Taxpayer Attitudes Toward & Acceptance of a Return-Free Tax Filing System* (October 2000), *in 2003 Treasury Return-Free Report, supra,* at 28.

we explained in detail in our companion piece,[73] the IRS has experienced substantial difficulties in attempting to safeguard private taxpayer information, particularly in electronic form.

For example, information security deficiencies identified by the GAO in 2006, coupled with unresolved deficiencies that had been identified previously, prompted the GAO to report *material weakness* in IRS's internal controls over financial and tax processing systems. Specifically, the GAO found that lax security controls "could impair IRS's ability to perform vital functions and increase the risk of unauthorized disclosure, modification, or destruction of financial and sensitive taxpayer information."[74] In addition, the GAO concluded in its report on IRS's fiscal years 2005 and 2006 that IRS' information security deficiencies could prevent "the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis."[75] More recently, in a January 2009 report, the GAO concluded once again that this material weakness at the IRS has yet to be sufficiently addressed:

> Information security weaknesses – both old and new – continue to impair the agency's ability to ensure the confidentiality, integrity, and availability of financial and taxpayer information. These deficiencies represent a material weakness in IRS's internal controls over its financial and tax processing systems. A key reason for these weaknesses is that the agency has not yet fully implemented certain key elements of its agencywide information security program. The financial and taxpayer information on IRS systems will remain particularly vulnerable to insider threats until the agency (1) begins to address and correct prior weaknesses across the service and (2) fully implements a comprehensive agencywide information security program that ensures risk assessments are appropriately reviewed for all systems, tests and

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[73] *Litan Study, supra*.

[74] United States Government Accountability Office, *Further Efforts Needed to Address Significant Weaknesses at the Internal Revenue Service* (GAO-07-364, March 2007) [hereafter *GAO Electronic Security Report 2007*] at "Highlights".

[75] *Id.* at 1.

> evaluations of controls for systems are comprehensive, and the remedial action process effectively validates corrective actions.[76]

The Treasury Inspector General for Tax Administration (TIGTA) has also identified security weaknesses in IRS electronic systems. In 2003, the TIGTA reported that it had identified unauthorized wireless networks which could be used to gain unauthorized entry into IRS computers.[77] Following this report, the IRS took corrective action to rectify those security vulnerabilities and reportedly adopted a "comprehensive wireless security policy."[78] Yet a subsequent TIGTA report identified new instances of unauthorized and vulnerable wireless connections to IRS systems in March 2007.[79] TIGTA reported in June 2007 that testing had revealed significant security vulnerabilities in the IRS Electronic Fraud Detection System (EFDS).[80] The IRS Criminal Investigation Division relies on the EFDS to detect fraudulent returns. In addition, the EFDS constitutes the second largest IRS taxpayer database. As a result of its findings, TIGTA concluded that "[u]ntil security control weaknesses are corrected, the [IRS] Criminal Investigation Division is jeopardizing the confidentiality, integrity, and availability of the System and the taxpayer data residing on it."[81] Still more recently, TIGTA reported that the IRS had deployed key phases of its Modernized e-File (MeF) system and its Modernized Tax Return Database (M-TRDB) despite known security vulnerabilities, increasing the risk that "1) an unscrupulous person could gain unauthorized access to the vast amount of

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[76] United States Government Accountability Office, *Continued Efforts Needed to Address Significant Weaknesses at IRS* (GAO-09-136, January 2009), at 19.

[77] United States Treasury Inspector General for Tax Administration, *Use of Unapproved Wireless Technology Puts Sensitive Data at Risk* (Ref. No. 2003-20-056, February 2003).

[78] United States Treasury Inspector General for Tax Administration, *Sensitive Data Remain at Risk From the Use of Unauthorized Wireless Technology* (Ref. No. 2007-20-60, March 28, 2007) at 2.

[79] *Id*. at 2.

[80] United States Treasury Inspector General for Tax Administration, *Sufficient Emphasis Was Not Placed on Resolving Security Vulnerabilities When Restoring the Electronic Fraud Detection System* (Ref. No. 2007-20-108, June 14, 2007).

[81] *Id.* at Introductory Letter.

taxpayer information the IRS processes with little chance of detection and 2) the system could not be recovered effectively and efficiently during an emergency."[82] These are hardly reassuring findings, which do not augur well for the immediate success of any new systems project such as RFF.

B. Accuracy Concerns

Under RFF systems, the burden is on the taxpayer to review IRS-prepared returns and to contest erroneous or incomplete information and calculations. Taxpayers may anticipate that this reversal of traditional roles in the U.S. tax system could complicate or frustrate multiple aspects of taxpayers' experience, such as the timeliness of refund payments or the resolution of tax disputes, and force taxpayers to bear the costs associated with government errors. As shown in Figure One, the IRS survey revealed significant doubts among eligible RFF participants as to the IRS's ability to calculate tax liabilities reliably and accurately: 47 percent of all respondents indicated that the IRS could not be trusted to calculate taxes under RFF, and 49 percent were concerned that the IRS would "calculate[] taxes to their benefit, not the taxpayers."[83]

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[82] United States Treasury Inspector General for Tax Administration, *The Internal Revenue Service Deployed the Modernized e-File System With Known Security Vulnerabilities* (Ref. No. 2009-20-026, December 30, 2008).

[83] These findings were confirmed – in even stronger form – in a 2008 survey conducted for the Information Technology & Innovation Foundation, which found that 57 percent of respondents believe that "if the IRS prepared their taxes, they would pay more than they really owed." That survey also found that 57 percent of respondents oppose RFF, compared with 36 percent who support it, and that 46 percent strongly oppose RFF compared to only 15 percent who strongly support it. *See* The Mellman Group, "Public Attitudes Towards the IRS and Tax Preparation Software" (Prepared for the Information Technology & Innovation Foundation, May 1, 2008) (available at http://www.itif.org/files/MellmanPollMemo.pdf).

Figure One:
Taxpayer Concerns About RFF[84]

Question: *After I read each statement, please tell me if you "agree completely," "agree somewhat," "disagree somewhat," or "disagree completely" with each statement as it applies to this optional tax filing method.*		
Response:	**Percent of Respondents**	**Confidence Range (Percent)**
It gives the government too much control of your life.	72	69 to 75
I worry about how you resolve a tax problem.	69	66 to 72
The IRS calculates taxes to their benefit, not the taxpayer's.	49	46 to 52
You can't trust the IRS to calculate your taxes this way.	47	44 to 50

IRS-driven errors could arise from faulty management of IT systems or from human error on the part of IRS personnel or, as in the case of the misaddressed economic stimulus payments noted above, IRS contractors. In any case, it is a virtual certainty that errors will occur.[85]

RFF advocates acknowledge these concerns, but tend to dismiss their importance, arguing (for example) that errors also occur under the current tax system, and that even private tax preparers make mistakes.[86] What they seem to ignore, however, is that the central issue is

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[84] *2003 Treasury Return-Free Report, supra,* at 28.

[85] For example, data collected by the IRS indicates that telephone assistors have provided incorrect answers to tax law questions to between 10 percent and 22 percent of taxpayers seeking assistance between 2004 and 2007. *See* United States Government Accountability Office, *Testimony Before the Subcommittee Financial Services and General Government, Committee on Appropriations, U.S. Senate, Statement of James R. White, Director, Strategic Issues, & David A. Powner, Director, Information Technology Management Issues, IRS Assessment of the 2008 Budget Request and an Update of 2007 Performance* (GAO-07-719T, May 2007), at 26. The experience of other nations also supports the notion that RFF programs are prone to errors. For example, tax officials in the United Kingdom recently sent erroneous tax credit checks to more than 1.5 million participants in the UK's RFF program, and then threatened taxpayers who refused to return the money, telling them they had no right of appeal. *See* Jon Ungoed-Thomas, "Bullying Tax Officials Lose £2.8 Billion," *The Sunday Times (London)* (July 27, 2008) ("The evidence uncovered by the tax-credit victims reveals: The computer routinely wiped out claimants' salaries, thus triggering overpayments. One claimant landed with tax-credit debts was told: 'The computer zeroed your wife's salary. It's a common fault.' Duplicate rogue files caused errors and sent out multiple awards. One claimant was sent 10 letters in one day – but was still assured there were no payment mistakes. He was subsequently threatened with court action over the overpayments. Victims were sent letters claiming they had 'no right of appeal' when they were pursued for overpayments caused by official error.")

[86] *See, e.g.*, *The Simple Return* at 18 ("Even if 99.99 percent of the returns were accurate, there would still be thousands of people receiving returns with mistakes …. [but w]hile it is impossible to avoid all mistakes in a Simple Return system, it is worth noting that the current system is not foolproof, either.").

not accuracy, but *trust.* We simply do not believe it is possible for the Internal Revenue Service to mail out hundreds of thousands, or even millions, of inaccurate tax returns and then – in the face of the inevitable Congressional oversight hearings and associated media coverage that would result – expect taxpayers to maintain sufficient trust in the system to encourage them to participate. And without trust, the system simply will not be used – especially since, under an RFF system, taxpayers would continue to be responsible for errors, even if the errors originated with the IRS.[87] Thus, taxpayers would still be responsible for collecting and maintaining all of the records, understanding the tax law, and performing all of the calculations, necessary to double check the IRS' information and calculations on their RFF tax returns – or risk facing stiff penalties, including perjury, for filing false returns, not withstanding the fact that the return was originally prepared and provided to them by the IRS itself. This fact can be reasonably expected to lead to some number of taxpayers assuming IRS-prepared returns to already be accurate and complete, and thus to be relied upon, signed and returned without changes or additions. It is not unreasonable to worry that such misinterpretations would be more likely among more vulnerable population groups such as those taxpayers that may be less well-educated, are elderly, or for whom English is a second language. Enforcement actions against such taxpayers would be especially likely to result in public controversy and Congressional scrutiny, further weakening taxpayer trust in the system.

C. Overall Participation Rates

Estimating participation rates in any prospective government program is a difficult exercise, all the more so when – as in this case – there are significant unknowns and uncertainties about how the program would actually operate. The available evidence suggests, however, that

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[87] *See, e.g.*, *The Simple Return* at 18.

actual participation would be far from universal among those eligible. Indeed, in our judgment, at most about two percent of U.S. taxpayers would ultimately participate in the program, and the true proportion would probably be much lower.

Our conclusion is based, first, on our conclusion that at most 18 percent of taxpayers would be eligible for the program as implemented. What proportion of this eligible base actually would participate? In 2000, as noted above, the IRS commissioned a survey to explore taxpayer attitudes towards RFF proposals.[88] Overall, the survey found that 13 percent of potentially eligible taxpayers indicated they were "definitely interested," and another 26 percent said they were "probably interested." (On the other hand, over 36 percent of respondents indicated they were "definitely not" or "probably not" interested in participating, and 24 percent were "uncertain.") On the basis of these figures alone, the survey seems to indicate that a maximum of 39 percent (13 percent plus 26 percent) of eligible taxpayers would participate.

The survey also found that only 17 percent of potentially eligible taxpayers would participate in the first year of implementation, with an additional 28 percent indicating they would wait a year to participate.[89] These figures are open to interpretation: If, as RFF advocates believe, the system turns out to be popular with taxpayers, these responses suggest as many as 45 percent of eligible participants might eventually participate; if, as we are inclined to believe, the system's implementation is accompanied by negative publicity (associated with, for example, mailing of inaccurate RFF returns), the survey suggests participation would never exceed 17 percent. Overall, the survey suggests a wide range of possible participation, between 13 percent

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[88] Survey respondents were required to be potentially eligible to participate in a return-free tax system. Russell Marketing Research, Inc., *Findings From Year 2000 Research Into Taxpayer Attitudes Toward & Acceptance of a Return-Free Tax Filing System* (October 2000), [*Russell Marketing Survey*] *in 2003 Treasury Return-Free Report, supra,* at 24-27.

[89] *Id.* at 24-27.

(who say they would "definitely" participate) and 45 percent (who say they might try RFF after the first year).

We believe even these survey figures overstate taxpayers' willingness to participate in the program as it would actually be implemented, for two primary reasons.

First, survey participants were not informed that participating in RFF would delay the receipt of their income tax refunds until after expressing their overall preference for the program. When (later in the survey) they were informed of this, and asked whether it would affect their interest in the system, 36 percent said they would like the system less if it involved a one-month delay, and 55 percent said they would like it less if it involved a two-month delay. While there is no way to precisely estimate the number of taxpayers who would be deterred by this problem (in part because there is no way to know how rapidly the IRS would actually be able to process and mail RFF returns), a very generous set of assumptions is that: (a) the IRS would process and mail RFF returns by February 15, implying that refunds would be delayed for about 35 percent of participating taxpayers;[90] and, (b) about 45 percent (the average of 36 percent and 55 percent) of those taxpayers would elect not to participate as a result. Thus, we estimate that the late refund issue would reduce participation by about 16 percent (0.45 times 0.35) relative to the figures implied by the raw survey data.

Second, while survey participants were informed that they would be required to "provide the IRS with some information, such as your marital status and the names and social security numbers of your dependents, so that the IRS could compute your tax liability,"[91] no mention was made of the need to, in effect, file two returns – an RFF information return in January, plus the

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[90] *See* section III above. Again, we do not mean to imply we believe it would be feasible for the IRS to mail RFF returns by February 15, only that we entertain the assumption for purposes of analysis.

[91] *Treasury Return-Free Report* at 26.

final RFF return itself a few weeks or months later. The fact that a system advertised as "return-free" would actually become a "two-return" system would inevitably strain taxpayer confidence in the declared benefits of "burden reduction".

One way of estimating the impact of the "two-returns" problem is to compare the additional cost taxpayers would incur in filing the taxpayer information return with their willingness to pay to participate in the program. Fortunately, the IRS survey included a question asking taxpayers how much they would be willing to pay to participate in an RFF system. Of those responding, 61 percent indicated they would not be willing to pay anything, 13 percent indicated they would be willing to pay $10, 17 percent would pay $25, seven percent would pay $50 and two percent would pay $100.[92] Based on these figures, and the time cost involved in filling out the RFF information return, it is possible to estimate the deterrent effect the information return would have on participation.

While the IRS does not publish paperwork burden estimates for the W-4 form, it does estimate that it takes taxpayers, on average, three hours to fill out and submit form 1040EZ (not including time associated with record keeping, tax planning, etc.), which is similar to form W-4 (both are two pages long and the information requested is similar). Further, it is generally agreed that an RFF information return would be substantially more complex than the current W-4. If we assume, very conservatively, that the RFF taxpayer information return would take just one hour to fill out, then, based on the average hourly earnings U.S. workers of $18 as of January 2009,[93] it is reasonable to assume (conservatively) that the 74 percent of filers (61 percent plus

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[92] *Treasury Return-Free Report* at 29. *See* Figure Two below.
[93] *See* Bureau of Labor Statistics, *Economy at a Glance* (http://www.bls.gov/eag/eag.us.htm).

13 percent) who indicated they were willing to pay $10 or less would not participate in RFF; or, conversely, that only 26 percent would participate.[94]

Taken together, these two factors (delayed refunds and paperwork costs associated with the taxpayer information return) would reduce participation (relative to the levels reported in the survey) by between 74 percent and 90 percent.[95] When we apply these percentages to the range of participation estimates discussed above, we arrive at a lower bound estimate of between 1.3 and 3.4 percent of eligible participants and an upper bound estimate of between 4.5 and 11.7 percent of eligible participants.[96]

Applying these figures to our conclusion that a maximum of 18 percent of taxpayers would be eligible to participate, we estimate that between 0.2 percent of taxpayers (0.013 x 0.18) and 2.1 percent (0.117 x 0.18) of taxpayers would participate in an RFF program. Based on 2008 filing season statistics, these percentages equate to between 340,000 and 3.1 million taxpayers, or between 0.8 percent and 7.6 percent of the "40 million" claim advanced by RFF advocates.[97]

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[94] Compare Holtzblatt at 19-20 ("[T]he impact of a return-free system on compliance costs may not be large under the current Federal system."and "Under both exact withholding and taxpayer agency reconciliation systems, taxpayers could incur new costs, offsetting the savings associated with a return-free system. These costs could result from new paperwork requirements or delays in the payments of tax refunds.")

[95] The proportion depends on the extent of overlap between the two groups, i.e., those who would not participate due to paperwork costs and those who would not participate due to delayed refunds. If there is complete overlap, then these two factors reduce participation by 74 percent; if there is no overlap, they reduce participation by 90 percent.

[96] The lower bound estimate from the raw survey results was 13 percent, based on those who said they would "definitely" participate. Assuming 74 percent of these would not participate, the actual participate rate would be (1-0.74) times 0.13, or 3.4 percent. If 90 percent would not participate, the actual participation rate would be (1-0.90) times 0.13, or 1.3 percent. The same adjustments were made to the upper bound figure of 45 percent (based on those who said they might eventually participate).

[97] As noted above, the IRS received 154 million individual income tax returns during the fiscal year 2008, up from approximately 140 million in fiscal year 2007; the Economic Stimulus Act of 2008 contributed to this large year-to-year increase. To correct for this effect, we assume that (without the stimulus bill) the number of returns filed would have increased by approximately 3.7 percent from 2007 to 2008 (the same rate of increase that occurred between 2006 and 2007). This implies that between 340,000 (≈140M*1.037*0.002) and 3.1 million

V. RETURN-FREE SYSTEMS AND THE "TAX GAP"

The "tax gap" is the difference between what taxpayers owe in taxes and what they pay.[98] The IRS estimates that the gross tax gap was roughly $345 billion for 2001,[99] but that late payments and IRS enforcement activities brought in another $55 billion, resulting in a net tax gap of about $290 billion.[100] In this section, we examine the likely impact of an RFF system to raise revenue by closing or narrowing the tax gap, and conclude that underpayments would almost certainly increase. That is, RFF would increase, and would certainly not reduce, the tax gap.

We begin by briefly discussing the nature and sources of the tax gap and noting the simple facts that taxpayers eligible for RFF do not have income which typically is under-reported and that the IRS already uses the information it receives to recover underpayments from under-reporting taxpayers. Next, we discuss the incentive structure of an RFF system and demonstrate that RFF is likely to *increase* incentives for under-reporting of income and thus result in a lower overall compliance rate and reduced tax collections.

(≈140M*1.037*0.021) taxpayers would participate in RFF. *See IRS 2008 Data Book* at 4; *see also IRS 2007 Data Book* at 4.

[98] *Hearings on Bridging the Tax Gap Before the Senate Committee on Finance*, 108th Cong. (2004) (statement of Mark Everson, Commissioner of Internal Revenue).

[99] Internal Revenue Service, Press Release IR-2006-28: *IRS Updates Tax Gap Estimates*, Feb. 14, 2006 [hereafter *IRS Tax Gap Estimates*], available at: http://www.irs.gov/newsroom/article/0,,id=154496,00.html. Tax gap estimates are calculated and released by the IRS with a substantial time lag. The 2006 *IRS Tax Gap Estimates* produced estimates for the 2001 tax year, and represent the most current tax gap data available. *See, e.g.,* United States Government Accountability Office, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* (GAO-09-238, January 2009). Prior to the 2006 update, tax gap estimates had been based on data from the 1988 tax year. *See, e.g.* United States Treasury Inspector General for Tax Administration, Hearing Before the U.S. House of Representatives Committee on Budget, Statement Of The Honorable J. Russell George, Treasury Inspector General For Tax Administration, *IRS and the Tax Gap*, (February 2007), [*2007 TIGTA Testimony*], at 2.

[100] Internal Revenue Service, *Tax Gap Update*, [hereafter *IRS Tax Gap Figures*], available at: http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf. As note above, the IRS releases tax gap estimates with a significant time lag.

A. RFF Would Not Enhance Compliance Efforts

The IRS estimates that the $345 billion gross tax gap results from three primary sources: (1) unfiled tax returns ($27 billion); (2) under-reporting of income on filed returns ($285 billion); and (3) underpaid taxes on filed returns ($33 billion).[101] Thus, under-reporting accounts for about 83 percent of the tax gap. IRS estimates disaggregate the sources of the tax gap into four categories of tax: (1) individual income taxes; (2) employment taxes; (3) corporate income taxes; and (4) estate taxes.[102] The available statistics indicate that the bulk of the tax gap (roughly 71 percent) is accounted for by individual income taxes.[103]

RFF, however, would do virtually nothing to reduce under-reporting on individual tax returns, because the almost all under-reporting is associated with types of income that would make filers ineligible to use RFF in the first place. Indeed, wage-based income accounts for only about five percent of the tax gap associated with under-reporting of individual income, implying a net misreporting percentage (NMP) of just 1.2 percent. In contrast, income earned by sole proprietorships[104] accounts for roughly 34 percent of the individual income tax gap, implying a NMP (for sole proprietorships) of roughly 57.1 percent.[105] Overall, the IRS estimates that

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[101] *IRS Tax Gap Figures.*

[102] While the IRS reports disaggregated statistics on various components of the gross tax gap, only a single, aggregate figure is reported for the net tax gap. Hence, by necessity in this paper we confine all disaggregated analysis of the tax gap to the gross tax gap.

[103] *See IRS Tax Gap Figures,* indicating that the individual income tax contributes $25 billion to the nonfiling gap, $197 billion to the under-reporting gap, and $23.4 billion to the underpayment gap, for a total of roughly $245.4 billion, equal to roughly 71% if the aggregate $345 billion gross tax gap.

[104] Sole proprietors report their business-related net profit or loss on IRS Form 1040, U.S. Individual Income Tax Return, through Schedule C. *See* United States Government Accountability Office, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (GAO-07-1014, August 2007) [hereafter *GAO Tax Gap Report*], at 5.

[105] The *IRS Tax Gap Figures* estimate the extent to which various categories of income contribute to under-reporting of income, the single largest component of the tax gap. (Similar estimates are not produced for the nonfiling and underpayment components). The *IRS Tax Gap Figures* show that the total individual income under-reporting tax gap comes to about $197.4 billion. Wages, salaries, and tips account for about $10.5 billion, or about 5.3% of this total. In contrast, sole proprietors account for about $68.0 billion, or 34% of the total. These estimates

roughly 10 percent of the gross individual income under-reporting tax gap is driven by items subject to "substantial information reporting and withholding" or items subject to "substantial information reporting." On the other hand, roughly 81 percent of the individual income tax gap is accounted for by income subject to "some information reporting" or "little or no information reporting."[106] RFF, which by definition utilizes information the IRS has in hand, can hardly increase compliance with respect to income about which the agency does not receive information. (As we discuss further in the next section, a greater risk may be that of RFF demonstrating to taxpayers not how much IRS knows, but how little, and thus providing taxpayers with increased incentives to under-report income.)

Moreover, the IRS already uses the information it receives to double-check individual tax returns for errors and send corrected returns (or, in the case of non-filers, IRS-produced returns) to errant taxpayers. Indeed, in 2008, the IRS closed 3.5 million cases through its Automated Underreporter Program and an additional 1.3 million cases through its Automated Substitute for Return (non-filer) program, resulting in total additional assessments of over $16.5 billion.[107] The IRS also double checks returns for math errors and, when it finds them, sends corrected returns; in 2008 the IRS detected over 3.6 million math errors, and sent out more than 2.8 million "math error notices."[108]

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imply that wage earners underreport their net income by about 1.2%, while sole proprietors underreport by about 57.1%. *See also GAO Tax Gap Report*, *supra*, at 'Highlights.'

[106] The *IRS Tax Gap Figures* show that about $10.5 billion + $9.1 billion = $19.6 billion, or about 10%, of the $197.4 billion under-reporting tax gap is accounted for by items subject to "substantial information reporting and withholding" or items subject to "substantial information reporting." In addition, $110.1 billion + $50.6 billion = $160.7 billion, or about 81%, is accounted for by income subject to "some information reporting" or "little or no information reporting." (The remaining 9% is not classified)..

[107] *IRS 2008 Data Book* at Table 14.

[108] A math error notice sent to a taxpayer may address more than one math error. *See IRS 2008 Data Book* at Table 15.

Similarly, RFF would not enhance IRS' ability to detect non-filers. For example, if a non-filer is benefiting from "under-the-table" transactions or through the "cash economy," nothing about RFF would cause such non-reported income to be reported, and RFF would not result in a return being generated for such a non-filer. Because RFF can only capture reported income, it would not result in increased filings by non-filers whose non-reported income contributes to the "tax-gap" today.

In short, to the extent the IRS can use information it already receives to increase taxpayer compliance, it already does so. Nothing about RFF would enhance or strengthen the efforts already underway.[109]

B. RFF Would Create Incentives for Under-Reporting and Thus Increase the Tax Gap

While RFF would do nothing to reduce the tax gap, there are good reasons to believe it would increase it. Simply put, taxpayers who receive RFF returns that understate their tax liabilities are likely to accept the IRS's faulty assumptions, while taxpayers who receive RFF returns that overstate their tax liabilities will likely elect to ignore the RFF return and file a correct return through the traditional process.

RFF proponents sometimes acknowledge this issue, but claim the effect would be small.[110] A recent analysis by the IRS, however, suggests the amount of under-reporting that

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[109] For a more extensive analysis of these issues, *See* Robert A. Boisture, Albert G. Lauber, and Holly O. Paz, *Policy Analysis of "Return-Free" Tax System*, Computer and Communications Industry Association (April 2006) at 9-13.

[110] *See* Bankman, *Tax Notes*, at 1433 ("What about evasion? The ReadyReturns were sent to taxpayers who reported only wage income in 2003 and who appear to have only wage income in 2004. It's possible that some of the recipients of the ReadyReturn did not report additional sources of income in 2003 and, more significantly, had additional sources of income in 2004. The ReadyReturn will not include that form of income and will therefore understate tax liability. However, *revenue loss from understatement should be small*. First, ReadyReturn recipients are explicitly told they must include additional sources of revenue and at least some participants will no doubt do so. Second, and most importantly, income not subject to third-party reporting received by members of this group (for example, cash for odd jobs) is generally not reported to the state any-way. Finally, members of this group are in the lowest tax rates.") (Emphasis added.)

could result from RFF could be substantial. In a June 2008 presentation,[111] Alan Plumley of the IRS Office of Research presented data which indicated that as much as 6.1 percent of individual income, or over $33.7 billion, would be under-reported on RFF returns. In addition, Plumley reported, RFF returns would likely miss an additional $7.8 billion in business income.

Data from the California "ReadyReturn" experiment appears to confirm that (a) RFF is likely to fail to capture income in a significant proportion of cases, and (b) taxpayers are unlikely voluntarily to correct the results. In 2004, the California Franchise Tax Board compared the adjusted gross income reported on the returns of ReadyReturn filers with income reported on those same taxpayers' Federal tax returns. The state-prepared returns under-reported income on 11 percent of all returns. Only about three percent of taxpayers who received such returns chose to correct the state's error. The high rate of apparent under-reporting was a primary reason the California legislature chose to limit the program's expansion.[112]

If we combine the data reported by Plumley with the experience in California, we can arrive at a very rough estimate of the likely costs of RFF in terms of tax avoidance. Specifically, Plumley finds that $41.5 billion in income could be under-reported on RFF returns. Plumley's estimate appears to be based on a larger eligibility pool than we assume (approximately 40 percent of taxpayers versus our assumption of 18 percent). Adjusting his figures to reflect our lower maximum participation rate, we estimate RFF as implemented would result in the under-reporting of $18.7 billion in income. Further, it seems reasonable to assume, based on the California experience, that virtually none of this under-reporting would be voluntarily corrected by taxpayers. Finally, we estimated above that between 4.5 and 11.7 of eligible RFF participants

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[111] Alan Plumley, "Potential Risks of the 'Ready Return' Concept" Presentation to the 2008 IRS Research Conference (June 11, 2008)

[112] *See* Holtzblatt at 11-12.

would take part in the system. If we conservatively assume an average tax rate of 15 percent on the under-reported income, the lost revenue (i.e., the increase in the tax gap) would be between $126 million ($18.7 billion x 4.5 percent participation x 15 percent tax rate) and $328 million ($18.7 billion x 11.7 percent participation x 15 percent tax rate).

VI. THE COSTS OF RFF FAR EXCEED THE BENEFITS

Based on our analysis, we conclude that there is no plausible set of assumptions under which one could conclude that the benefits of implementing RFF would exceed the costs. Our conclusion is based on the following facts.

First, the maximum possible eligibility pool for RFF at any time in the foreseeable future would include about 18 percent of taxpayers, far below the 40 percent RFF advocates suggest. Furthermore, only about two percent, and more likely less than one percent, of taxpayers would choose to take part in the program. At most, about 3 million taxpayers would benefit from the program, but a more realistic estimate is closer to half a million or fewer.

Second, while it is not possible to quantify all of the costs of implementing RFF, it is clear they would be substantial, running well into the hundreds of millions of dollars annually. Importantly, while some of these costs are variable (such as the costs of processing RFF information returns and the printing and postage costs of mailing RFF returns), others are essentially fixed. For example, an accelerated filing date for W-2 information returns would have to apply, as a practical matter, to W-2s for all taxpayers, thus imposing costs on all U.S. employers. Similarly, the modernization efforts required to accelerate processing of information returns would require the purchase and implementation of new computer systems and business processes, the costs of which would be insensitive to volume.

Still other costs would vary with the size of the eligible pool, but not with participation. For example, if 27 million taxpayers were theoretically eligible for RFF, the IRS would need to send out more than 27 million RFF information returns (since it would not know in advance who was eligible), even though only a fraction of these would be returned, and a still smaller fraction would ultimately result in the filing of RFF returns. Another cost of the program is the substantial increase in the tax gap we believe would result from implementation of RFF.

On the benefits side, RFF proponents tend to estimate benefits by calculating the average (time and money) costs to taxpayers of filling out tax forms, assuming some large reduction based on the presumed relative ease of reviewing RFF returns as opposed to filling out your own return, and then multiplying the result by the (large) number of taxpayers assumed to participate. For example, one recent study assumed arrived at its estimate of the benefits of RFF by assuming (a) that 100 percent of those eligible to participate in RFF would do so, (b) that those who did participate would save 80 percent of the total costs of filing, and (c) that participants would value participation at their average wage rate. Based on these assumptions, the study found that RFF would generate total savings to taxpayers of slightly greater than $2 billion, or slightly more than $75 per taxpayer.[113]

As we have explained above, there is no basis for assuming full participation, and the assumption of an 80 percent reduction in compliance burden (i.e., time spent filling out tax returns) is extremely questionable (especially given the fact that taxpayers would still be liable for any errors on their tax returns, and thus as a practical matter would still need to maintain all

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[113] *See The Simple Return* at Table 4 and accompanying text. In fact, RFF estimates overstate taxpayer burden (time) reduction because they include not just the time for "forms completion," but also the other elements of tax compliance (including record keeping, tax planning and form submission) that would not be affected by RFF. For example, compare *The Simple Return* at Table 2, p. 14 with IRS, *Tax Year 2004 Form 1040 Instructions*, p. 75.

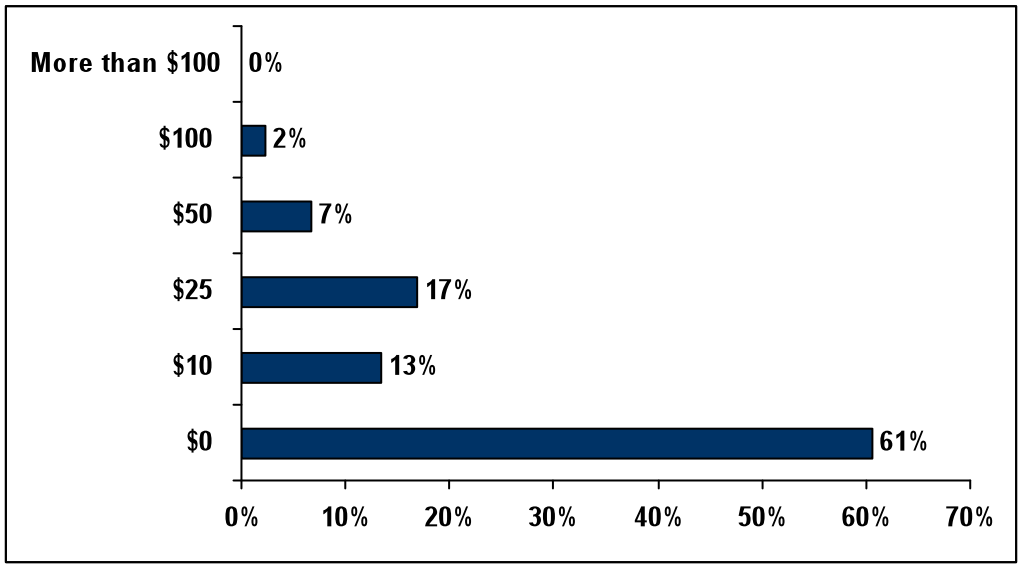
of the records and perform all of the calculations necessary to ensure their RFF returns were correct).

Another problem with this approach is that it arbitrarily assumes the value to taxpayers of RFF can be measured by the value of the time saved by not having to do their taxes. But this assumption is only valid to the extent taxpayers derive no ancillary benefits from the exercise—for example, it is assumed that taxpayers place no value whatsoever on knowledge gained about their personal financial situation, the nature of the tax system (and how it affects them), etc. We believe this assumption is especially problematic, from both a private and a public perspective. That is, we think it highly likely that the few hours of financial introspection Americans spend each year in conjunction with preparing their tax returns has private benefits (in the form of greater financial self-awareness, leading to improved financial decision making) as well as public ones (e.g., potentially higher retirement savings rates).

An alternative approach to valuation, and the one that is generally preferred in benefit-cost analysis, is to value program benefits based on participants' *willingness to pay*.[114] Further, in this instance, data on willingness to pay are available: As noted above, the IRS survey specifically asked taxpayers how much they would be willing to pay to participate in RFF. The results are reproduced in Figure Two below.

[114] *See, e.g.*, OMB Circular A-4, *Regulatory Analysis*, at 13 ("[W]illingness to pay is generally the preferred economic method for evaluating preferences.")

Figure Two:
Willingness to Pay to Participate in RFF[115]



Question: How much would you be willing to pay in order to be able to use the new system and not have to file a tax return?

In Section IV above, we relied on these figures to estimate the proportion of taxpayers who would be deterred from participating in RFF by the time costs associated with filling out RFF information returns, finding that no taxpayers who valued participation at $10 or less would participate.[116] We can also use this data to estimate taxpayers' willingness to pay for RFF. Specifically, we assume that the 26 percent of taxpayers willing to pay more than $10 would participate, and that the distribution of values of those who do participate are proportionate to the percentages shown in Figure Two: That is, 65 percent (17 divided by 26) of participants value participation at $25, 26 percent (7 divided by 26) value participation at $50, and nine percent (two divided by 26) value participation at $100. Thus, the average value to participants as

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[115] *Treasury Return-Free Report* at 29. Note that results have been normalized to reflect the fact that approximately 10 percent of survey participants did not respond to this particular question.

[116] Thus, we assumed that taxpayers do not gain ancillary benefits from filling out information returns. We distinguish information returns from actual tax returns, since information returns involve nothing more than providing the government with information already in the taxpayer's possession, while filling out tax returns involves calculating the impact of one's decisions on one's tax liability, i.e., learning about the tax code.

measured by their willingness to pay is $38.[117] When we apply this figure to our (generous) estimates of between 340,000 and 3.1 million RFF participants, the resulting estimate is that the gross benefit to RFF participants would be, at most, between $13 million (340,000 x $38) and $118 million (3,100,000 x $38).

These estimates reflect the *gross* benefits of RFF to taxpayers, but still do not take into account the increased cost to taxpayers of having to fill out RFF information returns. As we noted earlier, this fact was not explained in the course of the survey, and hence not taken into account by survey respondents in estimating their willingness to pay. If we assume taxpayers value the time spent filling out RFF information returns at the average hourly wage of $18, the *net* average value of RFF to participants is $20, and the total net benefits fall to between $6.8 million and $62.1 million. Needless to say, this is a far cry from the $2 billion estimated by RFF proponents.[118]

While the data required to estimate the total the costs of implementing RFF are not available, we do not believe a plausible argument could be made that it could be done for anything close to the figures above. As noted above, even the partially quantified on-budget costs of RFF would exceed $100 million annually, above the top end of our range of total taxpayer benefits, and these fail to take into account the costs associated with increased error rates and the private sector costs of moving up the filing deadline for information returns by two months. Further, our rough estimates of the reduced tax revenues that would result from RFF

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[117] Equal to $25 * 65% + $50 * 26% + $100 * 9%. .

[118] It should be noted that our assumptions remain extremely favorable to RFF. Most notably, the IRS Survey did not explain to respondents that taxpayers would remain legally liable for any inaccuracies in their returns, even if the inaccuracies originated with the IRS. Obviously, this fact dramatically undercuts RFF advocates' claims about the reduced burdens of RFF, and – had respondents to the IRS survey been aware of it – would surely have reduced their expressed "willingness to pay" for the RFF option.

(between $126 million and $328 million) far exceed our benefits estimate. All told, we conclude that the costs of RFF far exceed any plausible benefits.

VII. ALTERNATIVE APPROACHES TO REDUCING COMPLIANCE COSTS

As noted in the Treasury's 2003 *Return-Free Report*, "There are more immediate steps [than RFF] that can be taken to reduce taxpayer burden and administrative costs."[119] In recent years, the IRS has undertaken commonsense initiatives designed to ease filing burdens for taxpayer. These include measures intended to simplify the tax code and associated paperwork, and steps to encourage taxpayers to file electronically.

A. Simplification of Existing Regulations and Forms

One obvious method of reducing compliance burdens on taxpayers would be to implement commonsense simplifications of the tax system. Initiatives aimed at increasing the uniformity of definitions across tax provisions and eliminating the need for certain taxpayer computations can have a significant effect on taxpayer burdens. Recent proposals advocate steps such as adopting a uniform definition for qualifying children, doing away with the phase-out of adoption tax benefits, and allowing for greater flexibility in section 179 expensing on amended returns.[120] In addition, the IRS has developed specialized forms, such as forms 1040A and 1040EZ, which allow taxpayers with relatively simple and straightforward income profiles to simplify the return filing process. Ultimately, the way to simplify tax returns is to reduce the complexity of the Internal Revenue Code, a goal which President Obama has said he strongly supports.[121]

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[119] *Return-Free Report* at 41.

[120] *Id.* at 43.

[121] However, Administration officials have recently said tax simplification is not at the top of the Administration's current list of policy priorities. *See* "Obama, Advisers Suggest Tax Reform Is Low on List of Legislative Priorities," Bureau of National Affairs (February 24, 2009).

B. Advances in Electronic Filing Services

Electronic filing has reduced taxpayer burdens along several dimensions, by lowering tax return preparation time, accelerating tax refund payments, lowering error rates, and providing rapid confirmation to the taxpayer of receipt of returns by the IRS. Beginning in the mid-1980s, the IRS adopted a number of measures to facilitate electronic filing. Electronic filing began in 1986, when a handful of tax professionals electronically transmitted roughly 25,000 individual refund returns through third party transmitters.[122] The Telefile system was introduced in 1992, permitting eligible taxpayers to use a touch-touch telephone to file Form 1040EZ. Over one third of all individual taxpayers had begun to file electronically by 2002.[123] By 2008, only about 42 percent of all individual tax returns were filed on paper.[124]

To further facilitate electronic filing, the IRS has adopted its "Free File," program, consisting of a system of partnerships with private tax preparation software companies.[125] Free File currently offers free online tax preparation and e-filing services to roughly 70 percent of all taxpayers (over 97 million).[126] Free File Alliance members have introduced enhancements to the program that have increased pricing transparency for both free and fee-based services, removed refund anticipation loans, and generally made the system more user-friendly. The Electronic Tax Administration Advisory Committee (ETAAC) has noted that the program provides "access to free and convenient electronic filing," along with high levels of consumer satisfaction.[127] As a

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[122] *Id.* at 41.

[123] *Id.*

[124] *See IRS 2008 Data Book* at 1; *see also* IRS *2008 Filing Season Statistics, available at* http://www.irs.gov/taxstats/article/0,,id=96629,00.html

[125] A more detailed discussion of Free File can be found in our companion piece. *See Litan Study, supra.*

[126] Electronic Tax Administration Advisory Committee, *Annual Report to Congress* (June 19, 2008) [hereafter *ETAAC 2008 Report*] at 16.

[127] *See ETAAC 2008 Report* at 16; *see also* Electronic Tax Administration Advisory Committee, *Annual Report to Congress* (June 20, 2007) [hereafter *ETAAC 2007 Report*] at 8.

result of its continuing positive evaluation of the Free File program, ETAAC recommended in its 2008 report that the IRS dedicate additional resources to promoting use of the program.[128]

The most recent enhancement to the Free File program is Free File "Fillable Forms," which allows all taxpayers (including those with incomes that exceed the eligibility limits for standard Free File) to fill out the most commonly used tax forms online and submit them electronically.[129] Fillable Forms is available for the first time in 2009, and while initial reports indicate usage is fairly light,[130] they offer an additional electronic filing option for taxpayers who are comfortable with the tax code and do not require the "interview" based prompting available through the standard Free File software.

Finally, the broad availability of "free" online federal tax preparation outside of the Free File program is also a key contributor in driving increased electronic filing of individual tax returns by consumers.

C. Information Retrieval

An alternative proposal offered by some is for government to create the capability for taxpayers to electronically retrieve their own information from IRS databases, including W-2 wages, 1099 reported earnings, data from past tax returns, and more, by downloading the information directly into tax returns as they are being privately prepared, whether using do-it-yourself or professional tax software. It is suggested that such data downloading (or "data retrieval") would be another method of simplifying tax returns and reducing burdens, while avoiding some of the inherent flaws in the complete RFF concept.

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[128] *ETAAC 2008 Report* at 16.

[129] *See* Internal Revenue Service, "E-File Opens for 2009 With New Features to Expand Taxpayer Access, Help Speed Refunds," Press Release (January 14, 2009) (available at http://www.irs.gov/newsroom/article/0,,id=202537,00.html).

Indeed, the electronic downloading of personal financial data to pre-populate tax returns is something already commercially available today to taxpayers through consumer tax software, electronically drawing on original primary source data from payroll providers, banks and investment firms. Whether IRS should invest in replicating this type of service capability, but drawing upon its own databases after information has been reported to it by others, is an economic, operating and policy question to be further evaluated.

The concept of Information Retrieval from the IRS is proposed as a means of simplifying the process of private tax preparation by taxpayers or professional preparers. Under such an approach, the federal government would move in the same direction as RFF but stop "at the water's edge" and not expand upon its fundamental role as tax collector. Under this proposal, the IRS would instead limit project implementation and investment to making data available for external retrieval on demand, thus avoiding certain of the problems and issues unique to the full RFF concept. At the same time, however, the Information Retrieval proposal would still face many of the same practical challenges identified about RFF implementation, including but not limited to the dependencies reviewed in Part III of this report on everything from technology systems to data timeliness. These challenges should not be underestimated. An Information Retrieval strategy would require significant analysis, including determining what could be achievable within a reasonable period of time, seeking to balance all direct and indirect investment costs, and addressing other identified challenges, and weighing these factors against potential benefits, including whether this concept could potentially benefit all taxpayers and alter the cost-benefit analysis.

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[130] *See* Diane Freda, "New Fillable Forms May Reveal Little Demand for IRS's Return Filing Portal, Williams Says," BNA (February 17, 2009).

VIII. CONCLUSION

In sum, the notion of "return free" tax filing is superficially compelling – indeed, on its face, almost irresistible. But a closer look at the details shows that RFF in practice would be far less appealing than its supporters suggest – indeed, it would detract from efforts to encourage increased electronic filing, and provide, at best, a distraction from the broader objective of tax simplification. Policymakers should look elsewhere for opportunities to reduce tax filing burdens, as the Department of the Treasury has recommended.

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