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TAX ADMINISTRATION:

Opportunities to Reduce the
Burden of Filing and
Processing Tax Returns

Statement of
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OPPORTUNITIES TO REDUCE THE BURDEN OF FILING
AND PROCESSING TAX RETURNS

SUMMARY STATEMENT OF
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The Internal Revenue Service (IRS) is in the midst of a multi-billion dollar modernization of its tax administration systems. In testimony last year before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, GAO noted how the modernization effort offers IRS a chance to change the way it does business.

In this testimony, GAO reiterates the importance of business change if IRS is to fully realize the important benefits from modernization--better service to taxpayers and lower costs for administering the tax system. One area that GAO believes is a good candidate for change is the filing and processing of tax returns. In light of the significant burden on taxpayers associated with preparing and filing returns and the cost to the government of processing those returns, GAO thinks fundamental changes have to be considered by IRS and Congress.

In 1992, IRS offered several filing alternatives, such as electronic filing. Although these alternatives can eliminate paper and bring operational benefits, there is still a significant amount of burden. Taxpayers still have to accumulate their tax documents, prepare all or part of a return, and send paper documents to IRS. GAO believes that the ultimate reduction in tax filing burden will only come if some way can be found to relieve many taxpayers of the need to file a return.

IRS studied a form of "return-free filing" in 1987 and, for various reasons relating to timing and cost, concluded that such a system was infeasible. GAO thinks that technology can satisfy the timing and cost constraints, but even so, implementation of the kind of system envisioned by IRS might not be the best business decision. While reducing taxpayer burden, for example, this system would put extra burden on IRS. There is another version of return-free filing used by many foreign countries that reduces the burden not only on taxpayers but also on the tax administration agency because it eliminates the return altogether. That system is called "final withholding".

These are among the business options that IRS must consider as it plans for the modernized environment. Modernization presents IRS with opportunities to reduce its own burden as well as that of taxpayers through a combination of technology and revised business tactics. GAO believes that many of the benefits of IRS' modernization effort will go unrealized unless IRS revamps its fundamental business approach.

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before you to assist in your inquiry into the business implications of Tax Systems Modernization (TSM). As we testified last year before this Subcommittee, we believe that TSM offers the Internal Revenue Service (IRS) a chance to totally change the way it administers the tax system in the future.¹

Changes in the way IRS does business are essential if IRS is to fully realize the important benefits from TSM, namely, better service to taxpayers and lower costs for administering the tax system. Failure to address issues on how a modernized IRS will operate could not only jeopardize the level of productivity savings realized but also hamper the degree to which service to taxpayers is enhanced.

OPPORTUNITIES FOR BUSINESS CHANGE

As we discussed last year, we see various opportunities for changing the way IRS does business. In particular, we talked about the possibility of consolidating field locations, establishing cross-functional telephone service, merging enforcement functions into a single compliance unit, and revising work processes such as those associated with the information returns program.

IRS' new technological environment is intended to provide its employees with instantaneous access to taxpayer information at any time and anywhere. That new environment provides IRS with the opportunity to realize productivity gains and cut operating costs by reorganizing certain work areas. Work areas such as returns processing, correspondence, document matching, and notice review, for example, are currently replicated in each of IRS' 10 service centers. This decentralized structure with redundant programs is costly to operate and can foster inconsistent handling of cases and application of procedures as well as inefficient allocations of facilities, workload, staff, and training. The productivity savings that IRS must achieve from TSM will likely come from reorganizing work areas such as these.

We have been encouraged by recent statements by the Commissioner that IRS is committed to look at every aspect of its operations in an effort to ensure that it derives the greatest possible benefit from new and emerging technologies. In that regard, IRS established a working group in March 1992 to examine the organization and mission of its 10 service centers. Among the general guidelines that the group is to follow in its analyses are the following:

¹Identifying Options for Organizational and Business Changes at IRS (GAO/T-GGD-91-54, July 9, 1991).

- Assume each of the 10 current service center locations will remain active as an employment center.
- Assume the flexibility to establish differing combinations of programs at different service centers as long as all program requirements are met.
- Consider shifting programs between service centers and other IRS operating locations as appropriate.

Because the major activity at each of the service centers currently involves processing returns, we would expect the working group to assess potential changes in that area. In light of the significant burden on taxpayers to prepare and file returns and the considerable cost to the government of processing those returns, we think fundamental changes have to be considered by IRS and by Congress. Those changes must be predicated on eliminating paper. IRS' discussion of TSM objectives in the modernization's Design Master Plan recognizes the need to eliminate paper and, in the near term, IRS has taken steps to do just that. However, the absence of a business strategy leaves IRS poorly positioned to fully realize the benefits from its actions.

Since 1990, for example, IRS has allowed taxpayers nationwide to file electronically. Electronic filing eliminates much of the paper associated with returns processing, enables IRS to process returns more quickly and accurately at less cost, and offers taxpayers the opportunity to receive their refunds faster.

Despite the improved taxpayer service and reduced returns processing costs available through electronic filing, IRS has implemented this filing alternative in a way that limits taxpayer access to it. To file a return electronically, for example, taxpayers must go through an IRS-approved return preparer or transmitter and generally pay for the service. That requirement limits IRS' ability to maximize the benefits available through electronic filing. It is difficult to understand why, for example, a taxpayer with a balance due return would choose to pay someone to file it electronically.

To encourage a broader use of electronic filing, IRS would, at a minimum, provide electronic filing capabilities at its walk-in locations and take other steps to make the service available to taxpayers free of charge. Electronic filing is an excellent example of what happens when technology is implemented before business strategies are developed.

Another situation where the lack of a business strategy could prevent IRS from gaining the benefits of technology is in the use of various filing alternatives. These alternatives include

filing methods such as electronic filing, TeleFile, and 1040PC² that reduce the amount of paper IRS has to handle in processing returns. IRS has implemented these technologies as separate projects without a business analysis showing how IRS could maximize use of the various alternatives at the least cost. GAO called for a comprehensive business analysis of tax return filing methods as part of our testimony before this Subcommittee on April 29, 1992.³ We reiterate the need for such a business strategy, not just for tax filing methods but for all areas of IRS.

Although filing alternatives like electronic filing can eliminate paper and streamline operations, there is still a significant amount of burden associated with these alternatives. Taxpayers still have to accumulate their tax documents, prepare all or part of a return, and send paper documents to IRS. The ultimate reduction in tax filing burden comes from eliminating the return. We will devote the remainder of our statement to this concept of return-free filing.

RETURN-FREE FILING

In its TSM Design Master Plan, IRS describes its business vision as one that "above all, reduces the burden on taxpayers, and provides them with the service they deserve." One of the most burdensome activities associated with this country's tax administration system involves the filing of tax returns. Estimates of the time and cost it takes U.S. taxpayers to prepare their individual returns are as high as 3 billion hours and \$35 billion annually. To prepare and file the simplest individual tax return (Form 1040EZ) in 1992, for example, IRS estimated that the average taxpayer would spend a total of 2 hours learning about the law or the form; preparing the form; and copying, assembling, and sending the form to IRS.

²TeleFile is a system that IRS tested in Ohio during the 1992 filing season. It allowed certain 1040EZ taxpayers to file their returns over the telephone. As of April 10, 1992, IRS had received about 121,000 such returns. Under the 1040PC alternative, taxpayers or return preparers prepare returns on IRS-approved commercial software. Rather than generating typical multipage tax forms, the software generates a 1-page form that captures information from most typical tax forms and schedules. The form consists of line numbers and entries where applicable. This alternative is available nationwide. As of April 10, 1992, IRS had received about 983,000 1040PCs.

³Tax Systems Modernization: Input Processing Strategy is Risky and Lacks a Sound Analytical Basis (GAO/T-IMTEC-92-15, Apr. 29, 1992).

It seems clear that taxpayer burden would be significantly reduced if some way could be found to relieve many taxpayers of the need to file a return.

IRS Studied a Return-Free System in 1987

In 1987, in response to a provision in the Tax Reform Act of 1986, IRS explored the feasibility of a return-free tax system. Although labeled "return-free," the system studied by IRS would still have involved preparation of a return. The burden of preparing that return, however, would have shifted from the taxpayer to IRS.

The system envisioned by IRS would have required the taxpayer to initiate the process by sending a postcard to IRS with certain identifying information, such as name and Social Security number. IRS would then use information that it had available from wage and tax statements (Form W-2) filed by employers and information returns (Form 1099) filed by financial institutions and other payors to calculate the taxpayer's adjusted gross income and tax liability and to determine the amount of any refund or balance due. IRS would then mail the completed return to the taxpayer along with any refund or a bill for the amount owed. Taxpayers who disagreed with data recorded on the IRS-prepared return could modify the return and send it back to IRS.

IRS concluded that the system described above was infeasible for a number of reasons. IRS assumed little change in the way it currently receives, verifies, corrects, and posts over 900 million wage and information documents and consequently thought that it could not accomplish those steps and generate tax returns within the current legislated time frames. To successfully implement such a system, IRS estimated it would cost over \$1 billion and require about 17,000 additional staff. Most of these costs would be associated with establishing and operating 11 call sites to correct errors on wage and information returns submitted by employers and payors. To correct any errors, IRS believed that it would be necessary to call employers and payors because the current process of mailing the documents back to them for correction would be too slow.

We know from our experiences at IRS that erroneous information returns are a problem, and we agree that in IRS' current technological environment those returns would pose a sizeable barrier to the kind of return-free system studied by IRS. However, solutions to the problem are possible through technology.

For example, information returns are currently mailed to IRS, either on paper or magnetic media, thus requiring manual handling to put the information into the computer system. This time-

consuming task could be eliminated if instead of mailing the information, employers and payors transmitted it electronically. The Electronic Management System--a major component of TSM--could allow IRS to electronically receive information documents although it also calls for receipt of magnetic media through the mail. Electronic transmissions would enable IRS to instantly validate information, such as names and Social Security numbers, and correct errors. However, the TSM Design Master Plan does not clearly state the extent to which electronic transmission of wage and information return data will replace paper and magnetic media transmission. Further, whatever is being planned in this area will not be implemented until fiscal year 2000.

Although we believe that the kind of return-free system studied by IRS is feasible with today's technology, it may not be the most practical business decision for the near term. It is unclear, for example, how taxpayers would react to a system under which IRS computes the tax liability and sends the taxpayer a bill. Also, while significantly reducing the burden of affected taxpayers, this version of return-free filing would put extra burden on IRS.

There is another version of return-free filing used by many foreign countries that reduces the tax-filing burden both to taxpayers and to the tax administration agency because it eliminates the return altogether. Used by about 30 countries, including Germany, Great Britain, and Japan, that system is called "final withholding."

Many Countries Use a Final Withholding System

Under final withholding, employees provide information to their employers on such things as marital status and number of children. In some countries, the taxing authority takes this information and tells the employer how much to withhold. In other countries, the employer uses withholding charts to determine the amount of withholding. In both cases, sufficient amounts are withheld from employees' wages during the year to cover their tax liabilities. Employers adjust employees' withholding periodically to ensure that the total amount withheld by year's end is adequate to satisfy the employee's tax liability. If the taxpayer has no additional information to report and agrees that the amount withheld fairly reflects the tax liability, no return need be filed.

Interest and dividends are handled in a variety of ways. Some countries tax interest and dividends in a flat amount at the source. Other countries require filing a tax return and reporting interest and dividends if they exceed a threshold.

While there are circumstances that will require a return and factors, such as having a second employer or both spouses working, that will require some adjustment, experience with this system by some industrial nations has been that millions of taxpayers have been able to meet their tax obligations without filing a return. In Great Britain, for example, only 3 million (about 9 percent) of the 26 million taxpayers eligible for final withholding actually filed tax returns in 1991.

Of course, a final withholding system would not serve all U.S. taxpayers. At a minimum, however, we believe that most of those taxpayers who now file 1040EZ returns (about 17.4 million in 1991) and many of those who now file 1040A returns (about 22.4 million in 1991) could be eligible. Also potentially eligible would be some of those taxpayers who file 1040 returns and claim the standard deduction (about 36 million according to IRS data).

Implementation of a final withholding system in the United States would require significant changes in tax legislation and regulations. In addition, the taxpaying public and businesses would have to accept a totally new approach to satisfying tax liabilities. A change such as this may appear radical, but only through some such change will we truly reduce taxpayer burden.

Besides having considerably fewer individual income tax returns to process, IRS could reap other benefits from a final withholding system. For example, with taxpayers' liabilities being satisfied through withholding, IRS could have fewer unpaid accounts to carry on the books and try to collect and fewer refunds to process. IRS might also be able to more effectively use its audit resources by redirecting some of the resources away from those classes of taxpayers who would no longer be required to file returns.

More details on the return-free filing system studied by IRS and on final withholding can be found in a briefing report we just issued to the Senate Finance Committee.⁴

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In conclusion, Mr. Chairman, we commend the Subcommittee for focusing on the business implications of TSM and encourage you to continue monitoring IRS' efforts to change its current approach to managing the tax system. It is important that IRS complete the relevant and necessary business analyses before locking itself into a particular technical contract or implementation. Failure to do so could make it more difficult and costly to reduce the burden on individual and business taxpayers. As my

⁴Internal Revenue Service: Opportunities to Reduce Taxpayer Burden Through Return-Free Filing (GAO/GGD-92-88BR, May 8, 1992).

colleague will be discussing, it is also important that IRS, once it has decided how it will do business in the future, develop a plan showing how it will transition from the old way of doing business to the new.

That concludes my statement. I would be happy to respond to any questions.

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